



The Voice of the 1031 Industry

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Internal Revenue Service
Attn: CC:PA:LPD:PR (REG-117589-18)
Room 5203
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Washington, D.C. 20044

Attn: Mr. Edward C. Schwartz, Esq., Office of Associate Chief Counsel (Income Tax & Accounting)
Edward.c.schwartz@irscounsel.treas.gov

RE: Comments to Proposed Regulations REG-117589-18

Dear Mr. Schwartz:

The Federation of Exchange Accommodators thanks you and your colleagues for your efforts in issuing Proposed Regulations addressing the definition of real property for purposes of IRC Section 1031 like-kind exchanges. We are grateful for the comprehensiveness and clarity provided in these Proposed Regulations. However, we have identified a few areas in which further clarity would be helpful.

Definition of Interests in Real Property

An interest in real property in the Proposed Regulations includes fee ownership, co-ownership, a leasehold, an option to acquire real property, an easement, or a similar interest. The REIT definition under Regulations 1.856-3(c) goes on to additionally include [stock](#) held by a [person](#) as a tenant-stockholder in a cooperative housing [corporation](#) (as those [terms](#) are [defined](#) in section 216). There are several private letter rulings on cooperative under Section 1031 that rely on state law to find these interests are real property (PLRs [200137032](#) and [200631012](#) most recently). The Proposed Regulations state that federal law controls for the Section 1031 definition of real property. Thus, it would be helpful to add this additional language from Regulations 1.856-3(c) to the definition of an interest in real property for Section 1031 so that the real property characterization of a cooperative does not depend on state law but on federal law.

Distinct Assets that are not Machinery

You requested comments on whether the function of a distinct asset that is not machinery is appropriate to use as the basis for determining whether the asset qualifies as real property for Section 1031 purposes. We believe that it is not.

The preamble to the Proposed Regulations states, "nothing in pre-TCJA section 1031 law suggests that real property held for productive use in a trade or business or for investment should necessarily be excluded from the definition of real property because of an active rather than passive function." The appropriate test for real property under Section 1031 should instead be the factors listed in Proposed Regulations 1.1031(a)-3(a)(2)(ii)(C) and (iii)(B).

The example of the gas line in the preamble to the Proposed Regulations separates real from personal property based on its use, not its physical nature and character. In the example, the installed gas line servicing the building is treated as real property, while the installed gas line servicing a restaurant within the building is treated as personal property. Both gas lines should be real property regardless of whether used for heating the building furnace or heating the restaurant oven. Both meet the Proposed Regulations 1.1031(a)-3(a)(2)(iii)(A) and (B) definition of a structural component, being "a constituent part of, and integrated into, an inherently permanent

structure.” Both are permanently installed gas lines with the same physical characteristics, with the piping to the restaurant being a branch off of the main gas line into the building. The gas line to the restaurant could not be removed without destruction of the gas line and significant damage to the building interior.

Just as CCA 201238027 found that installed pipeline was real property regardless of state law characterization because it had the same physical characteristics, gas lines installed within a building with the same physical characteristics should be real property regardless of use. For the same reason, a generator that is part of an interrelated electrical system (Examples 5 and 6 in the Proposed Regulations) should be a real property component regardless of whether the electricity is used for the occupancy of space or for a particular business use.

Additionally, reliance on the term “machinery” is problematic because the Code does not contain an overall definition of machinery. It only provides examples of machinery such as a gasoline pump, hydraulic car lift, or automatic vending machine in Reg. § 1.48-1(c). Some items are obviously machinery, like a turbine or a 3D printer. But other assets are best defined using the analysis set forth in Proposed Regulations 1.1031(a)-3(a)(2)(ii)(C) and (iii)(B), and may, in some circumstances, be deemed to be machinery, and in others, to be so integrated into the system or building as to have lost their individual mechanical characteristic, and no longer be reasonably separated from the whole.

Impact upon Small Business

Comments were requested on the effect of the Proposed Regulations on small businesses. The gas line, generator and machinery examples would require a cost segregation study to determine the value of the machinery-like components. This would be an extraordinary financial burden for a taxpayer of modest means who operates a small business or who leases a building to an operating business. Taxpayers, especially small business and middle-class taxpayers, should be able to apply the factor analysis of Proposed Regulations 1.1031(a)-3(a)(2)(ii)(C) and (iii)(B) to conclude that items are real property because they are permanently affixed components of the structure.

Many smaller exchanges are of residential rental properties. The examples of structural components listed in Proposed Regulations 1.1031(a)-3(a)(2)(iii)(B) would be improved by including built-in appliances and plumbing fixtures, such as sinks and toilets, to give assurance to smaller taxpayers. The REIT definition of a component includes “central refrigeration systems” and those systems should also be included as a structural component for Section 1031 purposes.

3 Property Rule

Under the Proposed Regulations, each distinct asset must be examined separately to determine if it is real property. It should be clarified that the distinct asset test does not apply for the purposes of the 3-property identification rule.

Licenses and Permits

The definition of a license, permit or similar right in the Proposed Regulations appears to limit these types of assets to leaseholds and easements. There are existing private letter rulings under Section 1031 regarding transferable development rights (TDRs). The TDRs are not necessarily in the nature of a leasehold or easement. Thus, the Proposed Regulations 1.1031(a)-3(a)(5)(ii) should be revised to state “A license, permit or other similar right that is solely for the use, enjoyment, development or occupation of land or an inherently permanent structure and that is in the nature of a leasehold, easement, development or other similar right generally is an interest in real property under this section.”

Incidental Personal Property

Comments were requested regarding the proposed treatment of a taxpayer's receipt of personal property that is incidental to the taxpayer's replacement real property in an intended section 1031 exchange. Specifically, comments were requested 1) on the two-factor analysis for determining whether personal property is incidental to real property acquired in such an exchange, and 2) on the appropriateness of the proposed 15-percent fair market value limit set forth in that test for personal property transferred with real property.

It is important to first understand the scope of the issue. Under § 1.1031(k)-1(g)(6), a taxpayer may receive funds “upon or after the receipt ... of all the identified replacement property to which the taxpayer is entitled...” Thus, if the taxpayer's written identification of replacement property indicates that only one replacement property will be

acquired, then use of exchange funds for incidental personal property is irrelevant because the taxpayer could receive all the remaining funds upon receipt of that replacement property anyway (assuming after the 45th day). Thus, this exception would only apply in the limited circumstance when the taxpayer intends to acquire additional replacement property. For the taxpayer acquiring multiple replacement properties, we are grateful for the clarification that use of exchange funds for purchase of real estate that includes incidental personal property will not cause the exchange to fail.

To qualify for Proposed Regulations 1.1031(k)-1(g)(7), the personal property must be incidental to the real replacement property, having an aggregate fair market value not greater than 15% of the fair market value of the real estate, and must typically be transferred with the real property in a standard commercial transaction. Regardless of the value of the personal property acquired with exchange funds, personal property does not qualify for Sec. 1031 and thus exchange funds expended for personal property will be treated as taxable boot. While 15% will probably cover most incidental personal property, it would be helpful if the 15% threshold was identified as a safe harbor, so that acquisition of incidental personal property valued in excess of 15% of the real property will not necessarily cause the exchange to fail, and the transfer of relinquished property to be fully taxable. Additionally, certain properties, such as hotels, may be transferred with incidental personal property in both tangible and intangible form, such as goodwill. Thus, the proposed (g)(7) exception should clarify that it applies to tangible and intangible personal property.

Outdated Regulations

Comments were requested about whether existing regulations that predate the TCJA should be removed. The background statement in the preamble to the Proposed Regulations, in describing current regulations regarding “like-kind,” states “Real property of one kind or class may not, under section 1031, be exchanged for real property of a different kind or class.” This comment is an erroneous transcription of the prior law in which personal property assets exchanged under Section 1031 were not like-kind to personal property assets of a different kind or class. In the context of real property, differences of class relate to the grade or quality of the real estate, not to its nature or character, and prior to the TCJA were not used to define like-kind real estate.

We are grateful for the opportunity to provide these comments, and welcome any questions you may have or further discussion. Our contact information is below.

Sincerely,

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