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Taking the Bite out of the Wolf: Final Like-Kind Exchange Regulations Retain Incidental Property Rule

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New final regulations adopt an exception to a safe harbor for the acquisition of incidental personal property as part of a like-kind exchange of real property. Certain traps embedded in the exception could catch unsuspecting taxpayers by surprise, but changes made to the definition of "real property" in the Final Regulations could make its bark worse than its bite.

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 1031.[1] 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.

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 December 2, 2020, the IRS released final regulations the primary purpose of which was to define, for the first time, the term "real property"

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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).

for section 1031 purposes (the "Final Regulations").[4] As part of the Final Regulations, the IRS also adopted an exception to certain safe harbors in the deferred like-kind exchange regulations[5] 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 exception, highlights certain traps embedded in the exception that could catch unsuspecting taxpayers by surprise, and explains how changes made to the definition of "real property" in the Final Regulations could make the exception a little easier to navigate.

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

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[4] T.D. 9935, 85 Fed. Reg. 77365 (Dec. 2, 2020). For a discussion of the definition of real property in the Final Regulations, see Holly Belanger and Debbie Fields, *Final Like-Kind Exchange Regulations Reflect Requested Changes*, What's News in Tax (Feb. 1, 2021). Proposed regulations were issued on June 12, 2020. *See* REG-117589-18, 85 Fed. Reg. 35835 (June 12, 2020) (the "Proposed Regulations"). For a discussion of 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); and Holly Belanger and Debbie Fields, *A Wolf in Sheep's Clothing: The IRS Creates a New Safe Harbor in Proposed Like-Kind Exchange Regulations*, What's News in Tax (Sept. 14, 2020).

[5] Section 1.1031(k)-1.

[6] Section 1.1031(k)-1(g)(7)(iii). For a discussion of the issues identified with the corresponding exception in the proposed regulations, see Holly Belanger and Debbie Fields, *A Wolf in Sheep's Clothing: The IRS Creates a New Safe Harbor in Proposed Like-Kind Exchange Regulations*, What's News in Tax (Sept. 14, 2020).

[7] Section 1001(c).

[8] Section 1031(a).

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

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 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 (emphasis added).[15]

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

[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 tax 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). 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

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 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) provided (prior to the Final Regulations) that the taxpayer's receipt of, or right to receive, the following items is disregarded:

- 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) exceptions").[18]

In general, the purpose of the (g)(7) exceptions 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 Exception

In the preamble to the Proposed Regulations, the IRS indicated that taxpayers had questioned the potential U.S. federal income tax consequences under section 1031 if a taxpayer receives personal property that is associated with the taxpayer's identified replacement real property as part of a like-kind exchange. For example, taxpayers 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 were 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 could be considered to be in constructive receipt of all 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 proposed to add a new category of property that would be disregarded under the (g)(7) exceptions.[19] The Final Regulations adopted the addition to the (g)(7) exceptions in substantially the same form as the proposed exception.[20] Under the Final Regulations, in determining whether the agreement between the taxpayer and the QI expressly limits the taxpayer's

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cannot be obtained; or (3) the failure of the property to be re-zoned from residential to commercial use by a specific date. Section 1.1031(k)-1(g)(8), Example 2. Reliance on this exception is rare.

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).

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

20 Section 1.1031(k)-1(g)(7)(iii).

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 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;[21] 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 or properties received in the exchange.[22]

The Wolf in Sheep's Clothing

On its face, the new (g)(7) exception seems 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. Incidental personal property that is acquired as part of the real property, however, is disregarded *solely* for purposes of determining whether the transaction satisfies the deferred like-kind exchange safe harbors, including the QI Safe Harbor[23] and the (g)(6) limitations.[24] 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 though to understand what the new (g)(7) exception does *not* say. Incidental personal property is *not* disregarded under the new exception 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

B sells relinquished property with a fair market value (FMV) of $1,100,000 and adjusted tax basis of $400,000. B's replacement property is an office building and, as part of the exchange, B acquired 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 acquired is $1,000,000 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 the office furniture in the building. Moreover, the FMV of the personal property B acquired does not exceed 15 percent of the FMV of the real property that B acquires. Accordingly, under the new (g)(7) exception, the personal property is incidental to the real property and, therefore, is disregarded in determining whether B's rights to

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[21] Section 1.1031(k)-1(g)(7)(iii)(A).

[22] Section 1.1031(k)-1(g)(7)(iii)(B).

[23] The (g)(7) exceptions 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).

[24] Section 1.1031(k)-1(g)(7).

> 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).* (Emphasis added).[25]

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 section 1031.

Moreover, the Proposed Regulations did not describe the impact on the taxpayer's exchange if more than incidental personal property was acquired in connection with the acquisition of replacement real property. In particular, it was unclear from the Proposed Regulations whether the acquisition of more than incidental personal property automatically caused the exchange to fail because the taxpayer was viewed as being outside the QI safe harbor and, therefore, in constructive receipt of 100 percent of the exchange funds held by the QI from the date of sale.

Taking the Bite out of the Wolf

Although the Final Regulations adopt the new (g)(7) exception in essentially the same form as proposed, Treasury and the IRS provided some helpful explanatory language in the preamble to the Final Regulations intended to alleviate some concerns regarding the impact of this exception. Moreover, the changes made in the Final Regulations to the definition of "real property" may also go a long way to reduce the number of transactions to which this exception may inadvertently apply.

In the preamble to the Final Regulations, the IRS reiterated that the purpose of the new (g)(7) exception was to provide assurance to taxpayers that a QI's use of exchange funds to acquire incidental personal property does not cause the taxpayer to fail the QI Safe Harbor and, thus, the requirements of section 1031. 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. Thus, the IRS expressly stated that, although acquisitions of personal property valued in excess of 15 percent of the replacement real property are not disregarded in applying the safe harbors, these 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.[26] This acknowledgment by Treasury and the IRS that exceeding the 15 percent threshold is not an automatic failure may be helpful for taxpayers who find themselves in the unfortunate position of having exceeded the 15 percent threshold.[27]

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[25] Section 1.1031(k)-1(g)(8)(vi), Example 6.

[26] Preamble to the Final Regulations.

[27] Interestingly, the Final Regulations do not address how to take into account the acquisition of more than an incidental amount of personal property in applying the deferred like-kind exchange safe harbors. Presumably, U.S. federal income tax authorities regarding constructive receipt may be instructive. In addition, the facts and circumstances of the entire exchange transaction may be relevant.

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 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.

Finally, and perhaps most importantly, the Final Regulations significantly expanded the type of property that qualifies as "real property" for purposes of section 1031. Under the Final Regulations, regardless of its use or function,[28] 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 provided in the Final Regulations; or
- Considered real property based on all the facts and circumstances under the various factors provided in the Final Regulations.[29]

Moreover, under the Final Regulations, a determination that property is personal property under state or local law or that the property contributes to the production of income other than for the use and occupancy of space does not preclude a conclusion that the property is nevertheless real property under the Final Regulations.[30] 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 reduces the risk that a taxpayer will inadvertently find itself with too much personal property in an exchange.[31]

Navigating the New Exception

Although the changes made to the Final Regulations reduce the bite of the new exception, taxpayers still need to consider it when structuring a like-kind exchange that may include the acquisition of personal property. To the extent any of the replacement real property may be accompanied by items of property that cannot be classified as real property for purposes of section 1031, a taxpayer would be

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[28] The Proposed Regulations generally excluded property in the nature of machinery from the definition of "real property" if the property produced or contributed to the production of income other than for the use or occupancy of space. Proposed section 1.1031(a)-3(a)(2)(ii)(D). This focus on the use to which property was put in the Proposed Regulations was heavily criticized by taxpayers and would have resulted in property that was treated as real property in exchanges prior to the TCJA being excluded from section 1031. *See* preamble to Final Regulations.

[29] Preamble to Final Regulations.

[30] *Id.*

[31] For a more detailed discussion of the definition of real property in the Final Regulations, see Holly Belanger and Debbie Fields, *Final Like-Kind Exchange Regulations Reflect Requested Changes*, What's News in Tax (Feb. 1, 2021).

wise to contemporaneously document the value of the personal property and the extent, if any, to which the acquired personal property may exceed the value of the replacement real property in the transaction. As a result, it may be advisable in certain situations to negotiate a pre-closing purchase price allocation for the replacement property so that the parties to the transaction are consistently valuing the components of the replacement property. A taxpayer should also consider whether it can fund the acquisition of the identified personal property with funds from outside of the exchange. KPMG tax and valuation professionals can assist in these determinations.

Each exchange that potentially includes personal property will need to be evaluating based on the particular facts and circumstances. Taxpayers would be wise not to ignore the potential consequence of this new exception. Although the Final Regulations may have softened the potential adverse consequences from the new exceptions, it still could catch the unsuspecting (or unlucky) taxpayer by surprise.