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ARTICLES

Proposed Definition of Real Property Under Section 1031 and Related Topics

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One June 12, 2020, Treasury and the IRS published a notice of proposed rulemaking,[1] addressing the 2017 amendments to §1031.[2] The Tax Cuts and Jobs Act (TCJA) generally eliminated the application of §1031 to personal property, limiting the application of that section to real property.[3]

The regulations proposed under the notice (the "proposed regulations") define real property for purposes of §1031, which had not been previously defined in statute or regulation.[4] The proposed regulations also address a potential technical issue relating to the acquisition of personal property that is "incidental" to real property acquired in an exchange under §1031.[5]

I. GENERAL APPROACH AND NOTABLE ITEMS

A. Background and Guiding Principle

Prior to the TCJA, §1031(a)(1) read:

> No gain or loss shall be recognized on the exchange of *property* held for productive use in a trade or business or for investment if such *property* is exchanged solely for *property* of like kind which is to be held either for productive use in a trade or business or for investment.[6]

The TCJA modified this language by inserting the word "real" before each instance of the word "property."[7] The TCJA also made certain other conforming changes, discussed in part in I.D.1., below.[8] The legislative history states it was "intended that real property eligible for like-kind exchange treatment under [pre-TCJA] law will continue to be eligible for like-kind exchange treatment" after the TCJA.[9] The preamble (the "preamble") to the proposed regulations

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[1] Statutory Limitations on Like-Kind Exchanges, REG–117589–18, 85 Fed. Reg. 35,835 (June 12, 2020).

[2] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[3] *See generally* TCJA, Pub. L. No. 115–967, §13303.

[4] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,836.

[5] *See generally* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,838, 35,839.

[6] Emphasis added.

[7] TCJA, §13303(a).

[8] *See* TCJA, §13303(b).

[9] H.R. Rep. No. 115-466 at 396, n.726, 115th Cong., 1st Sess. (Dec. 15, 2017) (Conf. Rep.).

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references this principle seven times,[10] and expressly states that the proposed definition of real property is meant to be ''consistent'' with it.[11]

Understandably, rather than drafting a definition of real property from scratch, Treasury and the IRS looked to other regulatory definitions of real property. Among those considered were the definitions under §263 (capital expenditures), §263A (capitalization of certain expenses), §856 (real estate investment trusts), §897 (foreign ownership of U.S. real property, commonly called ''FIRPTA''), former §38 and §48 (the investment tax credit), and the ''depreciation definition'' (under §167, §168, §1245, and §1250).[12] The preamble distinguishes ''broad'' definitions (such as §856 and §897) and ''narrow'' definitions (such as the depreciation definition) of real property.

Treasury and the IRS determined that a ''wholesale adoption'' of any definition under another provision was ''not . . . appropriate . . . due to the varying purposes of each of [those] provisions.''[13] For similar reasons, the preamble states that local law should not control for these purposes.[14] Rather, the proposed definition ''extract[s] certain portions'' of other definitions to construct a definition that is ''consistent'' with §1031.[15] As discussed in II.A., below, the proposed definition appears to extract more from the real estate investment trust definition (the ''REIT definition''),[16] and, to a lesser extent, from the definition for certain capitalization purposes (the ''§263A definition''),[17] than from other definitions. The preamble states that the REIT definition is a broader definition of real property.[18] Additionally, portions of the preamble to the final regulations codifying the §263A definition indicate that definition may likewise be broad.[19] In at least one context (discussed in I.C.3., below), the difference in purpose among the various statutory provision raises questions as to the applicability of ''extracted'' portions of the definition under the proposed regulations.

B. Distinction Between Active Functions and Passive Functions

Treasury and the IRS appear to be giving some thought to whether the function of property is relevant to the determination that property is real property for purposes of §1031. Throughout the REIT definition, a distinction is made between property that serves an active function (for example, ''to manufacture, create, produce, convert, or transport'')[20] versus a ''passive'' function (for example, ''to contain, support, shelter, cover, protect, or provide a conduit or a route'').[21] Generally, the finding of a passive function supports the conclusion that property is real property.[22] The distinction appears to largely be that passive functions serve the *production of income for the use or occupancy of space*,[23] whereas active functions serve the production of other income. The REIT definition also indicates that property *capable* of producing income *other than* for the use or occupancy of space may still be real property if it does not actually ''contribute to the production of such income.''[24] This distinction makes sense in the REIT context, as REITs are generally limited to receiving certain passive income (such as ''rents from real property''),[25] rather than engaging in another business.

However, as the preamble states, ''nothing in pre-TCJA §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.''[26] Notwithstanding this statement, as discussed in II.A.3.iv., and II.A.6., below, the production of income for the use or occupancy of space is a concept relevant to the determination of whether machinery and intangibles are real property. Additionally, Treasury and the IRS have requested comments on whether the function of non-machinery property is relevant to the determination of whether that property

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[10] *See* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,836, 35,837 (two instances), 35,838, 35,839, 35,840, 35,841.

[11] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,836.

[12] *See* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,836–35,837, 35,839.

[13] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[14] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837. *See also* Prop. Reg. §1.1031(a)-3(a)(1).

[15] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,839.

[16] *See generally* Reg. §1.856-10.

[17] *See generally* Reg. §1.263A-8(c).

[18] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[19] *See* Capitalization of Interest, T.D. 8584, 59 Fed. Reg. 67,187 (Dec. 29, 1994).

[20] Reg. §1.856-10(d)(2)(iii)(A).

[21] Reg. §1.856-10(d)(2)(iii).

[22] *See, e.g.*, Reg. §1.856-10(d)(2)(iii)(A) (regarding inherently permanent structures), Reg. §1.856-10(d)(3)(i) (regarding structural components), and Reg. §1.856-10(d)(3)(iii) (regarding structural components).

[23] *See* Reg. §1.856-10(d)(3)(i) (emphasis added).

[24] Reg. §1.856-10(d)(3)(i).

[25] *See generally* §856(c)(2) and §856(c)(3) (certain REIT income tests).

[26] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

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is real property,[27] indicating their consideration of this concept. Even though function requirements appear to be relevant only to machinery and intangibles under the operative language of the proposed regulations,[28] an example in the preamble might lead someone to a different conclusion. In that example, the preamble states that a gas line is not real property because its purpose is ''to provide fuel to business equipment in a building, such as fryers and ovens in a building utilized as a restaurant.''[29]

Even with respect to machinery (where the function distinction exists), it is not clear if *any* active use disqualifies the property as real property entirely. In one example in the proposed regulations, where a steam turbine generates electricity that both powers the building that it occupies and that is sold in the building owner's electric utility business, the steam turbine is determined not to be real property.[30] However, this example must be contrasted with two other examples in the proposed regulations, which concern a 3D printer (which is not real property).[31] In one of the 3D printer examples, a power generator serves the entire building, including the 3D printer, in which case the generator was determined to be a real property.[32] In the other example, the generator serves only the 3D printer, in which case the generator was considered not to be not real property.[33] Under this rationale, the gas line in the example in the preamble may have been real property had it served the entire building, rather than the restaurant business alone.[34] Given these examples, it is not clear at what point machinery or other property serving some production of income other than the use or occupancy of space (an active function) causes that machinery not to be real property. Query what the outcome would be in the case of gas line that served an entire building, which building had only one tenant (a restaurant), or in the case of steam turbine that generally provided power for the building it occupied, but that sold excess energy produced. Similar issues exist with respect to intangibles (where the function distinction also exists).

C. Interests in Real Property

1. In General and the Like Kind Requirement

Under Prop. Reg. §1.1031(a)-3(a)(1) ''an interest in real property'' including, for these purposes, ''fee ownership, co-ownership, a leasehold, an option to acquire real property, an easement, or a similar interest'' is apparently real property for purposes of §1031. As discussed in I.C.2., and I.C.3., below, this list may have made more sense in other contexts. The concept of interests in real property seems to be relevant to the like kind requirement, however.

The operative language of the proposed regulations does not address the definition of like kind.[35] However, the preamble expressly states that the like kind requirement ''continues to exist after the changes to §1031 made by the TCJA.''[36] Just as the TCJA was not intended to change the definition of real property for purposes of §1031 (see discussion at I.A., above), it is probably safe to assume that the TCJA was not intended to change the definition of like kind for these purposes. That is, the pre-TCJA law on what real property was like kind to what other real property continues to apply.

In general, prior to the TCJA, what was considered like kind for purposes of real property was rather broad as compared to personal property.[37] However, the nature of the interest in real property is relevant to a like kind determination: notably, in an example in the existing regulations, a leasehold with 30 years remaining is said to be like kind to ''real estate''[38] (which is understood to mean or to include a fee interest).[39] For this reason, although options to acquire real property (call options) and other similar interests (described in I.C.2., below) may be interests in real property, they are not necessarily like kind to a fee interest in real property. It may be that a call option is like kind only to other call options, or only to call options with respect to real property of a similar use.

2. Options, Contracts, and Similar Interests

Prior to the issuance of the proposed regulations, it is unlikely that a tax professional would conclude that options or contracts could be exchanged under

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[27] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,838.

[28] *See generally* Prop. Reg. §1.1031(a)-3.

[29] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,838.

[30] *See* Prop. Reg. §1.1031(a)-3(b)(8) *Ex.* 8.

[31] *See* Prop. Reg. §1.1031(a)-3(b)(5) *Ex.* 5, §1.1031(a)-3(b)(6) *Ex.* 6.

[32] *See* Prop. Reg. §1.1031(a)-3(b)(5) *Ex.* 5.

[33] See Prop. Reg. §1.1031(a)-3(b)(6) *Ex.* 6.

[34] *See* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,838.

[35] *See generally* Prop. Reg. §1.1031(a)-3.

[36] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,836.

[37] *See, e.g.*, Reg. §1.1031(a)-1(b). *See also* H.R. Rep. No. 115-466, 395 115th Cong., 1st Sess. (Dec. 15, 2017) (Conf. Rep.); Joint Comm. on Taxation, General Explanation Of Public Law 115–97, JCS-1-18, 183, 115th Cong., 2d Sess. (Dec. 2018).

[38] Reg. §1.1031(a)-1(b).

[39] *See, e.g.*, *Starker v. United States*, 602 F.2d 1341, 1351 (9th Cir. 1979).

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§1031.[40] The proposed regulations do not address whether contracts are interests in real property, although the list of interests in real property includes call options. It is possible that at least certain contracts are meant to be included in the ''similar interests'' catch-all category at the end of the list of interests in real property.

A call option creates a unilateral right: the seller is compelled to sell, but the purchaser is not compelled to purchase. A contract creates bilateral rights: Both seller and purchaser are required to perform. The latter — where both parties were compelled to complete the transfer — would seem more like an interest in real property than the former. Contracts are often subject to contingencies, which often give the purchaser, but not the seller, a right to ''walk away'' (for example, purchaser's satisfaction upon the completion of environmental due diligence). A seller's only right to walk away may be if the purchaser fails to perform in accordance with the contract. A contract with those contingencies alone seems substantially similar to a call option. For this reason, at least certain contracts may be interests in real property (as similar interests). Nevertheless, as discussed in I.C.1., above, options and contracts may not be like kind to (and, therefore, ineligible to exchange with) fee interests.

Similar interests may also include hard-to-categorize real property rights, such as those in *Starker*, in which one of the replacement properties was nominally a contract that, essentially, granted the purchaser limited possession rights and a return on investment until the death of one of the sellers, at which time legal title and all beneficial rights passed to the purchaser.[41] The Ninth Circuit held that the contract was like kind to a fee interest in real property.[42] Additionally, similar interests may include the contract rights described in the mineral rights authority and guidance discussed in the preamble.[43]

3. Nature of Interests in Real Property

The qualifier ''apparently'' is used in I.C.1., above because of the unusual drafting of the provision listing interests in real property:

> Under paragraph (a)(5) [Intangible assets], an interest in real property of a type described in this paragraph (a)(1) [which generally defines real property], including fee ownership, co-ownership, a leasehold, an option to acquire real property, an easement, or a similar interest, is real property for purposes of section 1031 and this section.

One reading of this provisions is that the listed interests are themselves intangibles. Other than listing interests in real property[44] and with respect to intangibles,[45] the operative language of the proposed regulations does not seem to otherwise address the term interest in real property.[46] The preamble uses the term only in the context of intangibles,[47] but does not otherwise address the listed items or their relevance. Additionally, the authority and guidance that the preamble cites with respect to intangibles and interests in real property generally concern mineral rights, which appear to be in a category of real property *separate from intangibles* under the proposed regulations.[48] Notwithstanding this confusion and the peculiar drafting, the intent seems to be that the ownership of a nature different than a fee interest may be real property for purposes of §1031.[49] Among other things, it would be odd to characterize a fee interest in real property as an intangible.

A different reading of the provision is that was not properly harmonized when ''extracted'' from existing regulatory provisions.[50] There are no intangibles that are real property under the §263A definition,[51] however, that definition contains a nearly identical list of interest in real property.[52] In that context, the seeming reason to treat interests in real property as real property is to ensure that taxpayers capitalize interest expense with respect to the production of all interests in real property (rather than just fee interests).[53] Likewise, in the REIT context, there are different purposes to the term interests in real property: among other purposes, it is one of the types of permissible REIT assets.[54] The REIT regulations, in a section *separate* from the REIT definition of real property and without explicit reference to intangibles generally, define in-

[40] *Starker*, 602 F.2d 1341 at 1351 (discussed below) concerned, among other things, replacement property that was in form a contract but that granted the purchaser certain rights atypical of a bare agreement to acquire real property.

[41] *Starker*, 602 F.2d 1341 at 1351–1352.

[42] *Starker*, 602 F.2d 1341 at 1352.

[43] *See* discussion in II.A.6., below.

[44] *See* Prop. Reg. §1.1031(a)-3(a)(1).

[45] *See* Prop. Reg. §1.1031(a)-3(a)(5).

[46] *See generally* Prop. Reg. §1.1031(a)-3.

[47] *See* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,838.

[48] *See generally Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941); *Peabody Natural Resources Co. v. Commissioner*, 126 T.C. 261 (2006); Rev. Rul. 68-331. *See also* discussion at II.A.4., below.

[49] As discussed in I.C.1., above, that interest may or may not be like kind to, and therefore, eligible for exchange with, a fee interest.

[50] See discussion at I.A. above.

[51] *See generally* Reg. §1.263A-8(c).

[52] *See* Reg. §1.263A-8(c)(1).

[53] *See generally* Reg. §1.263A-8.

[54] *See* §856(c)(4)(A), §856(c)(5)(B).

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terests in real property for REIT purposes.[55] The list differs somewhat from the list under the proposed regulations. Like the proposed regulations, the REIT definition states that certain intangibles are ''real property or an interest in real property.''[56] It would seem from this statutory and regulatory structure that, for REIT purposes, intangibles may be interests in real property, but interests in real property are not necessarily intangibles.

D. Issues Related to Personal Property

1. Definition of Personal Property

By defining real property for purposes of §1031, the proposed regulations also effectively define by exclusion personal property. The preamble indicates that the proposed regulations ''distinguish'' real property from personal property,[57] even though the proposed regulations do not define personal property.[58] For the this reason and the reasons described below, it appears that there was not meant to be any ''space'' between the definition of real property and the definition (by exclusion) of personal property for purposes of §1031. That is, for §1031 purposes, property is either real property or personal property. This is important for purposes of the incidental personal property rule, discussed in II.B., below.

Prior to the TCJA, §1031(a)(2) excluded certain property from the application of §1031: (A) ''stock in trade or other property held primarily for sale;'' (B) ''stocks, bonds, or notes;'' (C) ''other securities or evidences of indebtedness or interest;'' (D) ''interests in a partnership;'' (E) ''certificates of trust or beneficial interests;'' and (F) ''choses in action.'' The TCJA struck this list and replaced it with only one type of excluded real property (''real property held primarily for sale''[59]), which was a reworking of former item (A). The legislative history indicates that the intent of the amendments to §1031 was to ''limit[the] application [of §1031] to real property that is not held primarily for sale.''[60] Additionally the legislative history seems to limit classes of property for purposes of §1031 to three: ''(1) depreciable tangible *personal* property; (2) intangible or nondepreciable *personal* property; and (3) *real* property.''[61] The Joint Committee on Taxation General Explanation (Blue Book) essentially repeats this statement.[62] The inference from the legislative history and the Blue Book is that items (B) through (F) included only personal property, and, therefore, no longer needed to be expressly excluded from the application of §1031, as limiting the application of §1031 to real property excluded those items by definition

2. Depreciation and Recapture Rules

The proposed regulations are explicit that there are different definitions of real property for §1031 purposes and depreciation purposes: Prop. Reg. §1.1031(a)-3(a)(6) provides that, ''The rules provided in this section concerning the definition of real property apply only for purposes of section 1031. No inference is intended with respect to the classification or characterization of property for other purposes of the Code, such as depreciation and sections 1245 and 1250.''[63] That provision also states that, ''For example, a structure or a portion of a structure may be section 1245 property for depreciation purposes and for determining gain under section 1245, notwithstanding that the structure or the portion of the structure is real property [for §1031 purposes].'' The language of Prop. Reg. §1.1031(a)-3(a)(6) is consistent with the idea discussed above that the definition of real property for these purposes is intended to be broader than for other purposes.[64] Interestingly, neither the REIT definition nor the §263A definition contains ''no inference'' language.[65]

This means that some property may be real property for §1031 purposes, but property other than real property for depreciation purposes. In fact, §168 and other sections regarding depreciation do not uniformly use the term ''personal property'' to refer to property other than real property.[66] For example, a taxpayer may have property that it historically depreciated as property other than real property, but which property is real property (and eligible for exchange) under §1031. Conversely, a taxpayer may acquire property in an exchange that is real property for §1031 purposes, but then later depreciate that property as property other than real property.

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[55] *See* Reg. §1.856-3(c).

[56] Reg. §1.856-10(f).

[57] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,839.

[58] *See generally* Prop. Reg. §1.1031(a)-3.

[59] §1031(a)(2).

[60] H.R. Rep. No. 115-466 at 395. *See also* JCS-1-18 at 184.

[61] H.R. Rep. No. 115-466 at 396.

[62] *See* JCS-1-18 at 183 (emphasis added).

[63] *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,838. Further, the proposed regulations would modify Reg. §1.168-8(c)(4)(i) (concerning the disposition of MACRS assets) to expressly state that the ''distinct asset'' rules of Prop. Reg. §1.1031(a)-3(a)(4) would not apply for that purpose.

[64] See I.A., above.

[65] The above-referenced §168 regulation also expressly states that the §263A definition does not apply for purpose of that §168 regulation.

[66] *See generally* §167, §168, §1245, §1250.

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Taxpayers should keep in mind, however, that the depreciation ''recapture'' rules under §1245 and §1250 continue to apply.[67] Even if a taxpayer receives no non–like-kind consideration (boot) in an exchange, that taxpayer may still have to recognize a portion of the gain realized in the exchange as ordinary income (rather than capital gain).[68] Among other situations, under §1245(b)(4), a taxpayer recognizes recapture income if it acquires in the exchange an insufficient amount of §1245 property — which generally includes non-real property and certain real property under the depreciation definition. As certain §1245 property is eligible for 100% ''bonus'' depreciation for the next few years,[69] many taxpayers will have a $0 adjusted basis in their §1245 property, exacerbating this issue.

As an aside, bonus depreciation has blunted the effect of the elimination of the application of §1031 to personal property. However, whereas the repeal of the application of §1031 to personal property was permanent, bonus depreciation phases out by the end of 2026.[70]

II. GENERAL SUMMARY AND ANALYSIS

A. Proposed Definition of Real Property (Prop. Reg. §1.1031(a)-3)

1. In General

Prop. Reg. §1.1031(a)-3(a) categorizes real property into: (i) land; (ii) ''improvements to land;'' (iii) ''unsevered natural products of land;'' (iv) ''water and air space superjacent to land;'' and (v) certain intangibles. As discussed below, the REIT definition[71] and the §263A definition[72] vary in their categorization of real property. Generally, local law definitions do not control for these purposes.[73] The same is true in the REIT definition.[74] However, the proposed regulations provide definitions or analytical frameworks for only some of the categories of real property.

With respect to land and improvements to land, the real property analysis is done at the level of a discrete unit, known as a ''distinct asset.''[75] As described herein, depending on the distinct asset, it may be essentially *per se* real property or may require a further facts-and-circumstances analysis to determine its status.[76]

Interestingly, none of unsevered natural products, superjacent water and air space, and intangibles requires a distinct asset analysis.[77] Does this mean that if one of those assets is transferred in connection with the transfer of land or an improvement to land, that asset is *per se* real property? What if one of those assets has historically been an asset separate from the land or improvement to land on the tax-basis balance sheet of the transferor? One benign explanation for this may be when this provision was imported from the REIT definition,[78] certain conforming changes were not made: In the REIT definition, land includes unsevered natural products of land and superjacent water and air space.[79] However, the distinct asset analysis in both the proposed regulations[80] and the REIT definition omits intangibles.[81]

2. Land

The proposed regulations do not define land.[82] As mentioned above, land must be analyzed as a distinct asset, separate from any improvements (or, perhaps, any other property)[83] with which it is transferred.[84] However, land itself is *per se* real property.[85]

As mentioned above, under the REIT definition, unsevered natural products of land and water and air space superjacent to land are (part of) land, rather than separate categories of real property.[86]

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[67] *See* Prop. Reg. §1.1031(a)-3(a)(6).

[68] *See generally* §1245, §1250. *See also* §1(h)(6) (regarding ''unrecaptured §1250 gain'').

[69] *See* §168(a) (generally providing for depreciation deductions under §167), §168(k) (bonus depreciation, generally), §1245(a)(3) (including certain property subject to the allowance for depreciation under §167 in the definition of §1245 property).

[70] *See generally* §168(k).

[71] Reg. §1.856-10(b).

[72] Reg. §1.263A-8(c)(1).

[73] Prop. Reg. §1.1031(a)-3(a)(1). *See also* Statutory Limitations on Like-Kind Exchanges, 85. Fed. Reg. 35,837. See II.A.6., below, for discussion on the exception to this rule for ''shares in a mutual ditch, reservoir, or irrigation company.''

[74] Reg. §1.856-10(b).

[75] *See generally* Prop. Reg. §1.1031(a)-3(a)(4). *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[76] This framework borrows largely from the REIT definition. *See generally* Reg. §1.856-10(d), Reg. §1.856-10(e).

[77] *See generally* Prop. Reg. §1.1031(a)-3(a)(4). *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[78] *See* Reg. §1.856-10(e).

[79] *See* Reg. §1.856-10(c).

[80] *See* Reg. §1.1031(a)-3(a)(4).

[81] *See* Reg. §1.856-10(e).

[82] *See generally* Prop. Reg. §1.1031(a)-3(a).

[83] See discussion in II.A.1. above.

[84] *See generally* Prop. Reg. §1.1031(a)-3(a)(4). *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[85] Prop. Reg. §1.1031(a)-3(a)(1).

[86] *See* Reg. §1.856-10(c).

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3. Improvements to Land

a. In General and Distinct Assets

Improvements to land include ''inherently permanent structures'' and their ''structural components.''[87]

As mentioned in II.A.1., above, the analysis as to whether property is real property is done at the level of discrete unit of property known as a distinct asset.[88] As described in more detail in II.A.3.b., and II.A.c., below, certain inherently permanent structures and structural components are *per se* distinct assets.[89] However, ''separately identifiable item[s] of property'' that are not *per se* distinct assets must be analyzed under a facts and circumstances test, including mandatory consideration of the following factors:[90]

> (a) ''Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;''[91]
>
> (b) ''Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;''[92]
>
> (c) ''Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part;''[93]
>
> (d) ''Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.''[94]

The preamble adds that ''no one factor is determinative.''[95] These factors are identical to the analogous factors in the REIT definition.[96] The proposed regulations do not include any examples that apply this test.[97]

b. Inherently Permanent Structures

i. In General and Permanent Affixation

An inherently permanent structure is (1) a distinct asset (2) that is a ''building'' or ''other structure'' (''other inherently permanent structure''), (3) that ''is permanently affixed to real property,'' and (4) ''that will ordinarily remain affixed for an indefinite period of time.''[98]

Requirements (3) and (4) seem to comprise a single ''permanent affixation'' requirement, as the definitions of buildings and other inherently permeant structures use the phrase ''permanently affixed'' without reference to the duration of the affixation.[99] An example references the intended ''indefinite duration'' of the affixation of a sculpture, but in that context, the statement regarding duration appears to exist in order to satisfy one of the factors under the test for other inherently permanent structures, described in II.A.3.b.ii, below, rather than to address the permanent affixation requirement.[100] The indefinite duration concept combines elements from the REIT definition and from the §263A definition.[101]

The definition of other inherently permanent structures (but not the definition of buildings) states that permanent ''[a]ffixation to real property may be accomplished by weight alone.''[102] An identical statement exists in the §263A definition with respect to (other) inherently permanent structures.[103] However, in the §263A definition, buildings are *per se* real property, and, therefore, the affixation-by-weight principle is not relevant to them.[104] Additionally, similar language also exists in the REIT definition, but there expressly applies to both buildings and other inherently permanent structures.[105] It would seem odd, therefore, that the affixation-by-weight principle was not meant to apply to buildings as well in the §1031 context. Query whether the same principle makes sense in the context of structural components as discussed in II.A.3.c., below.

ii. Buildings

A building is defined as ''any structure or edifice enclosing a space within its walls, and covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space.''[106] This definition com-

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[87] Prop. Reg. §1.1031(a)-3(a)(2)(ii).

[88] *See generally* Prop. Reg. §1.1031(a)-3(a)(4).

[89] *See* Prop. Reg. §1.1031(a)-3(a)(4)(i) (distinct assets in general), Prop. Reg. §1.1031(a)-3(a)(2)(ii)(B) (buildings), Prop. Reg. §1.1031(a)-3(a)(2)(ii)(C) (non-building inherently permanent structures), and Prop. Reg. §1.1031(a)-3(a)(2)(iii)(B) (structural components).

[90] Prop. Reg. §1.1031(a)-3(a)(4)(ii).

[91] Prop. Reg. §1.1031(a)-3(a)(4)(ii)(A).

[92] Prop. Reg. §1.1031(a)-3(a)(4)(ii)(B).

[93] Prop. Reg. §1.1031(a)-3(a)(4)(ii)(C).

[94] Prop. Reg. §1.1031(a)-3(a)(4)(ii)(D).

[95] *See* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[96] *See* Reg. §1.856-10(e)(2). *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[97] *See generally* Prop. Reg. §1.1031(a)-3(b).

[98] *See* Prop. Reg. §1.1031(a)-3(a)(2)(ii).

[99] *See* Prop. Reg. §1.1031(a)-3(a)(2)(i)(B) and Prop. Reg.§1.1031(a)-3(a)(2)(i)(C).

[100] Prop. Reg. §1.1031(a)-3(b)(3) *Ex. 3*.

[101] *See* Reg. §1.856-10(d)(2)(i) and Reg. §1.263A-8(c)(3).

[102] Prop. Reg. §1.1031(a)-3(a)(2)(i)(C).

[103] *See* Reg. §1.263A-8(c)(3).

[104] Reg. §1.263A-8(c)(1).

[105] Reg. §1.856-10(d)(2).

[106] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(B).

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bines elements from the REIT definition and from the definition for purposes of former §38.[107]

The following are *per se* distinct assets and, if permanently affixed, *per se* buildings (and, therefore, real property): ''[h]ouses, apartments, hotels, motels, enclosed stadiums and arenas, enclosed shopping malls, factories and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores.''[108] This list is essentially identical to the analogous list in the REIT definition.[109]

iii. Other Inherently Permanent Structures

Unlike the REIT definition,[110] the proposed regulations do not offer a general definition of other inherently permanent structure.[111] This appears to be, in part, due to lack of distinction between active functions and passive functions in the proposed regulations discussed in II.A.3.d., below.

As with buildings, the proposed regulations offer a list of distinct assets that are *per se* other inherently permanent structures (and, therefore, real property) if permanently affixed: ''In-ground swimming pools; roads; bridges; tunnels; paved parking areas, parking facilities, and other pavements; special foundations; stationary wharves and docks; fences; inherently permanent advertising displays for which an election under section 1033(g)(3) is in effect; inherently permanent outdoor lighting facilities; railroad tracks and signals; telephone poles; power generation and transmission facilities; permanently installed telecommunications cables; microwave transmission, cell, broadcasting, and electric transmission towers; oil and gas pipelines; offshore drilling platforms, derricks, oil and gas storage tanks; grain storage bins and silos; and enclosed transportation stations and terminals.''[112] This list is similar to the analogous list in the REIT definition.[113]

In the event that a distinct asset is not a *per se* other inherently permanent structure, the proposed regulations provide that its status as an inherently permanent structure is determined under certain factors:

(1) ''The manner in which the distinct asset is affixed to real property;''[114]

(2) ''Whether the distinct asset is designed to be removed or to remain in place;''[115]

(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;''[116]

(4) ''Any circumstances that suggest the expected period of affixation is not indefinite;''[117] and

(5) ''The time and expense required to move the distinct asset.''[118]

These factors are nearly identical to the analogous factors in the REIT definition.[119] However, in the REIT definition, the test of whether a distinct asset is an inherently permanent structure takes into account ''all of the facts and circumstances,'' although with the factors essentially listed above as mandatory considerations.[120] In this way, the REIT definition of inherently permanent structure is similar to the distinct asset test under the proposed regulations discussed in II.A.3.a., above.[121] However, there is apparently no such all-facts-and-circumstances requirement in the case of the other inherently permanent structure test under the proposed regulations;[122] rather, it seems that the only considerations are to be the factors listed above.

The factors largely focus on the nature of the affixation of the distinct asset to (other) real property. This may render the permanent affixation requirement somewhat duplicative. The examples underscore the emphasis on *permanent* affixation. One example (mentioned in II.A.3.b.i. above) concerns an indoor sculpture, which is determined to be an inherently permanent structure not only because of the time and expense required to move it, but also because it was intended to remain indefinitely.[123] In another example, bus shelters are determined not to be inherently permanent structures, in part, because they are intended to be moved from time to time.[124] The pro-

[107] *See* Reg. §1.856-10 (REIT definition) and Reg. §1.48-1(e) (former §38 definition). *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[108] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(B).

[109] *See* Reg. §1.856-10(d)(2)(ii)(B).

[110] Reg. §1.856-10(d)(2)(iii)(A).

[111] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(C).

[112] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(C).

[113] *See* Reg. §1.856-10(d)(2)(iii)(B).

[114] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(C)(1).

[115] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(C)(2).

[116] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(C)(3).

[117] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(C)(4).

[118] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(C)(5).

[119] *See* Reg. §1.856-10(d)(2)(iv). *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[120] Reg. §1.856-10(d)(2)(iv).

[121] Prop. Reg. §1.1031(a)-3(a)(4)(ii).

[122] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(C).

[123] Prop. Reg. §1.1031(a)-3(b)(3) *Ex.* 3.

[124] Prop. Reg. §1.1031(a)-3(b)(4) *Ex.* 4.

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posed regulations largely borrow these examples from the REIT definition.[125]

c. Structural Components

The proposed regulations generally define a structural component as (a) ''any distinct asset'' (b) ''that is a constituent part of, and integrated into, an inherently permanent structure'' (c) ''if the taxpayer holds its interest in the structural component together with a real property interest in the space in the inherently permanent structure served by the structural component.''[126] The proposed regulations are explicit that certain tenant improvements may be structural components.[127] However, raw building materials (for example, ''nails, paint, and windowpanes'') are seemingly not real property until they are installed.[128] Interestingly, customization of the distinct asset is not relevant to this analysis,[129] even though customization may make a distinct asset useless for any real property other than the one for which it was designed.

This definition of structural components largely borrows from the analogous REIT definition.[130] However, unlike the REIT definition,[131] there is no distinction between active and passive functions, which distinction the preamble indicates was not relevant in pre-TCJA authority under §1031.[132]

Although the distinct asset analysis largely looks to discrete units of property, in the structural component context, ''[i]f interconnected assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as *one distinct asset*.''[133]

The proposed regulations provide a list of distinct assets that are *per se* structural components (and, therefore, real property) if those components are ''constituent part of, and integrated into, an inherently permanent structure;'' ''Walls; partitions; doors; wiring; plumbing systems; central air conditioning and heating systems; pipes and ducts; elevators and escalators; floors; ceilings; permanent coverings of walls, floors, and ceilings; insulation; chimneys; fire suppression systems, including sprinkler systems and fire alarms; fire escapes; security systems; humidity control systems; and other similar property.''[134] This list is similar to the analogous list in the REIT definition.[135]

In the event that a distinct asset is not a *per se* structural component, the proposed regulations provide that its statutes as a structural component is determined under certain factors:

> (a) ''The manner, time, and expense of installing and removing the component;''[136]
>
> (b) ''Whether the component is designed to be moved;''[137]
>
> (c) ''The damage that removal of the component would cause to the item itself or to the inherently permanent structure to which it is affixed;''[138] and
>
> (d) ''Whether the component is installed during construction of the inherently permanent structure.''[139]

Although these four factors are nearly identical to four of the analogous factors in the REIT definition, the REIT definition contains four additional factors (whether the component: ''serves a utility-like function;'' ''serves . . . in its passive function;'' ''produces income from consideration for the use or occupancy of space;'' and ''will remain if the tenant vacates the premises.'').[140] It may be that the ''utility,'' ''passive,'' and ''use or occupancy of space'' factors are not relevant here as the special rules for machinery, discussed in II.A.3.d., below, essentially address them. Treasury and the IRS likely deleted the ''tenant'' factor as a taxpayer may use property acquired in an exchange for its own investment or trade or business, and not necessarily lease it to a tenant.

As is the case with respect to inherently permanent structures, in the REIT definition, the test of whether a distinct asset is a structural component takes into account ''all of the facts and circumstances,'' although with the factors essentially listed above as mandatory considerations.[141] However, there is apparently no such all-facts-and-circumstances requirement in the case of the structural component test under the pro-

[125] *See* Reg. §1.856-10(g) *Exs.* 3, 4.

[126] Prop. Reg. §1.1031(a)-3(a)(2)(iii)(A).

[127] Prop. Reg. §1.1031(a)-3(a)(2)(iii)(A).

[128] *See* Prop. Reg. §1.1031(a)-3(a)(2)(iii)(A).

[129] Prop. Reg. §1.1031(a)-3(a)(2)(iii)(A).

[130] *See* §1.856-10(d)(3).

[131] *See* Reg. §1.856-10(d)(3)(i).

[132] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837. See discussion in I.B., above about the active–passive function distinction in generally.

[133] Prop. Reg. §1.1031(a)-3(a)(2)(iii)(A) (emphasis added).

[134] Prop. Reg. §1.1031(a)-3(a)(2)(iii)(B).

[135] Reg. §1.856-10(d)(3)(ii).

[136] Prop. Reg. §1.1031(a)-3(a)(2)(iii)(B)(1).

[137] Prop. Reg. §1.1031(a)-3(a)(2)(iii)(B)(2).

[138] Prop. Reg. §1.1031(a)-3(a)(2)(iii)(B)(3).

[139] Prop. Reg. §1.1031(a)-3(a)(2)(iii)(B)(4).

[140] Reg. §1.856-10(d)(3)(iii).

[141] Reg. §1.856-10(d)(3)(iii).

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posed regulations;[142] rather, it seems that the only considerations are to be the factors listed above.

d. Machinery

The proposed regulations give special consideration to machinery (and equipment), which is generally not an inherently permanent structure.[143] However, machinery may be real property if it is (a) ''in the nature of . . . a structural component,'' (b) ''serves [an] inherently permanent structure,'' and (c) ''does not produce or contribute to the production of income other than for the use or occupancy of space.'' This rule is similar to a rule in the §263A definition, except that the §263A definition does not omit machinery that produces income other than for the use or occupancy of space.[144] The REIT definition apparently treats machinery as *per se* not real property, by reason of its ''active'' function.[145] As discussed in I.B., above, the rules regarding machinery are one of the few places in the proposed regulations that seemingly distinguish between active functions and passive functions of property.

4. Unsevered Natural Products of Land

Prop. Reg. §1.1031(a)-3(a)(3) provides that ''Unsevered natural products of land, including growing crops, plants, and timber; mines; wells; and other natural deposits, generally are treated as real property . . . .''[146] That provision continues, ''Natural products and deposits, such as crops, timber, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land.'' Prop. Reg. §1.1031(a)-3(b)(1) *Ex.* 1 further provides that ''Storage of harvested fruit upon or within real property does not cause the harvested fruit to be real property.'' The proposed regulations borrow this example from the REIT definition.[147] Presumably, the same principle applies to other severed products.

It is not clear why each of the two sentences of Prop. Reg. §1.1031(a)-3(a)(3) contains a separate list of natural products, which list partially overlaps with the other list. However, a natural product apparently included if it is in one list or the other. It is also not clear how the inclusion of ''water'' in the lists of natural products is meant to interact with real property that is ''water . . . space superjacent to land,'' which the proposed regulations do not otherwise define.[148] The proposed regulations also do not indicate what exceptions may apply to the rule that unsevered natural products are ''generally'' real property.

The proposed regulations largely borrow the definition of natural products from the REIT definition; however, as mentioned above, for purposes of the REIT definition, natural products are considered land, rather than an asset separate from it.[149] In contrast, under the §263A definition, natural products (with a similar definition)[150] are real property generally, rather than land specifically.[151]

5. Water and Air Space Superjacent to Land

The proposed regulations do not define ''water and air space superjacent to land'' or even of ''superjacent.''[152] In the case of water (but not air) there is one example (which the proposed regulations more or less borrow from the REIT definition),[153] which states that ''boat slips . . . are water space superjacent to land and thus are real property.''[154] Confusingly, boat slips would seem to be adjacent to land.

As is the case with respect to natural products, and as mentioned above, under the REIT definition, water and air space superjacent to land are considered land, rather than an asset separate from it.[155] Also the §263A definition makes no reference to water and air space.

It is not clear whether air space superjacent to land is meant to include certain development rights: Frequently, local land use laws permit the owner of land that has been improved to less than its maximum legal size to sell the ''unused'' portion of those ''as of right'' development rights to the owner of adjacent land. That purchasing owner could then use those rights to construct a larger building on the adjacent land.

6. Intangibles

Subparagraph (i) of Prop. Reg. §1.1031(a)-3(a)(5) includes in the definition of real property an intangible ''[t]o the extent'' it (a) ''derives its value from real property or an interest in real property,'' (b) ''is inseparable from that real property or interest in real property,'' and (c) ''does not produce or contribute to the production of income other than consideration for the use or occupancy of space.'' That provision also

[142] Prop. Reg. §1.1031(a)-3(a)(2)(iii)(B).

[143] Prop. Reg. §1.1031(a)-3(a)(2)(ii)(D).

[144] Reg. §1.263A-8(c)(4).

[145] Reg. §1.856-10(d)(2)(i).

[146] Emphasis added.

[147] Reg. §1.856-10(g) *Ex.* 1.

[148] *See generally* Prop. Reg. §1.1031(a)-3(a).

[149] Reg. §1.856-10(c). *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[150] Reg. §1.263A-8(c)(2). *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

[151] Reg. §1.263A-8(c)(1).

[152] Prop. Reg. §1.1031(a)-3(a).

[153] *See* Reg. §1.856-10(g) *Ex.* 2.

[154] Prop. Reg. §1.1031(a)-3(b)(2) *Ex.* 2 (emphasis added).

[155] Reg. §1.856-10(c). *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,837.

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includes in the definition of real property ''shares in a mutual ditch, reservoir, or irrigation company'' to the extent that those shares are real property under local law.[156]

Subparagraph (ii) creates a special rule for ''license[s], permit[s], or other similar right[s]'' (collectively, a ''license''). A license is generally real property if it ''is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold or easement.'' However, that provision distinguishes a license ''to engage in or operate a business on real property,'' which is generally not real property if it ''produces or contributes to the production of income other than consideration for the use and occupancy of space.''

The proposed regulations largely borrow this definition of included intangibles from the REIT definition, except that in the REIT definition certain GAAP intangibles are considered real property, but shares of mutual ditch, reservoir, or irrigation companies are not.[157] The §263A definition does not include intangibles.[158]

Other than licenses, the operative language of the proposed regulations does not address what other kinds of intangibles could be considered to be real property. The preamble references previous authority and guidance regarding pre-TCJA intangibles that were real property for §1031 purposes.[159] However, that authority and guidance generally relates to mineral rights (which would seem to be unsevered natural products, discussed in II.A.4., above) and certain contract rights with respect to mineral rights,[160] muddying with waters between an intangible that is treated as real property and an interest in real property which was discussed in I.C., above.

To the extent that development rights are not air space superjacent to land,[161] it is not clear if they would be intangibles that are considered real property. Query whether if those rights are transferable means that they necessarily are not ''inseparable from real property,'' and therefore not intangibles that are treated as real property.

B. "Safe Harbor" Exchanges (Reg. §1.1031(k)-1)

The proposed regulations address a potential technical issue the TCJA created regarding the acquisition of personal property incidental to real property pursuant to an exchange under a frequently used safe harbor.

In general, Reg. §1.1031(k)-1 provides guidance for ''deferred'' exchanges,[162] which, in this context, refers to the non-simultaneous nature of the exchange, as opposed to the deferral of gain recognition. Section 1031(a)(3) provides that taxpayers generally may identify potential replacement property within 45 days of the disposition of their relinquished property, and acquire replacement property within 180 days of such disposition.

Reg. §1.1031(k)-1(g)(4) generally provides a safe harbor for the use of a ''qualified intermediary'' (QI), a strawman with whom the taxpayer is considered to exchange property. In a standard deferred exchange, the QI receives the net proceeds of the sale of the relinquished property, and then uses those proceeds to acquire replacement property on behalf of the taxpayer.[163] The essential virtue of the safe harbor is that the taxpayer will not be considered to be in receipt of the cash (rather than replacement property) that the QI holds on its behalf,[164] which would cause the taxpayer to recognize gain.[165] Nearly all exchanges today rely on the QI safe harbor.

Among other restrictions on the QI safe harbor, Reg. §1.1031(k)-1(g)(6) provides for certain limitations (the ''(g)(6) limitations'') on a QI's use of funds held on behalf of a taxpayer.[166] In general, the (g)(6) limitations provide that ''the taxpayer [must have] no rights . . . to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.''[167] Reg. §1.1031(k)-1(g)(7) provides for certain items that may be disregarded when applying the (g)(6) limitations (the ''(g)(7) exceptions''), specifically (i) ''[i]tems that a seller may receive as a consequence of the disposition of property and that are not included in the amount realized from the disposition of property (e.g., prorated rents)'' and (ii) ''[t]ransactional items that relate to the disposition of the relinquished property or to the acquisition of the replacement property and appear under local standards in the typical closing statements as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes,

[156] Prop. Reg. §1.1031(a)-3(a)(5)(i).

[157] Reg. §1.856-10(f).

[158] *See generally* 1.263-A(8)(c).

[159] Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,838.

[160] *See generally Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941); *Peabody Natural Resources Co. v. Commissioner*, 126 T.C. 261 (2006); Rev. Rul. 68-331.

[161] See discussion in II.A.5., above.

[162] *See generally* T.D. 8346, 56 Fed. Reg. 19,937 (May 1, 1991).

[163] *See generally* Reg. §1.1031(k)-1(g)(4)(iii)(B).

[164] *See generally* Reg. §1.1031(k)-1(g)(4)(i).

[165] *See generally* Reg. §1.1031(k)-1(f)(1).

[166] *See* Reg. §1.1031(k)-1(g)(4)(ii) (which incorporates the (g)(6) limitations by reference).

[167] Reg. §1.1031(k)-1(g)(6)(i). *See also* Reg. §1.1031(k)-1(g)(6)(ii), Reg. §1.1031(k)-1(g)(6)(iii) (providing exceptions not relevant here).

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and title company fees).'' The (g)(6) limitations and the (g)(7) exceptions also apply to the safe harbor under Reg. §1.1031(k)-1(g)(3), for qualified escrow accounts and qualified trusts. However, as a practical matter, that safe harbor is seldom without the simultaneous use of the QI safe harbor.

After the TCJA, it was not clear whether there would be a violation of the (g)(6) limitations if a QI used funds it held on behalf of taxpayer to acquire personal property (to which §1031 no longer applied), even if that personal property was incidental to the acquisition of real property.[168] To address this issue, the proposed regulations added a new (g)(7) exception (the ''incidental personal property rule'') for ''personal property that is incidental to real property acquired in an exchange,'' which includes personal property if:

> (A) In standard commercial transactions, the personal property is typically transferred together with the real property; and
>
> (B) The aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property.[169]

Treasury and the IRS modeled the incidental personal property rule (including the 15% threshold) after a similar exception in the rules for the identification of potential replacement property.[170]

To be clear, a taxpayer will still have received boot in the form of the incidental personal property. However, the taxpayer will not have violated the (g)(6) limitations, and will remain in the QI safe harbor. For example, suppose, in an exchange under the QI safe harbor, a taxpayer exchanges vacant land worth $100x (with effectively zero dollar basis) for an office building worth $97x and incidental personal property in the form of lobby furniture worth $3x.[171] The taxpayer will have received $3x in boot in the exchange, with respect to which taxpayer must recognize gain.[172] However, by operation of the incidental personal property rule, the taxpayer will have not violated the QI safe harbor.[173]

III. CONCLUSION

The proposed regulations set forth a robust definition of real property for purposes of §1031. Certain concepts ''borrowed'' from regulations under other parts of the I.R.C. — such as the characterization of interests in real property and intangibles — need to be further conformed for this context. Additionally, clarity is needed regarding the relevance of the function of property (active or passive) (with respect to which Treasury and the IRS have requested insight). However, with these clarifications, the proposed regulations would provide comprehensive guidance for taxpayers in determining the status of real property.

[168] *See* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,838–35,839.

[169] Prop. Reg. §1.1031(k)-1(g)(7)(iii).

[170] *See* Reg. §1.1031(k)-1(c)(5)(i). *See also* Statutory Limitations on Like-Kind Exchanges, 85 Fed. Reg. 35,839.

[171] *See also* Prop. Reg. §1.1031(k)-1(g)(8)(vi) *Ex.* 6.

[172] *See generally* §1031(b).

[173] *See* Prop. Reg. §1.1031(k)-1(g)(7)(iii).

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Gluck v. Commissioner – A Cautionary Lesson for Real Estate Investors Claiming Entitlement to Like-Kind Exchange Treatment

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The U.S. Tax Court recently issued Memorandum Decision in Docket No. 3435-19, *Laurence Gluck and Sandra Prusock v. Commissioner*[1] (*Gluck*). Central among the issues before the Tax Court in this Memorandum decision was the petitioners' entitlement to like-kind exchange treatment under §1031[2] to defer capital gains realized upon a 2012 sale of a condominium unit that they owned in New York City. Beyond this issue, however, *Gluck* addresses several interesting questions appurtenant to real estate investors: the Tax Court's jurisdiction over delinquency cases that involve positions contradictory to a Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership's filed return; the distinction between computational and factual partnership items; the duties of a partner to contest partnership items under §6662(a) as reported by a TEFRA partnership; whether the Tax Court has jurisdiction over penalties assessed against an individual taxpayer as a result of a computational item adjustment; and what due diligence is required by real estate investors when taking tax return positions.

This article analyzes *Gluck* and examines the important lessons inherent in the case for partners in real estate investment partnerships. It also considers how taxpayers might avoid a factual scenario similar to that in *Gluck*, where the Court ultimately denied petitioners' request for redetermination of the IRS disallowance of their claimed §1031 like-kind exchange treatment on the sale of a real estate asset.

BACKGROUND

Laurence Gluck is a true denizen of New York City. Born and raised in the Bronx, and a graduate of Queens College and St. John's University School of Law, Mr. Gluck left his practice as a litigation associate at Proskauer, Rose, Goetz, & Mendelssohn in the early 1980s to become a real estate attorney at another, smaller New York City law firm.[3] It was during his tenure as a real estate specialist that Mr. Gluck purchased his first investment property and, in 1985, formed a property management company with one of his law partners called Stellar Management.[4] When the real estate market in the United States collapsed in 1998, Mr. Gluck dissolved Stellar Management and caused this partnership to distribute the residential properties previously held by it, which he continued to own and manage under the Stellar Management name.[5] Since the early 2000s, Mr. Gluck purchased dozens of mostly aging residential buildings in New York City under soon-to-expire housing subsidies.[6] He typically renovated these properties and, as the subsidies expired, replaced the rent-regulated tenants with market rate tenants.

In the past two decades, his company, Stellar Management, acquired over 24,000 apartment units in New York, Chicago, Washington, D.C., and San Francisco.[7]

THE 2012 TRANSACTION

Mr. Gluck and his wife, Dr. Sandra Prusock Gluck (petitioners), owned a condominium unit in New York City.[8] It appears that petitioners owned this property in their personal capacities and not as a part of Stellar Management. On June 30, 2012, Mr. Gluck sold the condominium unit for $10,214,000.[9] Wanting to defer the capital gain realized on this sale, he decided to do a §1031 like-kind exchange.

Mr. Gluck resolved to treat the sold condominium unit as a relinquished property and began his search for a replacement property that would qualify for like-kind exchange treatment under §1031, in order to defer the capital gain realized on the condominium unit sale.[10] He also deposited the proceeds from the condominium unit sale into a qualified escrow account

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[1] T.C. Memo 2020-66.

[2] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[3] Laurence Gluck Wikipedia (2019), *available at* https://en.wikipedia.org/wiki/Laurence_Gluck.

[4] Laurence Gluck Wikipedia (2019).

[5] Laurence Gluck Wikipedia (2019).

[6] Laurence Gluck Wikipedia (2019).

[7] Laurence Gluck Wikipedia (2019).

[8] T.C. Memo 2020-66 at 3.

[9] T.C. Memo 2020-66 at 3.

[10] T.C. Memo 2020-66 at 3.

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with a partnership—Royal Abstract Deferred, LLC — that acted as his escrow agent.[11]

On September 5, 2012, 67 days after selling the condominium unit, Mr. Gluck identified a possible replacement property — a rental apartment building located in Manhattan at 145 East 74th Street (Identified Property).[12] Mr. Gluck then formed 145 East 74th Owner, LLC (Gluck LLC), a single-member liability company, which was treated as a disregarded entity for federal income tax purposes.[13]

On November 29, 2012, 143 days after selling the condominium unit, Mr. Gluck executed a contract (Purchase Contract I) pursuant to which he would acquire an undivided 12.5% tenant in common interest in the Identified Property (including the land and the building) in exchange for a contribution of $4,625,000.[14] This contract listed the purchaser of the Identified Property as Gluck LLC and the seller as the estate of Arthur D. Emil. On that same day, November 29, 2012, Mr. Gluck entered into another purchase contract (Purchase Contract II) with terms substantially similar to those of Purchase Contract I.[15] Purchase Contract II was entered into by Mr. Gluck and Judy Tenney and, as a result of the same, Gluck LLC acquired another 12.5% tenant in common interest from Ms. Tenney in the Identified Property.[16] With the execution of Purchase Contracts I and II, and because of an earlier, unrelated, acquisition of an additional 25% interest in the Identified Property from another family, Gluck LLC held a 50% interest in the Identified Property.[17]

Attached to Purchase Contract I was a tenancy in common agreement (TIC Agreement). The TIC Agreement was executed on July 1, 1992, by those families who, at that time, held interests in the apartment building (e.g., the Identified Property).[18] This TIC Agreement memorialized the families' intent to ''maintain, manage and operate'' the Identified Property, and ''to lease the Identified Property ''in its entirety to a person or entity.''[19] This TIC Agreement also provided that the venture would have an office located at ''Eugene M. Grant & Co.'' on Park Avenue in Manhattan.[20]

On December 7, 2012, 160 days after selling the condominium unit, Gluck LLC assigned to Royal Abstract its rights under Purchase Contract I and Purchase Contract II.[21] This assignment agreement described the asset to be acquired by Royal Abstract as ''a 25% tenancy in common interest'' in the Identified Property.[22] Then, as the escrow agent for this transaction, Royal Abstract delivered proceeds to the sellers from Mr. Gluck's ''qualified escrow account.''

GREENBERG & PORTNOY

Greenberg & Portnoy (G&P) was a family partnership originally formed in 1962 engaged in a rental real estate business.[23] By 2012, interests in G&P had been divided and subdivided among family members and their heirs, and its mailing address was ''c/o Eugene M. Grant & Co.''[24] G&P was a partnership for federal income tax purposes and, for tax years 2011 and 2012, it filed a Form 1065, *U.S. Return of Partnership Income* (Form 1065), listing the Identified Property among its assets. Also listed on the Form 1065 for tax year 2012 was that Gluck LLC acquired an interest in G&P in that year.[25]

The Forms 1065 filed by G&P for tax years 2011 and 2012 also contained Forms 8825, *Rental Real Estate Income and Expenses of a Partnership or an S Corporation.*[26] Both of these Forms 8825 listed the sole rental asset of G&P as the property located at ''145 East 74th Street, New York, NY.''[27] Attached to the Form 1065 for tax year 2011 were Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc.* (K-1), showing that G&P had 13 partners each owning an interest in G&P in that year, including the estate of Arthur D. Emil and Judy Tenney.[28] Attached to the Form 1065 for tax year 2012 were K-1s that showed 15 partners who owned an interest in G&P at the start of 2012 and six partners who owned an interest at the end of that year.[29] Included among the partners who did not own their interests at the end of 2012 were the estate of Arthur D. Emil and Judy Tenney, and included as a partner who acquired an interest in the partnership during 2012 was Gluck LLC, who owned a 50% interest in G&P.[30]

The Tax Court record reflects that Gluck LLC received a K-1 for tax year 2012 from G&P that reported the following: a total capital contribution of

[11] T.C. Memo 2020-66 at 4.
[12] T.C. Memo 2020-66 at 4.
[13] T.C. Memo 2020-66 at 4.
[14] T.C. Memo 2020-66 at 4.
[15] T.C. Memo 2020-66 at 4.
[16] T.C. Memo 2020-66 at 5.
[17] T.C. Memo 2020-66 at 5.
[18] T.C. Memo 2020-66 at 5.
[19] T.C. Memo 2020-66 at 5.
[20] T.C. Memo 2020-66 at 5.
[21] T.C. Memo 2020-66 at 5.
[22] T.C. Memo 2020-66 at 5.
[23] T.C. Memo 2020-66 at 6.
[24] T.C. Memo 2020-66 at 6.
[25] T.C. Memo 2020-66 at 6.
[26] T.C. Memo 2020-66 at 7.
[27] T.C. Memo 2020-66 at 7.
[28] T.C. Memo 2020-66 at 7.
[29] T.C. Memo 2020-66 at 7.
[30] T.C. Memo 2020-66 at 8.

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$17,802,894, distributions of $62,500, and rental real estate income of $65,570 for its share in the partnership.[31] The record also reflects that neither Mr. nor Mrs. Gluck denied their receipt or knowledge of this K-1.[32]

G&P reported on its Forms 1065 for both 2011 and 2012 that it was a TEFRA partnership — meaning it was electing treatment under TEFRA and accordingly, the united partnership audit and litigation procedures under §6221 through §6234 applied to it.[33] G&P also reported that its tax matters partner (TMP) was Carolyn Grant and that for both 2011 and 2012 that one or more of its partners was a ''disregarded entity, a partnership [. . .], a trust, an S corporation, an estate (other than an estate of a deceased partner), or a nominee or similar person).''

PETITIONERS' 2012 INCOME TAX RETURNS AND THE IRS EXAMINATION

Mr. and Mrs. Gluck jointly filed their Form 1040, *U.S. Individual Income Tax Return*, for tax year 2012 (Form 1040), including with this Form 1040 a Form 8824, *Like-Kind Exchanges*.[34] The petitioners' Form 8824 provided that they had engaged in a like-kind exchange, described the replacement property for the same as, ''145 East 74th Street,'' and stated that the gain deferred under §1031 was $10,042,886.[35]

Petitioners did not report their distributive share of G&P's income on their 2012 Form 1040, and they did not file with the IRS Form 8082, *Notice of Inconsistent Treatment of Administrative Adjustment Request* (AAR).[36] Mr. and Mrs. Gluck's 2012 Form 1040 was selected for examination by the IRS.[37] Notably, while IRS Examination (Exam) did disallow in full the deferral of capital gain under §1031 for the full amount of capital gain realized by the couple in 2012 upon the sale of the condominium unit, IRS Examinations did not adjust the Form 1040 to include the unreported $65,570 in distributive share rental real estate income attributable to Gluck LLC (and thereby, to Mr. Gluck) for 2012.[38] The petitioners timely filed their petition for redetermination with the Tax Court (''the Petition'').[39] In response to the same, the respondent, the IRS filed a motion to dismiss for lack of jurisdiction, and the petitioners filed a motion for summary judgment, (both motions were objected to by the opposing party).[40]

PARTIES' ARGUMENTS AND THE TAX COURT'S MEMORANDUM DECISION

Respondent challenged the Tax Court's jurisdiction over the Petition on the basis that the Tax Court cannot consider certain cases where the deficiency in question arises from a TEFRA partnership issue.[41] Specifically, as respondent argued, the adjustment made to petitioners Form 1040 for 2012 was a computational adjustment pursuant to §6231(a)(6) because it disallowed the like-kind exchange treatment on the fact that the single-member LLC that Mr. Gluck formed — Gluck LLC — did not acquire a 25% interest in the Identified Property but rather, a 25% interest in the G&P partnership.[42] As respondent's disallowance of the §1031 claim was a change in the petitioners' tax liability that properly reflected G&P's treatment of a partnership item, respondent argued that it was a computational adjustment outside of the Tax Court's juridiction.[43]

In contrast to respondent's argument that the deficiency for tax year 2012 stemmed only from a computational adjustment that properly reflected the partnership's treatment of a partnership item and therefore, was outside of the scope of the Tax Court's jurisdiction, petitioners argued that there could be no partnership treatment in this case since Gluck LLC owned an interest in the Identified Property and not G&P.[44] Petitioners also argued that computational adjustments under §6321(a)(6) should be limited to numerical or mathematical operations, and that the disallowance of the §1031 treatment was also not a computational adjustment to a partnership-level item since the adjustment was only made on the petitioners' return. Finally, petitioners argued that they had no way of knowing that there were other owners who ''had filed a partnership return.''

Judge Lauber further noted that although the IRS did not initiate an audit of G&P, the adjustment made in this case — disallowance of petitioners' claim of like-kind exchange treatment of the basis that Gluck LLC owned a direct interest in the Identified Property,

[31] T.C. Memo 2020-66 at 8.
[32] T.C. Memo 2020-66 at 8.
[33] T.C. Memo 2020-66 at 8.
[34] T.C. Memo 2020-66 at 5.
[35] T.C. Memo 2020-66 at 5.
[36] T.C. Memo 2020-66 at 8.
[37] T.C. Memo 2020-66 at 8.
[38] T.C. Memo 2020-66 at 9.
[39] T.C. Memo 2020-66 at 9.
[40] T.C. Memo 2020-66 at 9.
[41] T.C. Memo 2020-66 at 9.
[42] T.C. Memo 2020-66 at 8.
[43] T.C. Memo 2020-66 at 2-3.
[44] T.C. Memo 2020-66 at 13-14.

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rather than Gluck LLC acquiring a partnership interest in G&P — was completely inconsistent with the G&P partnership return.[45] Since Gluck LLC's interest in G&P was a partnership item (e.g., the question of whether or not Gluck LLC held an interest in G&P is, itself, a partnership question), and because the position taken on the petitioners' return was completely inconsistent with the treatment that G&P reflected on the partnership's return, the Tax Court had no jurisdiction over the petitioners' case. The Tax Court notes, citing *Bedrosian v. Commissoner,* that computation items can be determined automatically once the relevant partnership item has been determined.[46] Since the partnership level item in this matter — that Gluck LLC held an interest in G&P and not in the Identified Property directly — was not in dispute, the disallowance of petitioners claimed §1031 like-kind exchange was a computational adjustment reflecting the correct ownership of the Identified Property by G&P.

Judge Lauber also noted that there were no partner-level determinations necessary in this case—that it was not relevant as to what ''Mr. Gluck's basis in the condominium unit was or his amount realized on its sale.''[47] Rather, Judge Lauber reasoned, ''once Gluck LLC is deemed to have acquired a partnership interest rather than a real estate interest, consistently (sic) with the treatment of partnership items on G&P's return, petitioners' non-entitlement to section 1031 deferral follows automatically as a matter of law. That result does not depend on any facts or circumstances particular to petitioners or Gluck LLC.''[48]

Finally, petitioners' arguments that ''it would have been impossible [. . .] to have any suspicion that certain other'' owners of the Identified Property would file a partnership return were dismissed by Judge Lauber as implausible since petitioners ''or their advisers presumably did due diligence before finalizing the decision to invest $9.25 million'' in the Identified Property. Although the Court cites to the existence in the record of annual financial statements prepared for the ''Joint Venture of Pauline Greenberg and Sophie L. Portnoy,'' the Court appears more convinced by the petitioners' admission to receiving a K-1 from G&P that showed the interest held, distributive share of net real estate income, and distributions made to Gluck LLC in 2012.

The only aspect of petitioners' Form 1040 that the Tax Court determined remained within its jurisdiction was the accuracy-related penalty assessed against the petitioners because of the disallowed gain deferral arising from their decision to claim §1031 like-kind exchange treatment.[49] The Tax Court, however, determined that accuracy-related penalty was not a partnership item. Citing *Malone v. Commissioner*, the Tax Court further held that the §6662 penalty was not a computational affected item because petitioners' liability ''hinges on factual determinations peculiar to them.''[50]

THE TAX COURT'S FOCUS ON FORM 8082

In response to petitioners' arguments that there was no partnership and therefore, the position reported on their Form 1040 should not have been disallowed, the Tax Court points out that, the petitioners ''should have filed a Form 8082 with their 2012 tax return, notifying the IRS that they believed the Schedule K-1 to be erroneous and that they were adopting a position inconsistent with it.''[51] The Tax Court supposed that had petitioners filed Form 8082, the IRS could have opened a partnership audit of G&P in an effort to determine which treatment was correct.[52] The Tax Court takes petitioners to task for not questioning the K-1 that they received from G&P and that, had they at least reached out to G&P to inquire about the K-1, they could have avoided the computational adjustment that led to the deficiency at issue in this case.

LESSONS FROM GLUCK

The disallowance of petitioners' reporting position pursuant to the §1031 Tax Court's decision in *Gluck* is not, on its own, surprising. Rather than acquiring what the petitioners' thought were several tenancy in common interests, a transaction that can be problematic for a host of reasons,[53] the petitioners acquired an interest in a tax partnership. In addition,

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[45] T.C. Memo 2020-66 at 16.

[46] T.C. 152, 158 (2015) (In *Bedrosian*, the petitioner unsuccessfully attempted to challenge disallowances of partnership deductions that had been previously determined at the partnership level).

[47] T.C. Memo 2020-66 at 18.

[48] T.C. Memo 2020-66 at 18-19.

[49] T.C. Memo 2020-66 at 24.

[50] T.C. 372, 380 (2017) (In *Malone*, the Tax Court determined that because the adjustments made to the liability reported on the petitioners' Form 1040 were computational adjustments to their tax liability to take into account the partnership items as originally reported, there were no adjustments to partnership items).

[51] T.C. Memo 2020-66 at 22.

[52] T.C. Memo 2020-66 at 22.

[53] This is because a tenancy in common might be a tax partnership, which would disqualify the identified asset as a replacement property eligible for like-kind exchange treatment under §1031. Section 761(a) defines a partnership as ''a syndicate, group, pool, joint venture, or other unincorporated organization through and by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.'' Accordingly, a tenancy in common interest that falls within the broad definition of partnership

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§1031(a)(2)(D) specifically excludes ''interests in a partnership'' from qualifying for like-kind exchange treatment under §1031. What is surprising about *Gluck* is that at least one of the petitioners involved in this case was a sophisticated real estate investor who, irrespective of the same, fell prey to a central tenant in any contemplated §1031 exchange — that is, the nature of the acquired interest.

In *Gluck*, a clue that what the petitioners may have thought they were acquiring—a tenancy in common interest—and what the Court determined that they had acquired — an interest in a partnership — were at odds were the terms of the TIC Agreement executed by the group of families who owned units in the Identified Property in 1992. This TIC Agreement, which was presumably still binding as it was attached to Purchase Contract I, provided that the ''venture'' would have an office located at a separate address in Manhattan. The TIC Agreement also memorialized the parties' intent to ''maintain, manage and operate'' the Identified Property,'' and to ''lease the [p]roperty in its entirety to a person or entity.''[54] There is no further description of what operations were contemplated by other than the lease activity.

The regulations provide that ''a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.''[55] The regulations also state that ''mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes.''[56] While it is clear that a tax partnership exists when an entity is formed as a partnership, a tenancy in common could be characterized as a partnership under the applicable regulations where, ''the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom.'' Here, there is no dispute that G&P was an entity formed as a tax partnership. It filed a Form 1065 as such and it provided its partners, including the petitioners, with Schedules K-1. However, even if G&P were not a tax partnership, it is unclear whether or not the tenancy in common interest that petitioners thought they had acquired could withstand scrutiny as a partnership, thus resulting in the Identified Property being disqualified for a §1031 like-kind exchange treatment under §1031(a)(2)(d) irrespective of G&P's existence.

The petitioners (and arguably, Mr. Gluck, given his notable experience as a real estate lawyer and real estate developer) may have known that for their planned like-kind exchange to work, any replacement property identified as part of the transaction could not be a partnership interest. While the petitioners may have been ultimately able to sustain that the tenancy in common interests held in the Identified Property did not represent anything more than mere co-ownership, the facts of *Gluck* are inconclusive on this point. Moreover, even if the petitioners were able to prevail on the argument they acquired mere co-ownership in the Identified Property, since their deficiency arose as a result of their taking a return position on their Form 1040 inconsistent with that of the Form 1065 filed by G&P, the Tax Court declined to retain jurisdiction over their argument.

The Tax Court spends a notable amount of time in *Gluck* on the petitioners' failure to file Form 8082 (as required by §6222(b)(2)), and on Form 8082 being the proper means to assert an inconsistent return reporting position on a Form 1040 contrary to that on a partnership's Form 1065 and a Schedule K-1. The Tax Court concludes that filing a Form 8082 would ''have enabled the IRS to open a partnership audit of G&P in an effort to determine which treatment was correct.''[57]

While the Tax Court does mention that ''at the very least petitioners could have contacted G&P [. . .] to express their disagreement and inquire about the next steps,'' the Court's decision may overlook certain practical considerations.[58] For example, the decision to file a Form 8082 is often subject to the relationship between the parties — both contractual and otherwise — and potential claims that could arise from such a filing. There was also no direct evidence that Pauline Greenberg or Sophie L. Portnoy were either living or known to the petitioners, that the petitioners had any contact information for G&P apart from the address on the Schedule K-1, or that they did not actually attempt to contact G&P.[59]

Notwithstanding, the Tax Court notes that it would have been reasonable to assume that petitioners knew of Ms. Greenberg and Ms. Portnoy from the financial statements, which were prepared for ''the partnership.''[60] And, the Tax Court points out that the reasonable approach for the petitioners would have been for the petitioners to notify G&P by mail that the Schedule K-1 was issued in error and ask that corrective ac-

under §761(a) and could, in fact, be a tax partnership.

[54] T.C. Memo 2020-66 at 5.

[55] Reg. §301.7701-1(a)(2).

[56] Reg. §301.7701-1(a)(2).

[57] T.C. Memo 2020-66 at 22.

[58] T.C. Memo 2020-66 at 22-23.

[59] T.C. Memo 2020-66 at 22-23. Petitioners acknowledged receipt of the Schedule K-1 at issue but there is no admission in the record that they failed to contact G&P about it.

[60] T.C. Memo 2020-66 at 22.

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tion be taken to remedy the situation.[61] The Tax Court, however, appears convinced that the Form 8082 would trigger an audit of the G&P partnership, thus allowing the question of whether or not a tax partnership existed to accordingly be resolved.[62]

Assuming that petitioners had done all the things suggested by the Tax Court — examined the underlying TIC vs. partnership issue during deal due diligence, contacted G&P when they received the Schedule K-1 and challenged the same, and filed the Form 8082 — the Court's determination appears to hinge on an audit of G&P. Since the Tax Court notes that the question of whether or not a partnership exists is a partnership-level item, irrespective of whatever the petitioners might have done or not done in this case, the issue would have only arisen had G&P's partnership return undergone examination as a result of the petitioners' filing the Form 8082. The takeaway from *Gluck* is clear — partners who disagree with a Schedule K-1 should take all reasonable steps to rectify the same, up to and including filing a Form 8082. If the issue in disagreement is a partnership-level issue, however, an audit must ensue for the partners to have a channel for relief at the Tax Court.

Finally, although the Tax Court determined that it had jurisdiction to decide whether the IRS properly applied an accuracy-related penalty under §6662 against the petitioners, it is likely that Mr. Gluck's expertise will be in central focus for the respondent going forward on this issue. Section 6664(c)(1) provides an exception to the accuracy-related penalty under §6662 where ''it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.''[63] Although Reg. §1.6664-4 provides that ''the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability,'' the regulations also emphasize the ''experience, knowledge and educations of the taxpayer.''[64] The Tax Court's decision is notably devoid of any mention of Mr. Gluck's notable career as a real estate lawyer or property developer; however, it seems unlikely that the respondent would not raise these facts in reply to any reasonable cause defense by the petitioners. In fact, the Tax Court seems ready to focus on Mr. Gluck referring to ''*Mr. Gluck's* basis in the condominium unit [and] *his* amount realized on its sale'' (emphasis added)[65] even though the condominium unit was owned and the Form 1040 reporting the like-kind exchange position was filed by Mr. Gluck and his wife jointly.

Imperatively, *Gluck* provides important lessons for partners in real estate partnerships regarding the types of issues the Tax Court retains jurisdiction over with respect to TEFRA partnership-level adjustments, the importance of filing Form 8082 in order to trigger a partnership audit, and the longstanding attention to due diligence applicable to partners who identify tenancy in common interests for acquisition in prospective like-kind exchange transactions.

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[61] T.C. Memo 2020-66 at 22.

[62] T.C. Memo 2020-66 at 22.

[63] §6664(c)(1).

[64] Reg. §1.6664-4(c)(1).

[65] T.C. Memo 2020-66 at 18.

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Amended Returns for Partnerships Leaves Unanswered Procedural Questions

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Coronavirus Aid, Relief, and Economic Security Act (CARES Act),[1] enacted on March 27, 2020, included several retroactive tax provisions designed to provide immediate access to refunds. On April 8, 2020, the IRS issued Rev. Proc. 2020-23 to make it easier for partnerships subject to the centralized partnership audit regime enacted by the Bipartisan Budget Act of 2015[2] (BBA) to claim CARES Act refunds for 2018 and 2019.

Without this relief, the only way for a BBA partnership to adjust prior year returns is to file an administrative adjustment request (AAR), which in most cases would delay the partner's refund until 2021. Under the revenue procedure, BBA partnerships have until September 30, 2020 to amend returns and Schedules K-1 for partnership returns that were filed before April 8, 2020.

To file an amended return under the revenue procedure, the partnership must use a Form 1065, *U.S. Return of Partnership Income* (Form 1065), with the "Amended Return" box checked, not the Form 1065X. The partnership must write "FILED PURSUANT TO REV PROC 2020-23" at the top of the amended return and attach a statement with each Schedule K-1 sent to its partners with the same notation. An amended return under the revenue procedure may be file electronically or on paper.

PROCEDURAL ISSUES RAISED BY AMENDED BBA PARTNERSHIP RETURNS

No additional guidance has been provided to describe how amended returns filed under the revenue procedure will be treated. Without guidance, it is unclear what procedural rules apply. Consider the following:

- **What is the authority to permit BBA partnerships to file amended returns?** Section 2.02 of Rev. Proc. 2020-23 states that the relief to file amended returns and amended Schedules K-1 is an exercise of the IRS's authority under §6031(b).[3] However, §6031(b) relates to partner statements (Schedules K-1), not partnership returns. While §6031(b) does not provide authority for amended returns under BBA, other authority, such as §7805(a), might provide that authority.
- **Do BBA procedures apply if the IRS adjusts items on the amended return?** Section 2.05 of Rev. Proc. 2020-23 states that "[a] BBA partnership that files an amended return pursuant to this revenue procedure is still subject to the centralized partnership audit procedures enacted by the BBA." However, an argument can be made that since an amended return is not contemplated under the BBA statutory regime, BBA procedures do not apply. A mere statement in a revenue procedure does not provide a strong basis for the IRS to defend a position that the amended return is subject to BBA procedures.
- **What is the period of limitations for the IRS to adjust items on amended returns?** Generally, filing an amended return does not extend the period of limitations on assessment. Section 6235 generally provides that the period for the IRS to make adjustments under BBA is three years after the later of filing a BBA partnership return or filing an AAR. How does the period of limitation for adjustment under §6235 apply (if at all) if an amended return is filed?
- **If BBA applies to amended returns, how will IRS adjustments to items reflected on the amended return be treated under BBA?** Will the adjustments reflected on the amended return be included in the notice of proposed adjustment (NOPA) or final partnership adjustment (FPA)? Will a court have jurisdiction over the adjustments reflected on the amended return in a BBA proceeding?
- **If BBA does not apply to amended returns, will there be one or two audits?** If the amended return is not subject to BBA, does that mean that the IRS must audit the entire tax year to which the amended return relates under non-centralized deficiency procedures (i.e., audit each partner separately), or would there be two audits: one under BBA for the original return and any AARs that

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[1] Pub. L. No. 116-136.

[2] Pub. L. No. 114-74.

[3] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

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were filed before the amended return and a second audit of each separate partner with respect to the adjustments made on the amended return?

- **How does a BBA partnership make further adjustment to items after filing an amended return (after September 30, 2020)?** Does the partnership file an AAR or another amended return? If the partnership is required to file an AAR, does the AAR take into account the adjustments made by the amended return?
- **How do partners take into account adjustments on the amended Schedules K-1 they receive?** Rev. Proc. 2020-23 is silent on this. It is likely that the IRS expects partners to file amended returns for the year to which the adjustments on the amended Schedule K-1 relate. However, guidance for partners would be helpful.
- **Do BBA consistency rules apply to partners receiving amended Schedules K-1?** Section 6222 requires a partner to treat partnership-related items on their return consistent with the treatment of the items on the return the partnership files. Under §6222, the IRS can use math error assessment against the partner to immediately assess any tax resulting from an inconsistent position. Reg. §301.6222-1(a)(4) provides that the partnership return includes any amendments or supplements to the return including an AAR. Section 3.03 of Rev. Proc. 2020-23 states: ''For purposes of section 6222, the amended return replaces any prior return (including any AAR filed by the partnership) for the taxable year for purposes of determining the partnership's treatment of partnership-related items.'' This language is vague and does not address math error assessment or notice of inconsistent treatment. Guidance specifically addressing a partner's inconsistent treatment would be helpful.

RECOMMENDATIONS

Legislation could solve much of the uncertainty and provide a consistent policy direction. One legislative option would be to amend §6227 to provide the IRS with regulatory authority to prescribe an alternative method for adjusting partnership-related items, including amended returns. In addition, legislation could address the following:

- A time limit for making adjustments under the alternative method;
- Whether the consistency requirement in §6222 applies to the alternative method (and if so, how);
- How partners take adjustments under the alternative method into account and procedural rules related to partners (i.e., do partners file amended returns, what is the period of limitations on assessment with respect to any tax due on the partner's return); and
- How a regulatory method for making adjustments is treated for purposes of §6232 through §6235 (assessment, collection and payment; interest and penalties; court jurisdiction; and the period for adjustment).

In the meantime, Treasury and the IRS should consider publishing regulations under BBA to address the procedural questions regarding amended returns. Regulations would provide authoritative guidance that is informed by comments from the public. While some taxpayers might still challenge IRS on the treatment of amended returns even if regulations are published, taxpayers would have certainty about the rules, and the IRS would have a stronger basis for defending its rules.

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