

News

I.1, Final Regs Define “Real Property” for Like-Kind Exchanges (T.D. 9935; IR-2020-262)

November 24, 2020

Final regulations clarify the definition of "real property" that qualifies for a like-kind exchange, including incidental personal property. Under the Tax Cuts and Jobs Act (TCJA, [P.L. 115-97](#)), like-kind exchanges occurring after 2017 are limited to real property used in a trade or business or for investment.

The final regs largely adopt regulations that were proposed in June (NPRM [REG-117589-18](#); [TAXDAY, 2020/06/12, I.1](#)). However, the final regs also:

- add a "state or local law" test to define real property, and
- reject the "purpose and use" test in the proposed regs.

In addition, the final regs classify cooperative housing corporation stock and land development rights as real property. The final regs also provide that a license, permit, or other similar right is generally real property if it is (i) solely for the use, enjoyment, or occupation of land or an inherently permanent structure; and (ii) in the nature of a leasehold, an easement, or a similar right.

General Definition of Real Property for Like-Kind Exchanges

Under the final regulations, property is classified as real property for like-kind exchange purposes if, on the date it is transferred in the exchange, it is real property under the law of the state or local jurisdiction in which it is located. The proposed regs had limited this "state or local law" test to shares in a mutual ditch, reservoir, or irrigation company.

However, the final regs also clarify that real property that was ineligible for a like-kind exchange before the TCJA remains ineligible. For example, intangible assets that could not be like-kind property before the TCJA (such as stocks, securities, and partnership interests) remain ineligible regardless of how they are characterized under state or local law.

Accordingly, under the final regs, property is real property if it is:

- classified as real property under state or local law,
- specifically listed as real property in the final regs, or
- considered real property based on all of the facts and circumstances, under factors provided in the regs.

These tests mean that property that is not real property under state or local law might still be real property for like-kind exchange purposes if it satisfies the second or third test.

Types of Real Property for Like-Kind Exchanges

Under both the proposed and final regs, real property for a like-kind exchange is:

- (1) land and improvements to land,
- (2) unsevered crops and other natural products of land, and
- (3) water and air space superjacent to land.

Under both the proposed and final regs, improvements to land include inherently permanent structures, and the structural components of inherently permanent structures. Each distinct asset must be analyzed separately to determine if it is land, an inherently permanent structure, or a structural component of an inherently permanent structure. The regs identify several specific items, assets and systems as distinct assets, and provides factors for identifying other distinct assets.

The final regs also:

- (1) incorporate the language provided in [Reg. §1.856-10\(d\)\(2\)\(i\)](#) to provide additional clarity regarding the meaning of "permanently affixed;"
- (2) modify the Example in the proposed regs concerning offshore drilling platforms; and
- (3) clarify that the distinct asset rule applies only to determine whether property is real property, but does not affect the application of the three-property rule for identifying properties in a deferred exchange.

Final Regs Eliminate “Purpose or Use” Test for Real Property in Like-Kind Exchange

The proposed regs would have imposed a "purpose or use" test on both tangible and intangible property. Under this test, neither tangible nor intangible property was real property if it contributed to the production of income unrelated to the use or occupancy of space.

The final regs eliminate the purpose and use test for both tangible and intangible property. Consequently, tangible property is generally an inherently permanent structure and, thus, real property if it is permanently affixed to real property and will ordinarily remain affixed for an indefinite period of time. A structural component likewise is real property if it is integrated into an inherently permanent structure. Accordingly, items of machinery and equipment are real property if they comprise an inherently permanent structure or a structural component, or if they are real property under the state or local law test—irrespective of the purpose or use of the items or whether they contribute to the production of income.

Similarly, whether intangible property produces or contributes to the production of income is not considered in determining whether intangible property is real property for like-kind exchange purposes. However, the purpose of the intangible property remains relevant to the determination of whether the property is real property.

Incidental Personal Property and Qualified Intermediaries in Like-Kind Exchange

The incidental property rule in the proposed regs provided that, for exchanges involving a qualified intermediary, personal property that is incidental to replacement real property (incidental personal property) is disregarded in determining whether a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or non-like-kind property held by the qualified intermediary are expressly limited as provided in [Reg. §1.1031\(k\)-1\(g\)\(6\)](#).

Personal property is incidental to real property acquired in an exchange if (i) in standard commercial transactions, the personal property is typically transferred together with the real property, and (ii) 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 (15-percent limitation).

This final regs adopt these rules with some minor modifications to improve clarity and readability. For example, the final regs clarify that the receipt of incidental personal property results in taxable gain; and the 15-percent limitation compares the value of all of the incidental properties to the value of all of the replacement real properties acquired in the same exchange.

Effective Dates

The final regs apply to exchanges beginning after the date they are published as final in the Federal Register. However, a taxpayer may also rely on the proposed regulations published in the Federal Register on June 12, 2020, if followed consistently and in their entirety, for exchanges of real property beginning after December 31, 2017, and before the publication date of the final regs. In addition, conforming changes to the bonus depreciation rules apply to tax years beginning after the final regs are published.

[T.D. 9935](#)

[IR-2020-262](#)