Final Like-Kind Exchange Regs Seen as Positive

by Kristen A. Parillo

The final regulations implementing the new limitation on like-kind exchange treatment give investors a good start in determining what qualifies as real property for section 1031 purposes, according to a practitioner.

The November 23 regs (T.D. 9935) are "overall positive for qualified intermediaries, Realtors, and investors, because they now have some clarity and a point to work from in figuring out if an asset is real property," James T. Walther of Legal 1031 Exchange Services LLC, a provider of qualified intermediary services, told *Tax Notes*.

The final rules, which address the Tax Cuts and Jobs Act provisions restricting like-kind exchange treatment to exchanges of real property held for use in a trade or business or for investment, include several notable changes to the proposed regs (REG-117589-18) issued June 11.

In response to tax professionals' comment letters, Treasury and the IRS expanded the degree to which state and local law controls in determining whether property should be classified as real property. The final regs now provide that property is real property for section 1031 purposes if it is:

- classified as real property under state and local law (subject to some exceptions);
- specifically listed as real property in the final regs; or
- considered real property based on all the facts and circumstances under the factors provided in the final regs.

"The enumeration of specific items as real property and adding local law definitions as a factor are both improvements," said Walther, adding that the government's decision to include land development rights and stock in a cooperative housing corporation in the definition of real property "is huge."

"Before, people had to look to state law to figure out if things like options and co-ops were eligible under section 1031," Walther said. "That created a legal cost burden on the investors because a lot of times there isn't always a clear answer — state law is all over the place. So, specifically listing those assets in the regs gives people more certainty and will alleviate a lot of the administrative burden and analysis that everyone had to do."

> ***'The enumeration of specific items as real property and adding local law definitions as a factor are both improvements,' Walther said.***

Eliminating the proposed regs' purpose or use test for machinery-type fixtures was also a good move, Walther said. "It just makes things clearer," he said. "Traditionally, you didn't have to have an income-producing property to qualify for section 1031 — it's more of an intent-based statute."

Left Out

Walther noted that Treasury and the IRS punted on some issues raised in comment letters, such as the application of section 453 to gain on a transfer of personal property and the interaction of the section 168 bonus depreciation rules with section 1031.

"There are other items they may have to address in future regs," Walther said.

Monte A. Jackel of Jackel Tax Law questioned the government's decision not to address the application of reg. section 1.1031(j)-1 to exchanges of both qualifying real property and nonqualifying property that involve indebtedness encumbering both types of properties.

"I don't understand why some guidance was not issued on this particular issue, as it is not uncommon and can have significant tax consequences," Jackel said. "Taxpayers should really be warned."

With personal property no longer covered under section 1031, there's no guidance on how or whether liabilities are netted in determining cash paid or boot received, Jackel said. "And it isn't clear how the multiple property rule in [reg. section] 1.1031(j)-1 applies in those cases," he added. "These rules will no longer work properly based on current guidance."

Also unaddressed is the application of Rev. Rul. 2003-56, 2003-23 IRB 1, to post-TCJA exchanges involving real and personal property, Jackel said. That revenue ruling dealt with a section 1031 exchange spanning multiple tax years in which all properties are encumbered.

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"The ruling describes how section 752(b) applies in that case and how the minimum gain rules apply under [reg. section] 1.704-2 in those cases with nonrecourse debt," Jackel said. "Taxpayers will no longer be able to apply that ruling as written if there is encumbered real and personal property, a not-uncommon situation."

Jackel also pointed out that reg. section 1.1031(j)-1(b)(2)(ii)(D) provides that if a section 1031 exchange is part of a larger transaction, the liabilities taken into account are also part of the larger transaction. "Boot attributable to excess liabilities relieved of is treated as money, a Class I asset," he said.

"Under reg. section 1.1060-1(b)(8) and 1.1060-1(d), the like-kind assets are excluded from the allocations under section 1060 and are treated solely under section 1031," Jackel added. "If there is boot, the proportionate part attributable to section 1031 assets is excluded from section 1060, which can apply if there is goodwill or going concern value, and that is based on the amount of boot needed to equalize both sides of a section 1031 exchange."

"How will this work now, because personal property, even if incidental, is still boot?" Jackel asked. "Is it fair or appropriate not to have dealt with these issues now?" ■

IRS, Taxpayers Hone Downward Attribution Focus on Look-Through

by Andrew Velarde

As the IRS works on finalizing proposed regs on constructive stock ownership following modification of downward attribution rules, practitioners' greatest concern, and the agency's greatest focus, is limitations imposed on the look-through rule.

In September the IRS released final (T.D. 9908) and proposed (REG-110059-20) regs addressing the Tax Cuts and Jobs Act's repeal of section 958(b)(4), which provided an exception for subpart F purposes to downward attribution of controlled foreign corporation stock held by a foreign person to a U.S. shareholder under section 318(a)(3). The repeal of section 958(b)(4) has drawn criticism for drastically — and arguably accidentally — increasing the number of foreign companies treated as CFCs.

The proposed regs would amend the rules concerning the subpart F exception provided by section 954(c)(6), which generally applies to payments between CFCs of a U.S.-based multinational group with active foreign earnings. According to the preamble of the proposed regs, the income of CFCs created solely by application of downward attribution typically falls outside U.S. tax jurisdiction and, as a result, those payments should be ineligible for the section 954(c)(6) exception. The proposed regs would apply to foreign corporation tax years ending on or after September 21 and U.S. shareholder tax years in which or with which such tax years end.

That exception provides that a CFC's dividends, interest, rents, and royalties received from a related CFC are not foreign personal holding company income if attributable to income of the related CFC that is not subpart F income or effectively connected with a U.S. trade or business.

The preamble provides an example of a transaction between a foreign-parented multinational group's CFC (FC1) and another CFC group member (FC2) without U.S. shareholders that is a CFC solely because of downward attribution. The regs limit the application of the look-through exception when FC1 makes a loan to FC2.

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