



TaxNewsFlash

United States



No. 2020-731
December 2, 2020

KPMG report: Final regulations under section 1031, like-kind exchanges

Final regulations (T.D. 9935), published in today's edition of the Federal Register, provide guidance regarding like-kind exchanges.

Read the [final regulations](#) [PDF 315 KB]

Background

The 2017 tax law (Pub. L. No. 115-97) that is often referred to as the "Tax Cuts and Jobs Act" (TCJA), made a significant change in a taxpayer's ability to defer gain under the like-kind exchange rules of section 1031. In particular, the TJCA narrowed section 1031 so that it applies 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. As a result, for property exchanges occurring after December 31, 2017, gain (or loss) realized on the sale of personal property (both tangible and intangible), including personal property associated with real property, generally is no longer eligible for deferral under section 1031.

In June 2020, the Treasury Department and IRS (collectively, "Treasury") issued proposed regulations that defined, for the first time, the term "real property" for purposes of section 1031. Read [TaxNewsFlash](#)

Final regulations

The final regulations under section 1031 published today in the Federal Register adopt the rules from the proposed regulations, but with several notable changes as described below.

Under the final regulations, property is classified as real property for purposes of section 1031 if the property is:

- Specifically listed as real property in the final regulations;
- Classified as real property under the state and local law test included in the final regulations; or
- Considered real property based on all the facts and circumstances under the various factors provided in the final regulations.

State and local law test

Under the proposed regulations, the classification of property under state or local law was not taken into account in classifying a property for purposes of section 1031, with one limited exception for mutual ditch, reservoir, or irrigation companies. **Based on taxpayer comments, Treasury reconsidered and ultimately changed its position on the degree to which state or local law may be relevant. Under the final regulations, property is real property for purposes of section 1031, if, on the date it is transferred in an exchange, the property is classified as real property under the law of the state or local jurisdiction in which the property is located.** This test applies to both tangible and intangible property. As a result of this change, property that might otherwise have failed to be real property under the tests provided in the proposed regulations may be classified as real property under the final regulations and continue to be eligible for like-kind exchange treatment under section 1031.

In making this change, however, Treasury was clear that the final regulations do not allow property that was ineligible for section 1031 under pre-TCJA law to now become eligible simply because the property is classified as real property under state or local law. Property that was ineligible for like-kind exchange treatment under pre-TCJA law remains ineligible for like-kind exchange treatment after the enactment of the TCJA, even if the property is classified as real property under the relevant state or local law. Accordingly, the final regulations provide that the following assets are not real property for purposes of section 1031, regardless of the classification of such property under state or local law: stock (other than stock in a cooperative housing corporation or shares in certain mutual ditch, reservoir, or irrigation companies), bonds, and notes; other securities or evidences of indebtedness or interest; partnership interests (other than an interest in a partnership that has in effect a valid election under section 761(a)); certificates of trust or beneficial interests; and choses in action.

Specific assets as real property and structural components

In addition to property that may be classified as real property under the state and local law test, the final regulations describe five categories of property that may be real property for purposes of section 1031, including land; improvements to land (i.e., inherently permanent structures and their structural components); unsevered natural products of land (e.g., minerals, plants, trees); water and air space superjacent to land; and certain intangible interests in real property (e.g., leaseholds). To assist taxpayers in determining whether an item of property is considered real property, the final regulations provide lists of specific assets that qualify as improvements to land and intangible interests in real property. For property not included on the lists, the final regulations provide a list of factors that should be taken into account in determining whether based on all the facts and circumstances, a particular item of property should be considered real property for purposes of section 1031.

In applying the specified factors to property that could be a structural component of an inherently permanent structure, the proposed regulations included special rules for property that might be a structural component but was in the nature of machinery. Under the proposed regulations, in addition to satisfying the criteria to be a structural component, property in the nature of machinery had to (1) serve the inherently permanent structure, and (2) not produce or contribute to the production of income other than for the use or occupancy of space. Treasury received a number of comments that the focus of the proposed regulations on the use or function of property inappropriately narrowed the scope of the definition of real property for purposes of section 1031, and that if adopted, certain types of property that had historically been treated as real property for section 1031 purposes would now be treated as personal property ineligible for section 1031 and contrary to the stated intention of Congress.

In the second significant area of change in the final regulations, Treasury agreed with the commentators and eliminated a purpose or use test from the final regulations for tangible property. Under the final regulations, items of machinery or equipment may be real property for

purposes of section 1031 if they comprise an inherently permanent structure, a structural component or are real property under the state or local law test regardless of their purpose or use or whether they contribute to the production of income. In making this determination, the focus under the final regulations is on the degree to which the property should be considered permanently affixed, not on whether the property contributes to the production of income.

Incidental personal property

Finally, in the proposed regulations, Treasury proposed to disregard under section 1.1031(k)-1(g)(7) of the deferred like-kind exchange regulations a taxpayer's receipt of incidental personal property in determining whether a taxpayer had complied with the safe harbors provided for qualified intermediaries, qualified trust or escrows, and interest and growth factors. The final regulations have adopted the new exception in substantially the same form as proposed.

Under the final regulations, in determining whether the agreement between the taxpayer and the qualified intermediary, qualified trustee, or qualified escrow agent expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property as required by Reg. 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 exception, 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; and
- The aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15% of the aggregate fair market value of the replacement real property or properties received in the exchange.

In the preamble to the final regulations, Treasury reiterated that the purpose of the new exception was to provide assurance to taxpayers that the use of exchange funds to acquire incidental personal property does not cause the taxpayer to fail the deferred exchange safe harbors. It was intended to be helpful to the taxpayer and to operate as part of the existing safe harbors and not as a bright-line rule pursuant to which an exchange could automatically fail and become fully taxable. Treasury expressly stated that, although acquisitions of personal property valued in excess of 15% of the replacement real property are not disregarded in applying the safe harbors, such acquisitions do not automatically cause the exchange to fail section 1031 and the transfer of the relinquished property to be treated as a sale or taxable exchange.

The final regulations also clarify that, in determining whether acquired personal property is incidental, the proper comparison is the value of all of the acquired personal properties to the value of **all** of the replacement real properties acquired in the same exchange. Under the proposed regulations, it was unclear whether the denominator included only the specific real property to which the acquired personal property was associated or whether it included all replacement real property acquired in the exchange. By confirming that the denominator includes all replacement real property acquired in the exchange, the final regulations make it more likely that the personal property in an exchange will be incidental and thus disregarded. In addition, the expansion of the term "real property" in the final regulations to include property that is real property under state or local law and the removal of a use or function test from the final regulations reduce the risk that a taxpayer will inadvertently find itself with too much personal property in an exchange.

Effective date

The final regulations are applicable for exchanges beginning after December 2, 2020, the date the final regulations' publication in the Federal Register. Taxpayers may rely on the proposed regulations (as published in the Federal Register on June 12, 2020 (35 FR 35835)), if they are followed consistently

and in their entirety, for exchanges of real property beginning after December 31, 2017, and before December 2, 2020.

For more information, contact a tax professional with KPMG's Washington National Tax:

Holly Belanger | +1 202 533 4096 | hbelanger@kpmg.com
Debbie Fields | +1 202 533 4580 | dafields@kpmg.com
Bev Katz | +1 202 533 3820 | beverlykatz@kpmg.com

The information contained in TaxNewsFlash is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230, as the content of this document is issued for general informational purposes only, is intended to enhance the reader's knowledge on the matters addressed therein, and is not intended to be applied to any specific reader's particular set of facts. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

KPMG International is a Swiss cooperative that serves as a coordinating entity for a network of independent member firms. KPMG International provides no audit or other client services. Such services are provided solely by member firms in their respective geographic areas. KPMG International and its member firms are legally distinct and separate entities. They are not and nothing contained herein shall be construed to place these entities in the relationship of parents, subsidiaries, agents, partners, or joint venturers. No member firm has any authority (actual, apparent, implied or otherwise) to obligate or bind KPMG International or any member firm in any manner whatsoever.

Direct comments, including requests for subscriptions, to [Washington National Tax](#). For more information, contact KPMG's Federal Tax Legislative and Regulatory Services Group at + 1 202.533.4366, 1801 K Street NW, Washington, DC 20006-1301.

To unsubscribe from TaxNewsFlash-United States, reply to [Washington National Tax](#).

[Privacy](#) | [Legal](#)