A Wolf in Sheep's Clothing: The IRS Creates a New Safe Harbor in Proposed Like-Kind Exchange Regulations

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The new safe harbor for the acquisition of incidental personal property as part of a like-kind exchange of real property could catch unsuspecting taxpayers by surprise.

The Tax Cuts and Jobs Act (the "TCJA") significantly curtailed a taxpayer's ability to defer gain under the like-kind exchange rules of section[1] 1031. In particular, the TCJA narrowed section 1031(a) to apply only to an exchange of *real property* that is (1) held for productive use in a trade or business or for investment, and (2) not held primarily for sale.[2] As a result, for property exchanges occurring after December 31, 2017,[3] gain (or loss) realized on the sale of personal property (both tangible and intangible) is no longer eligible for deferral under section 1031.[4]

Because section 1031 is now limited to real property, the definition of what constitutes real property for purposes of section 1031 has taken on increased importance. On June 12, 2020, the IRS released

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1 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

2 Section 1031(a).

3 The changes to section 1031 generally do not apply to exchanges for which one "leg" was completed prior to January 1, 2018. *See* Pub. L. No. 115-97, § 13302(c)(2).

4 The adverse impact of this change in section 1031 may be tempered by the increased availability of "bonus" depreciation for certain tangible personal property. *See* section 168(k).

proposed regulations the primary purpose of which was to define, for the first time, the term "real property" for section 1031 purposes (the "Proposed Regulations").[5] As part of the Proposed Regulations, the IRS also proposed a new safe harbor in the deferred like-kind exchange regulations for the acquisition of incidental personal property as part of a like-kind exchange of real property.[6] This article provides an overview of the new proposed safe harbor and highlights certain traps embedded in the safe harbor that could catch unsuspecting taxpayers by surprise.

Background

In general, a taxpayer is required to recognize the amount of gain (or loss) realized for U.S. federal income tax purposes on the sale or exchange of property.[7] Section 1031 provides an exception to this general rule and requires a taxpayer to defer the gain (or loss) realized on an exchange of real property that is held for productive use in a trade or business or for investment and that is not held primarily for sale, if the property is exchanged for like-kind real property that is also held for productive use in a trade or business or for investment and not held primarily for sale.[8]

In the most common like-kind exchange transaction—a deferred like-kind exchange—the taxpayer sells its relinquished property to one person (the buyer) and subsequently acquires like-kind replacement property from a different person (the seller). A sale of property followed by a reinvestment of the sale proceeds in like-kind property, however, does not qualify as a like-kind exchange if the taxpayer has actual or constructive receipt of the sale proceeds before the reinvestment—even if the taxpayer ultimately receives only like-kind replacement property.[9] To qualify for deferral under section 1031, the sale and subsequent reinvestment typically are structured to satisfy the deferred like-kind exchange rules of sections 1031(a)(3) and 1.1031(k)-1. If satisfied, these rules convert the sale/reinvestment transaction into an "exchange" for U.S. federal income tax purposes.

The most common method for creating a deferred like-kind exchange is to use the qualified intermediary safe harbor in section 1.1031(k)-1(g)(4) (the "QI Safe Harbor"). To qualify for the QI Safe Harbor, the taxpayer and a qualified intermediary (the "QI"), an unrelated third party, must enter into a written exchange agreement (the "Exchange Agreement") that requires the QI to acquire the relinquished property from the taxpayer, transfer the relinquished property to the buyer, acquire the replacement property from the seller, and transfer the replacement property to the taxpayer.[10] If the QI Safe Harbor is satisfied, the QI is not treated as the agent of the taxpayer for purposes of section 1031

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5 For a discussion of the definition of real property in the Proposed Regulations, see Holly Belanger and Debbie Fields, *Familiar Things Made New: Proposed Regulations Define "Real Property" for Like-Kind Exchanges*, What's News in Tax (Sept. 14, 2020).

6 Proposed section 1.1031(k)-1(g)(7)(iii).

7 Section 1001(c).

8 Section 1031(a).

9 Section 1.1031(k)-1(a).

10 Section 1.1031(k)-1(g)(4)(iii)(B).

and the taxpayer's transfer of the relinquished property to the QI and receipt of replacement property from the QI is treated as an "exchange."[11]

To ensure that the taxpayer does not have actual or constructive receipt of the sale proceeds from the relinquished property while the proceeds are held by the QI, the Exchange Agreement in the QI Safe Harbor must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the sale proceeds before the end of the exchange period (the "(g)(6) limitations").[12] As a result of the (g)(6) limitations, the QI holds the sale proceeds generally until the earlier of (1) the reinvestment of those proceeds in the specifically identified replacement property, [13] or (2) the expiration of the exchange period.

The (g)(6) limitations do include exceptions pursuant to which the QI can release the sale proceeds prior to the expiration of the exchange period. In particular, the taxpayer may access (or benefit from) the funds held by the QI prior to the expiration of the exchange period only at the following very limited points in the transaction:

- When the QI purchases identified replacement property;
- At any time after the 45th day, if the taxpayer has identified no potential replacement property at the expiration of the 45-day identification period;[14] and
- If the taxpayer has identified potential replacement property at the expiration of the 45-day identification period, the taxpayer may receive any funds remaining with the QI only after the QI has acquired and transferred to the taxpayer *all properties* to which the taxpayer is entitled under the Exchange Agreement.[15]

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[11] Section 1.1031(k)-1(g)(4)(i).

[12] Section 1.1031(k)-1(g)(6)(i). The exchange period in a deferred like-kind exchange begins on the day beneficial ownership of the first relinquished property in the exchange is transferred to the buyer and ends on the earlier of (1) the 180th day thereafter, or (2) the due date (including extensions) for the taxpayer's tax return for the taxable year in which the transfer of the first relinquished property occurs. Section 1031(a)(3)(B); section 1.1031(k)-1(b)(2)(ii).

[13] To comply with the deferred like-kind exchange requirements, the taxpayer must specifically identify, in writing, the potential replacement property that may be acquired in the exchange no later than 45 days after the transfer of the first relinquished property in the exchange (the 45-day identification period). Section 1031(a)(3)(A); section 1.1031(k)-1(b)(2)(i). Identification must be made in the manner described in section 1.1031(k)-1(b)-(e).

[14] Section 1.1031(k)-1(g)(6)(ii).

[15] Section 1.1031(k)-1(g)(6)(iii)(A) (emphasis added). The regulations also allow the taxpayer to have early access to the sale proceeds upon the occurrence, after the end of the 45-day identification period, of a material and substantial contingency that relates to the deferred exchange, is provided for in writing, and is beyond the control of the taxpayer and of any disqualified person (as defined in section 1.1031(k)-1(k)) other than the person obligated to transfer the replacement property to the taxpayer. Section 1.1031(k)-1(g)(6)(iii)(B). The deferred exchange regulations provide as examples of this type of contingency: 1) the destruction, seizure, or condemnation of the property; 2) a determination that regulatory approval necessary for the transfer cannot be obtained; or 3) the failure of the property to be rezoned from residential to commercial use by a specific date. Section 1.1031(k)-1(g)(8), Example 2. Reliance on this exception is rare.

If none of these exceptions apply, the taxpayer must wait until the expiration of the exchange period to receive any proceeds in excess of the amounts needed to buy the identified replacement property.

The (g)(6) limitations on the taxpayer's ability to access the sale proceeds from the relinquished property apply even if the taxpayer subsequently decides not to complete the like-kind exchange or completing the exchange is no longer possible.

> **Example 1**. Taxpayer sells Greenacre in a sale structured as part of a like-kind exchange using a QI. Taxpayer timely and adequately identifies Whiteacre and Blackacre as the two potential replacement properties for Greenacre. The QI uses a portion of the sale proceeds from Greenacre to acquire Whiteacre. After acquiring Whiteacre and after the expiration of the 45-day identification period, the taxpayer and the current owner of Blackacre cannot agree on acquisition terms and the taxpayer decides that it no longer wants to acquire Blackacre. Although the QI will no longer be able to acquire Blackacre in the exchange, because taxpayer has not received all the identified replacement properties, the QI cannot release the remaining proceeds to the taxpayer until the exchange period expires.

Finally, the QI Safe Harbor ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the QI.[16] In determining whether the QI Safe Harbor ceases to apply and whether the taxpayer is in actual or constructive receipt of the sale proceeds, section 1.1031(k)-1(g)(7) currently disregards the taxpayer's receipt of, or right to receive, the following items:

- Items that a seller may receive because of the disposition of property and that are not included in the amount realized from the disposition of property (e.g., prorated rents),[17] and
- Transactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statement as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees) (the "(g)(7) safe harbor").[18]

In general, the purpose of the (g)(7) safe harbor is to allow the taxpayer access to the proceeds from the sale of the relinquished property to pay transactional items associated with the sale of the relinquished property or the purchase of the replacement property without being considered to have constructive receipt of 100 percent of the sale proceeds.

The New Safe Harbor

In the preamble to the Proposed Regulations, the IRS indicated that taxpayers have questioned the potential U.S. federal income tax consequences under section 1031 if a taxpayer receives personal

16 Section 1.1031(k)-1(g)(4)(vi).

17 Section 1.1031(k)-1(g)(7)(i).

18 Section 1.1031(k)-1(g)(7)(ii).

property that is associated with the taxpayer's replacement real property as part of a like-kind exchange. For example, taxpayers have asked the IRS whether an exchange fails to satisfy the (g)(6) limitations if proceeds from the sale of the relinquished real property held by the QI are used to acquire an office building that includes both real and personal property. According to the preamble to the Proposed Regulations, taxpayers and QIs are concerned that a taxpayer would be considered to be in constructive receipt of all of the exchange funds held by the QI if the taxpayer is able to direct the QI to use those funds to acquire property that is not of like kind to the taxpayer's relinquished property.

To alleviate these concerns, the IRS has proposed adding a new category of property that is disregarded under the (g)(7) safe harbor.[19] Under the proposed additional safe harbor, in determining whether the agreement between the taxpayer and the QI expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the QI as required by section 1.1031(k)-1(g)(6), the taxpayer's receipt of, or right to receive, personal property that is incidental to real property acquired in the exchange will be disregarded. For purposes of this new safe harbor, personal property is incidental to real property acquired in an exchange if:

- In standard commercial transactions, the personal property is typically transferred together with the real property;[20] and
- The aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property.[21]

In the preamble to the Proposed Regulations, the IRS stated that the 15 percent limitation is responsive to ordinary course exchanges that often commingle personal property and real property as part of the aggregate exchanged property. The IRS expressed concern that with a higher limitation, a taxpayer may be induced to bundle more personal property with the replacement real property. Such a result would lead to increased amounts of personal property exchanged with real property under section 1031 and effectively unlock a class of personal property that would no longer be "incidental" to the real property. IRS personnel have informally expressed concern that a taxpayer may obtain inappropriate access to the sale proceeds by having the QI purchase an airplane or a yacht with the sale proceeds in excess of the amounts needed to acquire the replacement real property.

The Wolf in Sheep's Clothing

On its face, the proposed safe harbor appears to be a taxpayer-favorable development as it appears to "disregard" the acquisition of a small amount of personal property in an otherwise valid like-kind exchange. Under the proposed safe harbor, incidental personal property that is acquired as part of the real property, however, is disregarded *solely* for purposes of determining whether the transaction

[19] Proposed section 1.1031(k)-1(g)(7)(iii).

[20] Proposed section 1.1031(k)-1(g)(7)(iii)(A).

[21] Proposed section 1.1031(k)-1(g)(7)(iii)(B).

satisfies the deferred like-kind exchange safe harbors, including the QI Safe Harbor,[22] and the (g)(6) limitations.[23] That is, the acquisition of incidental property in the exchange does not cause the QI Safe Harbor to cease to apply or cause the taxpayer to be in actual or constructive receipt of the sale proceeds.

It is important to understand what the proposed safe harbor does *not* say. Incidental personal property is *not* disregarded under the new safe harbor for purposes of calculating the gain recognized by the taxpayer. The fair market value of any incidental personal property is still taxable boot under section 1031(b).

> **Example 2**. B sells relinquished property with a fair market value (FMV) of $1 million and adjusted tax basis of $400,000. B's replacement property is an office building and, as part of the exchange, B acquires certain office furniture in the building that is not real property, which is industry practice in a transfer of this type. The FMV of the real property B acquires is $1 million and the FMV of the furniture is $100,000. In a standard commercial transaction, the buyer of an office building typically also acquires some or all of the office furniture in the building. Moreover, the FMV of the personal property B acquires does not exceed 15 percent of the FMV of the real property that B acquires. Accordingly, under the proposed new (g)(7) safe harbor, the personal property is incidental to the real property and, therefore, is disregarded in determining whether B's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property are expressly limited as provided in section 1.1031(k)-1(g)(6).
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> *Upon receipt of the personal property, B recognizes gain of $100,000 under section 1031(b), the lesser of the realized gain on the disposition of the relinquished property ($700,000) and the FMV of the non-like-kind property B acquires in the exchange ($100,000).*[24]

As this example demonstrates, the incidental personal property acquired in an exchange is still taxable boot under section 1031(b); it is not disregarded for all purposes of applying section 1031.

Moreover, the implication embedded in the proposed safe harbor presents a potential trap for an unsuspecting (or unlucky) taxpayer. Under the proposed safe harbor, if the aggregate FMV of the incidental personal property exceeds 15 percent of the aggregate FMV of the replacement real property,[25] the (g)(6) limitations and, therefore, the requirements of the QI Safe Harbor are no longer satisfied—even if the personal property is of a character that would typically be acquired with the real property in a standard commercial transaction.

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[22] The proposed safe harbor would also apply to the qualified trust and escrow safe harbor in section 1.1031(k)-1(g)(3) and the interest and growth factors safe harbor in section 1.1031(k)-1(g)(5).

[23] Proposed section 1.1031(k)-1(g)(7).

[24] Proposed section 1.1031(k)-1(g)(8)(vi), Example 6 (emphasis added).

[25] It is important to note that, under the proposed safe harbor, personal property cannot exceed 15% of the FMV of the aggregate FMV of the replacement real property. The limitation is not measured by the aggregate FMV of all of the purchased property (i.e., real and personal).

Once outside the QI Safe Harbor, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer receives like-kind replacement property is made under the general rules concerning actual and constructive receipt and without regard to the taxpayer's method of accounting.[26]

> **Example 3.** Assume B in Example 2 above was acquiring a hotel as replacement property in the like-kind exchange. The total FMV of the hotel is $1.1 million; however that amount includes furniture and fixtures with an aggregate FMV of $150,000. Under the proposed safe harbor, if B acquires the hotel with the proceeds from the relinquished property, B cannot satisfy the (g)(6) limitations because the incidental personal property exceeds 15 percent of the FMV of the acquired real property. Unless B can establish under the general constructive receipt authorities that B did not have actual or constructive receipt of the sale proceeds prior to the reinvestment in the replacement property, the *entire* like-kind exchange may be at risk.

Under this proposed safe harbor, the consequence of being wrong on the characterization of the replacement property as real or personal[27] or the valuation of the personal property acquired with the real property in a standard commercial transaction is potentially catastrophic from a safe harbor standpoint. If the FMV of the personal property exceeds 15 percent of the FMV of the related real property, the entire transaction no longer qualifies for the QI safe harbor in section 1.1031(k)-1(g)(4). To save the exchange, the taxpayer must now navigate the constructive receipt authorities to determine whether the taxpayer can satisfy those authorities adding to the expense of what would otherwise be a standard commercial transaction. This is a heavy price to pay for being wrong on valuation.

Moreover, the proposed safe harbor will put a premium on a pre-closing purchase price allocation by the parties in negotiating for the acquisition of the replacement property. The taxpayer's desire to achieve a valuation within the 15 percent safe harbor could distort the negotiations of what should otherwise be a straight-forward commercial transaction.

Why Now?

It is unclear why this potential constructive receipt issue is being raised at this time. Prior to the TCJA, taxpayers had routinely acquired non-like-kind property as part of a like-kind exchange with the consequence of having taxable boot on the exchange under section 1031(b). In fact, section 1.1031(k)-1(j) provides a specific methodology for taxpayers to calculate the U.S. federal income tax consequences from an exchange that involved multiple types of assets, including assets that are not

[26] Section 1.1031(k)-1(f)(2).

[27] For an overview of the ambiguities created by the definition of real property under the Proposed Regulations, see Holly Belanger and Debbie Fields, *Familiar Things Made New: Proposed Regulations Define "Real Property" for Like-Kind Exchanges*, What's News in Tax (Sept. 14, 2020). These ambiguities potentially increase the risk that a taxpayer may inadvertently acquire more personal property in connection with the real property than expected which under the proposed safe harbor could result in a failed exchange.

like-kind to each other and assets that were not eligible for like-kind exchange treatment. Moreover, prior to the TCJA, taxpayers exchanged under section 1031 lines of business that included goodwill and going concern value, assets which were per se excluded from like-kind exchange treatment under pre-TCJA law. The non-like-kind property acquired in those transactions, including goodwill and going concern value, created boot in the transaction. However, those transactions were typically not challenged as violating the (g)(6) limitations simply because the goodwill, going concern value, or other non-like-kind property included in the transaction exceeded 15 percent of the like-kind replacement property. While the TCJA may have increased the likelihood that a replacement property may include personal property components ineligible for like-kind exchange treatment, it is unclear why the acquisition of personal property that is acquired in connection with related real property should cause the entire transaction to fail.[28]

Is This Really Just Timing?

In proposing the new (g)(7) safe harbor, the IRS appears to be concerned with taxpayers inappropriately obtaining early access to excess sale proceeds. In particular, the IRS has indicated a concern that a taxpayer would bundle personal property (e.g., a yacht or plane) with real property to get access to funds that would not otherwise be released by the QI until the expiration of the exchange period. This concern seems to be largely a question of timing that will apply in some, but not all, like-kind exchange transactions. Moreover, it would be more appropriate to address this concern with a more targeted anti-abuse provision under which the IRS could challenge the qualification of a transaction as a deferred like-kind exchange to the extent the taxpayer inappropriately bundled unrelated personal property in the replacement property with a view to obtaining access to excess sale proceeds in contravention of the (g)(6) limitations. Alternatively, it appears that the IRS could achieve its desired result without creating a trap for the unsuspecting taxpayer by expanding the proposed (g)(7) safe harbor to disregard any personal property typically transferred with the replacement real property in standard commercial transactions without an arbitrary 15 percent limitation.

Taxpayers that acquire the related personal property are already subject to taxable boot on the transaction under section 1031(b). It is inappropriate to catch them by surprise and invalidate the entire exchange simply because the boot exceeded an arbitrary limitation. Hopefully, the IRS will reconsider the proposed safe harbor and create a solution that targets the perceived abuse without creating a trap for taxpayers engaging in standard commercial transactions.

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[28] We note that as part of the Proposed Regulations, the IRS is also proposing to limit the application of the multiple asset exchange regulations in section 1.1031(j)-1 only to qualifying exchanges of real property. Section 1.1031(a)-1(a)(3). No rules, however, have been proposed for how to compute the gain recognized or deferred on an exchange that includes both real and personal property. It is not clear from the Proposed Regulations why the existing multiple asset exchange regulations in section 1.1031(j)-1 no longer provide an appropriate methodology for calculating gain recognized and gain deferred in a like-kind exchange with boot post-TCJA. Moreover, by failing to include an alternative methodology, the Proposed Regulations create additional (and unnecessary) ambiguity.

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