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Section 1031 Update: Proposed Regulations and the COVID-19 Relief Extension Date

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Summary

On June 11, 2020, the Treasury Department released proposed regulations regarding like kind exchanges under Internal Revenue Code section 1031 ("**1031 Exchange**"). The regulations clarify a number of outstanding questions that taxpayers have been concerned about.

However, the IRS has not addressed the more immediate uncertainty surrounding the temporary Covid-19-related extensions for 1031 Exchange transactions under Notice 2020-23 which leaves taxpayers facing an imminent deadline to act without any clarity on what the deadline actually is *(see Section III of this alert for more detail)*.

I. Proposed Regulations Defining Real Property

Background

Taxpayers engaged in 1031 Exchanges have been awaiting further guidance after the Tax Cuts and Jobs Act ("**TCJA**") generally limited 1031 Exchanges only to "real property" for exchanges completed after December 31, 2017. Prior to the TCJA, personal and intangible properties were also eligible for like kind exchange treatment. Accordingly, taxpayers exchanging real estate of a similar class (e.g., an exchange of one apartment building for another similar building) could generally count on the entire exchange qualifying under Code section 1031, with incidental personal property associated with the relinquished property being exchanged for a similar quantum of incidental personal property associated with the replacement property. Taxable boot would then be limited to the difference between the amount of real and personal property associated with the relinquished property and the replacement property, which is often minimal. The TCJA elimination of like kind exchange treatment for personal property requires taxpayers to be able to identify personal property components in every exchange and increases the importance of defining real property eligible for exchange treatment. This issue is especially relevant to exchanges involving hotel properties, due to the large amount of personal property typically involved in the operation of a hotel.

Key guidance in the proposed regulations provides a detailed list of what constitutes "real property", generally defined as land and improvements to land, unsevered natural products of land, water and air space superjacent to land, and certain intangible properties, as well the definitions of each of the enumerated categories.

Applicability

The proposed regulations are effective only prospectively for exchanges occurring after the rules are finalized. However, pending issuance of the final regulations, taxpayers may rely on the proposed regulations, if followed consistently and in their entirety, for exchanges of real property after December 31, 2017, and before the final regulations are published.

Real Property

Under the proposed regulations, for purposes of Code section 1031, the term "real property" is defined to include land, improvements to land, unsevered natural products of land, air or water that is superjacent to land, and certain intangibles that are closely associated with real property.

A. Improvements to Land

Improvements to land include "inherently permanent structures" and any "structural components" of such inherently permanent structures. The evaluation of whether property falls into one of the two foregoing categories is made on an asset by asset basis, by separately analyzing each "distinct asset" (a term that is carefully defined in the proposed regulations).

i. Inherently Permanent Structures

An "inherently permanent structure" is any building or other inherently permanent structure that is permanently affixed to real property and that will ordinarily remain affixed for an indefinite period of time (note that affixation may be accomplished by weight alone). Other inherently permanent structures specifically include the following distinct assets, if permanently affixed: in-ground swimming pools; roads; bridges; tunnels; paved parking areas, parking facilities, and other pavements; special foundations; stationary wharves and docks; fences; inherently permanent advertising displays for which certain election is in effect; inherently permanent outdoor lighting facilities; railroad tracks and signals; telephone poles; power generation and transmission facilities; permanently installed telecommunications cables; microwave transmission, cell, broadcasting, and electric transmission towers; oil and gas pipelines; offshore drilling platforms, derricks, oil and gas storage tanks; grain storage bins and silos; and enclosed transportation stations and terminals.

An item of property that is not specifically listed in the proposed regulations may still be considered an inherently permanent structure based on the following factors:

- The manner in which it is affixed to real property;
- The time and expense required to move it.
- Any circumstances that suggest the expected period of affixation is not indefinite; and
- The damage that removal would cause to the item itself or to the real property to which it is affixed;
- Whether it is designed to be removed or to remain in place;

An item of machinery or equipment is generally not considered to be an inherently permanent structure and thus is generally not treated as real property. However, machinery that otherwise meets the definition of a structural component of a building or inherently permanent structure, serves the building or inherently permanent structure, and does not produce or contribute to the

production of income other than for the use or occupancy of space, is treated as real property. For example, elevators and escalators should be treated as real property under this rule.

ii. Structural Component

A "structural component" generally means any distinct asset that is a constituent part of, and integrated into, an inherently permanent structure. Examples of structural components specifically mentioned in the proposed regulations include walls; partitions; doors; wiring; plumbing systems; central air conditioning and heating systems; pipes and ducts; elevators and escalators; floors; ceilings; permanent coverings of walls, floors, and ceilings; insulation; chimneys; fire suppression systems, including sprinkler systems and fire alarms; fire escapes; security systems; humidity control systems; and other similar property.

For a component of a building or inherently permanent structure that is not listed above, the determination of whether the component is a structural component is made based on the following factors:

- The manner, time, and expense of installing and removing the component;
- Whether the component is installed during construction of the inherently permanent structure.
- The damage that removal of the component would cause to the item itself or to the inherently permanent structure to which it is affixed; and
- Whether the component is designed to be moved;

B. Unsevered Natural Products of Land

"Unsevered natural products of land" include growing crops, plants, and timber; mines; wells; and other natural deposits, and are generally treated as real property for 1031 Exchange purposes. Natural products and deposits, such as crops, timber, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land.

C. Water and Air Space Superjacent to Land

"Water and air space superjacent to land" is not defined in the proposed regulations. However, development air rights should be included in this category. An example in the proposed regulations indicates that boat slips at a marina would qualify as well.

D. Intangible Properties

Intangible property that derives its value from real property or from an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space, is considered real property or an interest in real property for purposes of 1031 Exchange. Such intangible property could include a trademark name associated with a property or shares in co-op or condominium association. A special rule applies to shares in a mutual ditch, reservoir, or irrigation company described in Code section 501(c)(12)(A). Such shares are treated as real property only if, at the time of the exchange, the shares have been recognized by the highest court of the State in which the company was organized, or by a State statute, as constituting or

representing real property or an interest in real property. This is the only context under the proposed regulations in which local law definitions control for purposes of determining the meaning of the term "real property" for 1031 Exchange purposes.

Furthermore, a license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold or easement generally is an interest in real property for purposes of 1031 Exchange. However, a license or permit to engage in or operate a business on real property is not real property or an interest in real property if the license or permit produces or contributes to the production of income other than consideration for the use and occupancy of space.

II. Incidental Personal Property

The proposed regulations would also put to rest a longstanding issue relating to the treatment of personal property incidental to a real property 1031 Exchange. The deferred exchange safe harbors permitting the use of a qualified intermediary ("**QI**") to hold funds paid by a purchaser of relinquished property. Even before the TCJA's elimination of like kind exchange treatment for personal property, taxpayers and QIs worried that a taxpayer who exchanges a piece of real estate for another property that includes incidental personal property could be considered to be in constructive receipt of all of the exchange funds held by the QI if the QI exchange agreement permits the taxpayer to direct the QI to use those fund to pay for the incidental personal property, which is not of a like kind to the taxpayer's relinquished property. The concern here is not merely that the personal property is treated as taxable boot, but rather that the entire exchange is tainted by the ability of the taxpayer to use funds for this portion of the purchase, such that the exchange is fully taxable.

In response to this concern, the proposed regulations provide that the use of exchange proceeds to pay for incidental personal property does not cause taxpayers to be treated as in constructive receipt of the exchange funds and does not disqualify the exchange as whole. Personal property is considered to be 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. An example in the proposed regulations illustrates that office furniture is considered to be property of a type typically transferred with an office building and would satisfy the first prong. Note that the relief for incidental personal property is in line with the currently existing rules that ignore such incidental property in determining whether a taxpayer has properly identified replacement property.

Importantly, however, the new safe harbor does not treat incidental personal property as real property for purposes of the 1031 Exchange rules generally and any personal property acquired with proceeds from the sale of real property would constitute taxable boot notwithstanding its incidental character under the new safe harbor.

III. Questions Remain on COVID-19 Relief Extension

On April 9, 2020, the Internal Revenue Service issued Notice 2020-23 which provides extensions (generally until July 15th, 2020) for various tax filing deadlines and other specified acts falling

between April 15th and July 15th, 2020. The specified acts identified in Notice 2020-23 include time sensitive actions listed Revenue Procedure 2018-58, which include the identification of replacement property in a 1031 Exchange (normally required to be made within 45 days of the sale of the relinquished property) and the completion of the exchange (normally required to occur within 180 days of the sale). Revenue Procedure 2018-58 provides an automatic 120-day extension of these two 1031 Exchange deadlines in the event that any future IRS News Release or other guidance provides general relief for acts specified in Rev. Proc. 2018-58 (unless the news release or other guidance specifies otherwise). Notice 2020-23 provides general relief for acts specified in Rev. Proc. 2018-58 and does not specify that the automatic 120-day extension provided by Rev. Proc. 2018-58 is not available to taxpayers with 1031 Exchange deadlines falling in the specified period. Accordingly, a plain reading of Rev. Proc. 2018-58 would suggest that the 120-automatic extension is available for 1031 Exchange acts. However, some commentators have expressed a concern that the extension provided by Notice 2020-23 falls within the parenthetical exception to the 120-day automatic extension provided by Rev. Proc. 2018-58 because Notice 2020-23 provides a general extension to July 15th and does not specifically provide that 1031 Exchange acts are not subject to the July 15th deadline.

In the face of this legal uncertainty, most QIs have adopted the conservative position that the extension for 1031 Exchange acts runs only to July 15th, 2020. This leads to some oddities where taxpayers who rely on the extension of the 45-day identification period to delay identifying replacement property until the deadline could find themselves left with insufficient time to complete their 1031 Exchanges. For example, a taxpayer who sold relinquished property on March 2nd and who waits until July 15th to identify suitable replacement property would have just 45 days to close on the purchase of the replacement property, which needs to occur before the end of August. Other QIs are allowing taxpayers to take the position that the automatic 120-day extension is available, but are requiring taxpayers to indemnify the QI if the IRS ultimately refuses to allow the extension beyond July 15th.