

# KBKG TAX INSIGHT: PROPOSED 1031 REGS SHOULD NOT MATERIALLY IMPACT COST SEGREGATION BENEFITS

The definition of personal property and real property for Section 1031 purposes has been a source of confusion for many years for taxpayers who conduct cost segregation studies of real property.

Last week, the IRS has issued proposed regs that define what real property is for purposes of 1031 exchanges. This became necessary due to changes in the Tax Cuts and Jobs Act (TCJA) that no longer allows personal property from being eligible for 1031 exchange. To address complications due to the inherent personal property included in a real property exchange (e.g., from cost segregation studies), the proposed regs provide a rule addressing personal property that is incidental to the purchase of real property received in the exchange.

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## KBKG INSIGHT

The definition of personal property and real property for Section 1031 purposes has been a source of confusion for many years for taxpayers who conduct cost segregation studies of real property. Most cost segregation experts have historically interpreted the definition of real property and personal property for 1031 rules are different than definitions under depreciation rules. These proposed regs offer clarity by indicating these definitions for 1031 purposes should not rely on the definitions used for deprecation purposes.

As many tax professionals read the proposed regs, it may first appear that cost segregation studies may cause problems if a taxpayer intends to exchange the property in the future. However, upon deeper analysis, this is not the case. The proposed regs provide that personal property which is incidental to replacement real property is disregarded. Personal property is 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 does not exceed 15 percent of the aggregate fair market value of the replacement real property.

## KBKG CASE STUDY

A property is sold in a Sec. 1031 exchange for \$10 million with a corresponding land value of \$3 million and building value of \$7 million. A cost segregation study was performed on that building resulting in the following allocations:

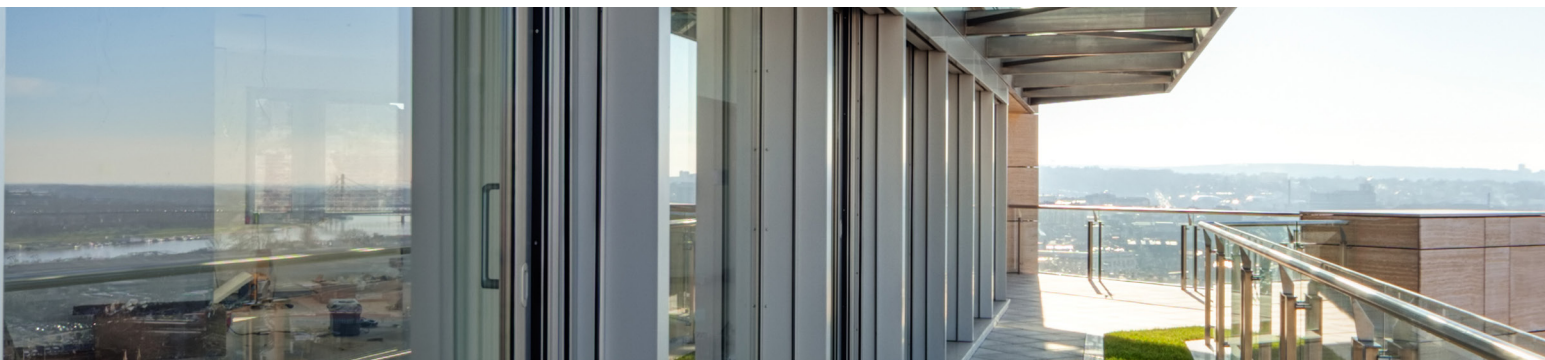
5 & 7-year property	\$1.4 million (20%)
15-year land improvements	\$1.05 million (15%)
39-year property	\$4.55 million (65%)

The replacement property is purchased for \$10 million. The “incidental” rule would disregard any personal property up to 15% of the total purchase price of the new property, or \$1.5 million, making this a valid exchange under the proposed 1031 regulations.

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Even though this is considered a valid exchange under the proposed regulations, taxpayers must still match or exceed personal property values in the new property in order to avoid 1245(b)(4) recapture tax. This has been an issue for many years before these proposed regulations and can be avoided with careful planning.

When considering that most taxpayers tend to “exchange up,” meaning their replacement property is generally purchased for more than the sale price of relinquished property, there is even more room for higher allocations to personal property from cost segregation. In its current form, these proposed regs do not seem to cause any material issue for taxpayers who would like to conduct cost segregation studies on properties they intend to exchange in the future.





## BACKGROUND

Prior to enactment of the TCJA, neither the Code nor the income tax regulations provided a definition of the term “real property” for purposes of section 1031. The legislative history to the TCJA provides that real property eligible for like-kind exchange treatment under pre-TCJA law should continue to be eligible for like-kind exchange treatment after the enactment of the TCJA.

Various income tax regulations provide definitions of real property for sections other than section 1031 (see §1.263A-8(c); §1.1250-1(e)(3); and §1.856-10). Although there are many similarities in the way various sections of the code and the regulations define “real property,” there are also differences in those definitions. Some sections apply broad sets of rules for the definition of real property, while others apply narrower definitions. For example, §1.1250-1(e)(3) uses a narrow definition of real property, which is relied upon for depreciation purposes. In contrast, sections related to REITs and also for foreign investments use broad definitions of real property that can seemingly include items of personal property that are associated with the use of real property.

## PROPOSED DEFINITION OF REAL PROPERTY FOR SECTION 1031

The proposed definition of “real property” includes a list of many common items most of us think of as real property or inherently permanent structures. However, for items not listed in the regulations, taxpayer must apply new tests to make this determination. This can be highly subjective when considering many types of building components that typically qualify as personal property for depreciation purposes. These tests include:

1. The manner in which the distinct asset is affixed to real property;
2. Whether the distinct asset is designed to be removed or to remain in place;
3. The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;
4. Any circumstances that suggest the distinct asset was not affixed for an indefinite period; and
5. The time and expense required to move the distinct asset.
6. Whether the component is listed during construction of the building structure.

An easier way to grasp what qualifies for 1031 exchanges (as proposed) is to understand what does not qualify. Under the proposed regulations, property that is in the nature of machinery is not real property under section 1031. In the case, however, of a building that includes property in the nature of machinery, the machinery is real property if it serves the inherently permanent structure (i.e. HVAC, sewage pumps etc.) and does not produce or contribute to the production of income other than for the use or occupancy of space.

If interconnected assets work together to serve a permanent structure (e.g., systems that provide a building with electricity, heat, or water), the assets are analyzed together and may qualify as a structural component. For example, a gas line that provides fuel to a building's heating system qualifies as real property for section 1031 purposes. However, if the purpose of a gas line is to provide fuel to business equipment in a building, such as fryers and ovens in a building utilized as a restaurant, the gas line is not a constituent part of an inherently permanent structure and therefore not real property for section 1031 purposes.

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If the IRS is going to rely on the inherent function of each building component for 1031 purposes, expanded cost segregation studies may be needed to assist with these calculations. Comments are requested by the IRS 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

## **CONCLUSION**

The proposed 1031 regulations appear favorable for cost segregation studies because of the 15% incidental rule. Since the IRS has specifically asked for comments on this rule, taxpayers in the real estate industry should submit comments affirming that 15% appears to be a reasonable exception. Anything lower may be problematic. Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at <https://www.regulations.gov> (indicate IRS and REG-117589-18).

» [View the entire Proposed 1031 Regulations](#)

*To find out if a cost segregation study for your property involved in a 1031 exchange makes sense for you, visit: [KBKG.com/qualify](https://www.kbkg.com/qualify)*

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