

## PROPOSED 1031 EXCHANGE REGULATIONS DEFINING “REAL PROPERTY”

Beginning January 1, 2018, the Tax Cuts and Jobs Act (TCJA) amended IRC section 1031 to limit its application to exchanges of real property thereby eliminating personal property exchanges from its purview. It is therefore now more important than ever to ascertain whether an asset can be classified as real property so it can be utilized as part of a 1031 exchange. On June 11, 2020, the US Treasury released guidance in the form of [Proposed Regulations](#) that clarifies and defines what constitutes real property for 1031 exchange transactions.

The Proposed Regulations create a definition of real property that is specific to 1031 exchanges and can only be used in conjunction therewith. Specifically, real property for 1031 purposes includes land and improvements to land, unsevered crops and other natural products of land, as well as water and air space superjacent to land. Improvements to land include inherently permanent structures and their structural components. In addition, licenses, permits, and other rights that derive their value from real property are eligible (such as mineral and extraction rights). However, a license or permit to operate a business on real property is not considered a real property interest.

The Proposed Regulations also discuss how to treat different types of assets by classifying them as distinct assets. If interconnected assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), those assets are analyzed together as one distinct asset that may qualify as a structural component (and thus represent real property). The Proposed Regulations give the example of a gas line running into a building. If the gas line provides fuel to the building’s heating system, it would be a structural component that would constitute real property. If the gas line is providing fuel to non-structural components in the building (e.g., an oven), then the gas line is personal property for section 1031 purposes.

The Proposed Regulations further provide that an exchange will not be disqualified if exchange funds are used to purchase personal property that is incidental to replacement property, as long as the personal property does not exceed 15% of the aggregate value of such property.



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Prior to the Proposed Regulations there was concern that using exchange funds to pay for incidental personal property could invalidate an exchange. Under the Proposed Regulations it is now clear that such use will merely result in taxable “boot” being recognized with respect to the incidental personal property but will not disqualify the exchange.

The Treasury has again made it clear that the real property definition contained in the Proposed Regulations applies only to IRC Section 1031 and does not apply to any other tax code provisions. It is therefore quite possible that an asset can be IRC section 1245 property for depreciation purposes (personal property afforded accelerated depreciation) while at the same time being treated as real property under section 1031. This can be highly beneficial for property owners and has significant implications when performing a cost segregation study on like-kind exchange property.

Taxpayers may rely upon the Proposed Regulations for all 1031 exchanges beginning after December 31, 2017 and before any final regulations are published. The IRS and Treasury have called for comments which must be received by Aug. 11, 2020. Taxpayers who may be affected by these Proposed Regulations are encouraged to participate.

As always, please do not hesitate to contact the Peak 1031 exchange team for any and all questions you may have. You can always reach me directly at 949-836-7604 or by email at [steven@peakexchange.com](mailto:steven@peakexchange.com).



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