What Qualifies as “Real Property” for Tax-Deferred Section 1031 Like-Kind Exchanges

Abstract
Internal Revenue Code Section 1031 provides for tax-deferred exchange of like-kind property in certain circumstances. The tax code places a number of requirements on transactions in order to be considered a qualified Section 1031 exchange. The 2017 Tax Cuts and Jobs Act (TCJA) eliminated the application of the like-kind exchange treatment to property that is non–real estate, providing that such treatment is limited to “real property.” In 2020, the US Treasury Department and Internal Revenue Service issued final regulations relating to the provisions of Section 1031 under TCJA. This article examines what qualifies as “real property” that is eligible for tax deferral for purposes of Section 1031 under the final regulations.

What Is IRC Section 1031?
Many appraisers are familiar with the basic rules under Internal Revenue Code (IRC) Section 1031,1 “Exchange of Real Property Held for Productive Use or Investment.” This federal income tax law2 regulates when an exchange of property will be allowed to be undertaken without generating recognized, taxable income for federal income tax purposes.3 IRC Section 1031(a)(1) provides as follows:

(a) Nonrecognition of Gain or Loss from Exchanges Solely in Kind
   (1) In General
   No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.

Nothing contained in this article is to be considered the rendering of legal or tax advice; readers are responsible for obtaining such advice from their own legal counsel or tax advisor.

1. See 26 USCA § 1031 of the Internal Revenue Code.
2. This article addresses federal income tax law and not state tax laws. This distinction is important because there is no assurance that the rules will be the same on the federal and state levels. Although a federal statute, IRC Section 1031, provides for deferring the federal income tax on qualified like-kind exchanges, such a rule will not necessarily apply on the state level. Every state must be examined separately to determine if the given transaction will allow for a deferral under the state law. See Mark Lee Levine, Handbook on Exchanging Real Estate (Denver, CO: Professional Publications and Education, 2020) for additional discussion.
Section 1031 Like-Kind Exchange Criteria
Since 1921, this code section has allowed taxpayers to defer paying tax on realized gain when the requirements of the section are met. While such exchanges have been commonplace for years, there are specific legal requirements as to what constitutes a qualified like-kind exchange, and these have been changed over time. Congress amended the tax code to allow for more control and more limitations on such exchanges. For example, modifications to Section 1031 added significant parameters related to the timing of exchanges in response to significant uncertainty as to timing and qualifications for nonsimultaneous exchanges.

To limit nonsimultaneous exchanges, time limits were placed on qualified exchanges; Section 1031(a)(3) provides as follows:

(3) Requirement that Property Be Identified and that Exchange Be Completed Not More Than 180 Days after Transfer of Exchanged Property
For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if—
(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
(B) such property is received after the earlier of—
(i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or
(ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

Transactions that fail to meet these time requirements generally will be outside the parameters of the tax code for the deferral of taxable income.

The tax code includes a number of other limitations on the use of the Section 1031 deferral of recognition of capital gains. However, the discussion here will focus on recent changes in the tax code and regulations that limit tax deferral to exchanges of real property.

Section 1031 Recent Modifications
In 2017, the Tax Cuts and Jobs Act (TCJA) eliminated property that is non–real estate from like-kind exchange treatment. Instead, Section 1031, as revised, provides that such favorable tax-deferral treatment is limited to “real property.” Therefore, when a Section 1031 transaction is considered, it became crucial to determine whether the property being exchanged is real property or not.

Although on its face the issue of “what is real property” might not appear to be enigmatic, the distinction between real property, which is like-kind exchange eligible, and non–like-kind exchange property generated many tax audits and disputed cases following the TCJA changes.

4. For example, Section 1031(a)(2) specifically excludes “any exchange of real property held primarily for sale.” Section 1031(a)(3) excludes real property located outside the United States from like-kind favorable tax treatment. Section 1031(f) provides limitations on nonrecognition of gains where the exchange involves “related parties.”

5. For a detailed examination of the timing issue, see chapter 10 in Levine, Handbook on Exchanging Real Estate. That text discusses the most-frequently cited case on this issue, Starker v. United States, 602 F.2d 1341 (9th Cir. 1979), which recognized delayed exchanges. The timing issues created after the Starker ruling led to statutory changes on nonsimultaneous exchanges. Section 1031(a)(3) pulled back from the broad statements made by the court in Starker. Like-kind exchanges have sometimes been referred to as “Starker exchanges.”

The definitional uncertainty was exacerbated because, up to this point, consideration of what constitutes real estate on the state level had been important in federal tax cases but it was not necessarily a controlling consideration given the 2017 TCJA change. Also at issue was the effect, if any, of the receipt of personal property that is incidental to the exchange of replacement real property.

In June 2020, the Treasury Department and the Internal Revenue Service issued proposed regulations to address these concerns. Final regulations, issued on November 23, 2020, were formally published and became effective as of December 2, 2020.7

**Proposed Regulations.** The proposed like-kind exchange regulations originally stated, “The term ‘real property’ for purposes of Code Sec. 1031 and its Regs means land and improvements to land, unsevered natural products of land, and water and air space superjacent to land.”8 The proposed regulations also included a noteworthy statement that personal property that is incidental to the replacement real property is disregarded in determining whether the taxpayer qualifies to receive the tax benefits of a like-kind exchange.9 As to this issue of whether the personal property is “incidental” to the realty being exchanged, the proposed regulations looked to the nature of the personal property involved and its contribution to the aggregate fair market value of the real property.

**Final Regulations—Real Property Defined.** The final regulations provide a definition of real property to distinguish it from personal property, as the TCJA limited the nonrecognition of gain or loss in like-kind exchanges to exchanges of real property. The final regulations state as follows: “The term real property under section 1031 means land and improvements to land, unsevered natural products of land, and water and air space superjacent to land.”10 The regulations then go on to provide definitions and clarifications as to what constitutes “improvements to land,” which can be key considerations in determining what qualifies as real property for purposes of Section 1031.

The proposed regulations had suggested that the function of property be considered in deter-

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8. See Proposed Regulation Section 1.1031(a)-3(a)(1).
9. Such personal property must also normally be part of the commercial property usually transferred when such real property is transferred. Keep in mind that personal property generally is not subject to tax deferral since it is not like-kind property.
10. Section 1.1031(a)-3(a)(1).
mining whether the property qualifies as real property—referred to as the “purpose or use test.” The commentators on this proposed regulation “uniformly disagreed with the ‘purpose or use test’” as improperly narrowing the scope of the definition of real property. As a result, the final regulations eliminate the proposed purpose or use test. The final regulations recognize that the definition’s reference to “improvements to land” means inherently permanent structures that are “permanently affixed to real property and that will remain affixed for an indefinite period.” Thus, an inherently permanent structure is real property for Section 1031 purposes, irrespective of the purpose or use of the improvement or whether it contributes to the production of income.

The final regulations also clarify that “property that is real property under State or local law ...is real property for purposes of section 1031.” The commentary to the regulations states,

In summary, under the final regulations, property is classified as real property for purposes of section 1031 if the property is (i) so classified under the State and local law test, subject to certain exceptions, (ii) specifically listed as real property in the final regulations, or (iii) considered real property based on all the facts and circumstances under the various factors provided in the final regulations.

The final regulations exclude from real property the intangible assets that had been listed in Section 1031(a)(2) prior to its amendment by TCJA. The final regulations state that intangible assets that are real property for the purposes of Section 1031 include “fee ownership, co-ownership, a leasehold, an option to acquire real property, an easement, stock in a cooperative housing corporation, shares in a mutual ditch, reservoir, or irrigation company [to the extent recognized by state law] and land development rights.”

Final Regulations—Effect of Incidental Personal Property. The news release for the final regulations highlights that the regulations “also provide a rule addressing the receipt of personal property that is incidental to real property received in a like-kind exchange.” (Emphasis added.) The regulations make clear that incidental non–real property may be part of a like-kind exchange of real property. However, that does not mean that the incidental personal property is eligible for tax deferral. The legislative history to the TCJA amendments to section 1031 provides,

Congress “intended that real property eligible for like-kind exchange treatment under present law will continue to be eligible for like-kind exchange treatment under the [amended] provision.” H.R. Conf. Rept. 115-466, at 396, fn. 726 (2017) (Conference Report). However, left unchanged by the TCJA, section 1031(b) provides that a taxpayer must recognize gain to the extent of money and non–like-kind property the taxpayer receives in an exchange.

11. Section 1.1031(a)-3(a)(2).
12. Section 1.1031(a)-3(a)(1).
13. The State and local law test applies to both tangible and intangible property classifications. The regulations’ comments point out, however, “a determination that property is personal property under State or local law does not preclude the conclusion that property is real property as specifically listed in [the federal regulations].”
14. Section 1.1031(a)-3(a)(5).
15. Non–real property can be tangible or intangible.
This statement means the taxpayer will be taxed on the gain from the transfer of the personal property, even if it is incidental to the Section 1031 exchange of the realty.  

Section 1.1031(k)-1 of the final regulations provides examples of items that are to be disregarded when considering whether an exchange is within one of the enumerated safe harbors. It states as follows:

§1.1031(k)-1 Treatment of deferred exchanges. In determining whether a safe harbor under [this section] ceases to apply and whether the taxpayer’s rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property are expressly limited as provided in ...this section, the taxpayer’s receipt of or right to receive any of the following items will be disregarded [Emphasis added]—

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(g)(7) (iii) Personal property generally resulting in gain recognition under section 1031(b) that is incidental to real property acquired in an exchange. [Emphasis added.]

For purposes of this paragraph (g)(7), personal property is incidental to real property acquired in an exchange if—

(A) In standard commercial transactions, the personal property is typically transferred together with the real property [Emphasis added]; and

(B) The aggregate fair market value of the property described in ... this section [that is] 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. [Emphasis added.]

The final regulations then go on in Section 1.1031(k)-1(g)(8) to offer the following example related to personal property:

Example 6. (A) In 2020, B transfers to C real property with a fair market value of $1,100,000 and an adjusted basis of $400,000. B’s replacement property is an office building and, as a part of the exchange, B also will acquire certain office furniture in the building that is not real property, which is industry practice in a transaction of this type. The fair market value of the real property B will acquire is $1,000,000 and the fair market value of the personal property is $100,000. (B) In a standard commercial transaction, the buyer of an office building typically also acquires some or all of the office furniture in the building. The fair market value of the personal property B will acquire does not exceed 15 percent of the fair market value of the office building B will acquire. Accordingly, under paragraph (g)(7)(iii) of this section, the personal property is incidental to the real property in the exchange and is disregarded in determining whether the taxpayer’s rights to receive, pledge, borrow or otherwise obtain the benefits of money or non–like-kind property are expressly limited as provided in paragraph (g)(6) of this section. Upon the 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 fair market value of the non–like-kind property B acquired in the exchange, $100,000.

Conclusion

The latest regulations on Section 1031 like-kind exchange transactions are not as generous as one might have first thought. That is, while the regulations provide that incidental personal property may be included in a real property like-kind exchange, the personal property involved in the like-kind exchange is not subject to the tax ben-

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17. The final regulations do provide that if the property is incidental to the larger property, it is not treated as a separate property. The regulations state, “Property is disregarded in evaluating the identification rules if it is incidental to a larger item of property and therefore, is not treated as property separate from the larger item. Property is incidental to a larger property if, in standard commercial transactions, the property is typically transferred with the larger item of property, and the aggregate fair market value of all of the incidental property does not exceed 15 percent of the aggregate fair market value of the larger item of property.” See Section 1031(b).
efits under Section 1031. Rather, what this analysis illustrates is that such personal property incidental to the exchange is subject to tax. It is a form of boot or non–like-kind real property. As such, it is subject to taxation where there is a realized gain. It will be recognized (taxed). The final regulations also did not identify the incidental property rule as a separate safe harbor.

Appraisers, among others, need to know that although there might be a tax-deferred exchange involved in the realty, the personal property involved with the exchange may not exceed fifteen percent of the aggregate fair market value of the real property and it can generate taxable income, even if it is incidental to the like-kind exchange.

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Additional Resources

Internal Revenue Service

- **Statutory Limitations on Like-Kind Exchanges**
  https://www.federalregister.gov/documents/2020/12/02/2020-26313/statutory-limitations-on-like-kind-exchanges

- **Tax Cuts and Jobs Act: A Comparison for Businesses**

- **The Treasury Department and IRS Issue Final Regulations Regarding Like-Kind Exchanges of Real Property**

US Congress—Tax Cuts and Jobs Act of 2017