Current Federal Tax Developments

Week of November 30, 2020

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ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF NOVEMBER 30, 2020
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SECTION: 475
NO RELIEF GRANTED TO TAXPAYER WHO ASKED TO FILE ELECTION UNDER §475(F) LATE

Citation: PLR 202048009, 11/25/20

In PLR 202048009[1] a taxpayer asks the IRS to allow him to make a late election under §475(f)(1), a request the agency turned down.

Mark to Market Election

The mark to market election allows a trader to get around the $3,000 annual limit on net capital losses, treating the transactions as leading to ordinary income and loss. However, the taxpayer must agree to "mark to market" any securities held at year end, reporting a gain/loss based on their value at the end of the year, resetting their basis to that level at the beginning of the following year.

Since a true trader generally is working with changes in value over extremely short periods of time, traders do not tend to hold any significant number of securities overnight due to the risk of events occurring over times the markets are closed that can't be reacted to during that time. Similarly, they aren't harmed by treating gains as ordinary since a trader won't be holding the securities for a period anywhere near the one year holding period necessary to get long term capital gain treatment.

IRC §475(f)(1)(A) reads:

> (f) Election of mark to market for traders in securities or commodities
>
> (1) Traders in securities
>
> (A) In general
>
> In the case of a person who is engaged in a trade or business as a trader in securities and who elects to have this paragraph apply to such trade or business—
>
> (i) such person shall recognize gain or loss on any security held in connection with such trade or business at the close of any taxable year as if such security were sold for its fair market value on the last business day of such taxable year, and
>
> (ii) any gain or loss shall be taken into account for such taxable year.

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[1] PLR 202048009, November 25, 2020, https://www.irs.gov/pub/irs-wd/202048009.pdf (retrieved November 27, 2020)

> Proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain or loss taken into account under the preceding sentence. The Secretary may provide by regulations for the application of this subparagraph at times other than the times provided in this subparagraph.

The IRS has provided guidance on making this election in Revenue Procedure 99-17. Relevant to the letter ruling in question, the procedure has the following deadline to make the election:

> The statement must be filed not later than the due date (without regard to extensions) of the original federal income tax return for the taxable year immediately preceding the election year and must be attached either to that return or, if applicable, to a request for an extension of time to file that return.[2]

Taxpayer's Facts

In this case the taxpayer had been asking about the tax issues of a trader:

> During Date 3, Husband communicated with Accountant 1, Taxpayers' federal income tax return preparer and tax advisor, regarding potentially making a § 475(f) election. In a memorandum to file, Accountant 1 noted that he discussed with Husband in detail the requirements for qualifying as a trader eligible to make a § 475(f)(1) election. Based on Husband's claim that he was making multiple trades per day, Accountant 1 noted that it appeared that Husband qualified as a trader.[3]

In a footnote it appears the accountant did believe that the election was an option at this time:

> In his affidavit, Accountant 1 stated, "I believed at that time [Date 3] that [Husband] appeared to satisfy and meet all the requirements for a valid mark-to-market election."[4]

As is often the case, the taxpayer was losing money in this trading activity:

> Taxpayers reported having a short-term capital loss carryover in the amount of a on their Year 3 federal income tax return. Husband's stock trading generated significant additional net losses prior to the Date 4 due date for making the § 475(f)(1) election effective for Year 3. Husband continued to trade and incurred substantial additional trading losses after the election due date. Husband's largest monthly trading losses were incurred in Date 5, after the due date of the election, and approximately b percent of his net trading losses, in the

[2] Revenue Procedure 99-17, Section 5.03(1)

[3] PLR 202048009

[4] PLR 202048009

> amount of c for Year 3, also arose after the election due date. Further, Husband was unable to generate gains in Year 4 to absorb Taxpayers' capital losses. In early Year 4, Husband received a Form 1099 reporting that Husband's trading activities had generated substantial wash sale losses in the amount of d for Year 3.[5]

Now the taxpayer, staring at these large losses, apparently ran into information that told him that it was possible for a trader to deduct these losses on selling the securities in excess of $3,000. He then asked the accountant about this issue:

> On Date 6, e months after the Date 4 election due date, Husband emailed Accountant 1, asking whether it was true that a day trader can deduct more than $3,000 per year in trading losses. Accountant 1 advised Husband that there is some truth to that if Husband qualified as a trader. Accountant 1 did not inform Husband at that time that the deadline to make a § 475(f)(1) election had passed for Year 3, or otherwise inform Husband that making a timely election was required.[6]

This is the first time the facts note that the accountant appears to not have realized when this election was required to be made. As the facts go on, it's clear the accountant believed the option to make the election was still available.

> On Date 7, Husband requested Accountant 1 to do whatever was possible to reduce his federal income tax liability. More specifically, Husband communicated that he would like to deduct all of his stock losses for both Year 1 and Year 2. On Date 8, Accountant 1 emailed Husband information regarding income tax planning considerations associated with potentially making a § 475(f)(1) election. Accountant 1 described additional information that he needed to make the election for Year 2, and provided a description of the requirements for being a trader, including that a taxpayer's trading activities must be frequent, regular, and continuous. Accountant 1 indicated that he was prepared to make the election for Year 2 on Taxpayers' Year 2 federal income tax return if Husband (a) believed he met the requirements for being a trader, (b) was willing to bear the risk of making the election, and (c) provided the additional information needed to make the election.[7]

In a footnote, the letter notes that the taxpayer claimed the accountant had committed to making just such an election:

> Husband asserts that Accountant 1 made a commitment in the Date 8 email to make a § 475(f)(1) election effective for Year 3 on Taxpayers' behalf.[8]

However, now another accountant with the same firm comes into the mix (referred to as "Accountant 1" in the ruling) and states that the taxpayer has missed the date to

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[5] PLR 202048009

[6] PLR 202048009

[7] PLR 202048009

[8] PLR 202048009

make the election—and also claims the other accountant had told the taxpayer about this date:

> Taxpayers' Year 2 and original Year 3 federal income tax returns were filed by reporting stock gains and losses on a realization basis. In preparation of Taxpayers' Year 3 tax return, Advisor informed Husband by email on Date 9 that, "Consistent with [Accountant 1]'s earlier analysis, you won't be able to claim trader status for [Year 3]."3 Following a meeting with Husband and Lawyer, Accountant 2, who was employed at the same accounting firm as Accountant 1 and Advisor, informed Husband by email on Date 10 that a § 475(f)(1) election should have been filed by the unextended due date of the federal income tax return for the year preceding the year for which the election is made. Accountant 2 also alerted Husband of the opportunity to pursue relief under § 301.9100-3 to make a late § 475(f)(1) election for Year 3.[9]

Relief Under Reg. §301.9100-3 for a Late Regulatory Election

The letter ruling is asking for relief under the provision that Accountant 2 referred to—Reg. §301.9100-3. Under this regulation, a taxpayer may ask the IRS to grant relief to make a late election where the date is set by regulation.[10] The taxpayer makes that request via a private letter ruling[11] which will require the payment of the appropriate user fee published each year in the initial Revenue Procedure for that year.

For a ruling to be granted under this regulation the taxpayer must meet two criteria:

- The taxpayer acted reasonably and in good faith with regard to the election and
- The grant of relief will not prejudice the interests of the Government.[12]

However, if the requested election involves a change of accounting methods (which the election under §475(f)(1) does) the interests of the Government will be deemed to be prejudiced absent unusual and compelling circumstances if the election for which relief is granted:

- Is subject to the procedure described in Reg §1.446-1(e)(3)(i) (requiring the advance written consent of the Commissioner);
- Requires an adjustment under section 481(a) (or would require an adjustment under section 481(a) if the taxpayer changed to the method of accounting for which relief is requested in a taxable year subsequent to the taxable year the election should have been made);
- Would permit a change from an impermissible method of accounting that is an issue under consideration by examination, an appeals office, or a federal court and

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[9] PLR 202048009

[10] Reg. §301.9100-2(a)

[11] Reg. §301.9100-2(e)(5)

[12] Reg. §301.9100-2(a)

the change would provide a more favorable method or more favorable terms and conditions than if the change were made as part of an examination; or

- Provides a more favorable method of accounting or more favorable terms and conditions if the election is made by a certain date or taxable year.[13]

This case presents problems both with regard to the need for a §481(a) adjustment and the fact that the results would be much more favorable for the taxpayer if he had permission to change his accounting method earlier—he now has the full advantage of hindsight.

As well, Reg. §301.9100-3(b)(3)(iii) also provides a more generic bar on granting a change with the advantage of hindsight, holding a taxpayer is deemed not to have acted reasonably and in good faith if the taxpayer:

> Uses hindsight in requesting relief. If specific facts have changed since the due date for making the election that make the election advantageous to a taxpayer, the IRS will not ordinarily grant relief. In such a case, the IRS will grant relief only when the taxpayer provides strong proof that the taxpayer's decision to seek relief did not involve hindsight.

So the question becomes—do these facts represent unusual and compelling circumstances along with strong proof the decision to seek relief did not involve hindsight?

Failure to Act Reasonably or in Good Faith

The PLR finds that the facts demonstrate rather clearly that the taxpayer had the benefit of hindsight in seeking to make the late election:

> To make a timely § 475(f)(1) election for Year 3, Taxpayers had to make the § 475(f)(1) election by Date 4, the unextended due date of Taxpayers' federal income tax return for Year 2. Taxpayers did not file their first request for relief under § 301.9100-3 until Date 11. Taxpayers' request for a late filing of the § 475(f)(1) election was made with the benefit of nearly f months of hindsight. Husband continued to trade during Year 3 and Year 4. Husband realized his largest monthly trading loss during Date 5, after the due date for filing a § 475(f)(1) election for Year 3. Further, Husband suffered approximately b percent of his trading losses for Year 3 after the election due date. Additionally, Husband received a Form 1099 in early Year 4 reporting wash sale losses in the amount of d from his trading activities in Year 3, and knew the outcome of his trading activities in Year 4 before filing a request for relief under § 301.9100-3 to make a late § 475(f)(1) election. Taxpayers gained a benefit from hindsight because they were able to determine the effect of a § 475(f)(1) election with the benefit of knowledge that Husband's ongoing trading activities (a) produced a significant increase in realized trading losses and wash sale losses, and

[13] Reg. §301.9100-2(c)(2)

> (b) did not produce meaningful gains to absorb Taxpayers' capital losses. Thus, Taxpayers' specific facts materially changed after the due date for making the § 475(f)(1) election, and those specific fact changes made that election advantageous to Taxpayer. Moreover, Taxpayers did not provide strong proof showing that their decision to seek relief to make a late election did not involve hindsight. Accordingly, under § 301.9100-3(b)(3), Taxpayers are deemed to have not acted reasonably and in good faith.[14]

The IRS also did not find the taxpayer's assertion that he had instructed Accountant 1 to timely make the election persuasive, noting in a footnote:

> Husband's assertion that he instructed Accountant 1 to timely make a § 475(f) election is not supported by the facts provided. Rather, it is evident that Husband and Accountant 1 did not even begin to revisit the prospect of making a § 475 election until at least e months after the election due date had passed.[15]

The footnote suggests there might be a possible finding of reasonable cause in a case where an adviser failed to make an election after having been timely informed by the taxpayer to prepare such an election. But since that wasn't the case here, we can't say for sure that such a situation would lead to relief being granted.

Granting Relief Would Prejudice the Interests of the Government

The IRS was also not impressed with the taxpayers' claims that granting relief would not prejudice the interests of the government:

> Taxpayers have not presented unusual and compelling circumstances. After suffering large trading losses during Date 5, Husband revisited the prospect of making the election with Accountant 1 on Date 6, more than e months after the due date for making the § 475(f)(1) election. Accountant 1 advised Husband of the possibility of deducting his trading losses if Husband qualified as a trader, but Accountant 1 failed to point out the need to have timely made an election (the due date for which had already passed). Those circumstances are neither unusual nor compelling.[16]

[14] PLR 202048009

[15] PLR 202048009

[16] PLR 202048009

SECTION: 512
FINAL REGULATIONS RELEASED ON TCJA UBIT RULES

Citation: TD 9933, 11/20/20

The IRS has released final regulations dealing with the revisions made to the unrelated business income tax (UBIT) by the Tax Cuts and Jobs Act (TCJA) in 2017.[17] TCJA added IRC §512(a)(6) which provides:

> (6) Special rule for organization with more than 1 unrelated trade or business
>
> > In the case of any organization with more than 1 unrelated trade or business—
> >
> > > (A) unrelated business taxable income, including for purposes of determining any net operating loss deduction, shall be computed separately with respect to each such trade or business and without regard to subsection (b)(12),
> > >
> > > (B) the unrelated business taxable income of such organization shall be the sum of the unrelated business taxable income so computed with respect to each such trade or business, less a specific deduction under subsection (b)(12), and
> > >
> > > (C) for purposes of subparagraph (B), unrelated business taxable income with respect to any such trade or business shall not be less than zero.

The IRS had initially released Notice 2018-67 dealing with these issues in August of 2018, followed up by proposed regulations (REG-106864-18) that were issued in April 2020. These regulations are now being finalized with some modifications.

The key provisions are found in new Reg. §1.512(a)-6, with some modifications made to Reg. §§1.170A-9, 1.509(a)-3, 1.512(a)-1, 1.512(b)-1 and 1.513-1.

Reserved Issues

The preamble to the final regulations remind readers that the IRS still has additional guidance it plans to release in this area, noting:

> The proposed regulations reserved two issues for additional consideration. The first issue relates to the allocation of expenses, depreciation, and similar items shared between an exempt activity and an unrelated trade or business or between more than one unrelated

[17] TD 9933, November 20, 2020, https://www.irs.gov/pub/irs-drop/td-9933.pdf (retrieved November 25, 2020)

> trade or business. The second issue relates to changes made to the section 172 NOL deduction by the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116-136, 134 Stat. 281 (2020) (CARES Act). The Treasury Department and the IRS anticipate publishing a separate notice of proposed rulemaking that will address these issues.[18]

General Rule for Identifying Separate Trades or Businesses – NAICS Codes

Except as otherwise provided in Reg. §1.512(a)-6(c), (d) and (e), "an organization identifies each of its separate unrelated trades or businesses using the first two digits of the North American Industry Classification System code (NAICS 2-digit code) that most accurately describes the unrelated trade or business based on the more specific NAICS code, such as at the 6-digit level, that describes the activity it conducts…"[19]

The regulation continues:

> The descriptions in the current NAICS manual (available at www.census.gov) of trades or businesses using more than two digits of the NAICS codes are relevant in this determination. In the case of the sale of goods, both online and in stores, the separate unrelated trade or business is identified by the goods sold in stores if the same goods generally are sold both online and in stores.[20]

The regulation warns that the code has to be limited to the unrelated trade or business, not related to the conduct of the taxpayer's exempt function:

> The NAICS 2-digit code must identify the unrelated trade or business in which the organization engages (directly or indirectly) and not activities the conduct of which are substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)). For example, a college or university described in section 501(c)(3) cannot use the NAICS 2-digit code for educational services to identify all its separate unrelated trades or businesses, and a qualified retirement plan described in section 401(a) cannot use the NAICS 2-digit code for finance and insurance to identify all of its unrelated trades or businesses.[21]

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[18] TD 9933, Background

[19] Reg. §1.512(a)-6(b)(1)

[20] Reg. §1.512(a)-6(b)(1)

[21] Reg. §1.512(a)-6(b)(2)

An entity reports each NAICS 2-digit code only once. As the regulation notes:

> For example, a hospital organization that operates several hospital facilities in a geographic area (or multiple geographic areas), all of which include pharmacies that sell goods to the general public, would include all the pharmacies under the NAICS 2-digit code for retail trade, regardless of whether the hospital organization keeps separate books and records for each pharmacy.[22]

Activities in the Nature of Investments Treated as a Separate Unrelated Trade or Business

All of an organization's *activities in the nature of investments (investment activities)* are treated as a separate unrelated trade or business for the purposes of these rules. Such activities are limited to:

- Qualifying partnership interests;
- Qualifying S corporation interests; and
- Debt-financed property or properties within the meaning of IRC §514.[23]

The investment activity rules do not otherwise impact:

- The application of IRC §512(c) and
- The fragmentation rule under IRC §513(c).[24]

Qualifying Partnership Interests (QPI)

If an organization holds a direct interest in a partnership (*directly-held partnership interest)*, it is treated as a qualifying partnership interest (QPI) if the holding meets either

- the *de minimis test* (found in Reg. §1.512(a)-6(c)(3) *or*
- the participation test (found in Reg. §1.512-6(c)(4).[25]

If the entity holds a direct interest in a partnership, but that particular holding is not a QPI because neither test is met, any partnership interest held by that partnership may still qualify under the *look through rule* if the indirectly-held interest meets either the *de minimis* test or the participation test.[26]

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[22] Reg. §1.512(a)-6(b)(3)

[23] Reg. §1.512(a)-6(c)(1)

[24] [24] Reg. §1.512(a)-6(c)(8)(iii)

[25] Reg. §1.512(a)-6(c)(2)(i)

[26] Reg. §1.512(a)-6(c)(2)(ii)(A)

The organization designates a partnership as a QPI as follows:

> An organization that has a partnership interest meeting the requirements of paragraph (c)(2)(i) or (ii) of this section in a taxable year may designate that partnership interest as a QPI by including its share of partnership gross income (and directly connected deductions) with the gross income (and directly connected deductions) from its other investment activities (see paragraph (c)(1) of this section) in accordance with forms and instructions.[27]

The QPI designation once made remains in force until and unless the interest no longer meets the requirements to be a QPI.[28]

EXAMPLE – REG. §1.512(A)-6(C)(2)(III)

For example, if an organization designates a directly-held partnership interest that meets the requirements of the de minimis rule as a QPI in one taxable year, the organization cannot, in the next taxable year, use NAICS 2-digit codes to describe the partnership trades or businesses that are unrelated trades or businesses with respect to the organization unless the directly-held partnership interest fails to meet the requirements of both the de minimis test and the participation test (after application of the grace period described in paragraph (c)(6) of this section, if appropriate).

It's not clear if an organization can treat a partnership the qualifies as a QPI as not being an investment activity by simply not designating it. While the designation rule states the organization *may* designate the activity as a QPI by reporting as noted (which suggests a choice can be made), the definition of a QPI indicated that a partnership interest *is* a QPI if it meets the various tests, and the investment related activity definition indicates that such activities *are* treated as a separate unrelated trade or business (which implies there is no choice to be made). The above example found in the regulation seems to imply that the designation is voluntary, but again this is never stated explicitly.

The QPI rules do not apply to social clubs described in IRC §501(c)(7).[29]

As well, if an interest is held as a general partnership interest, it may not be treated as a QPI by the organization holding the interest or any other organization in a combined group that contains such a general partner:

> Any partnership in which an organization, or an organization whose interest is combined with that organization's interest for purposes of paragraph (c)(4)(ii) of this section, is a general partner under applicable state law is not a QPI within the meaning of paragraph (c)(2) of this section, regardless of the organization's percentage interest. Such partnership interest cannot be a QPI for any organization or for any of

[27] Reg. §1.512(a)-6(c)(2)(iii)
[28] Reg. §1.512(a)-6(c)(2)(iii)
[29] Reg. §1.512(a)-6(c)(8)(i)

> the organizations whose interest is combined with that organization's interest for purposes of paragraph (c)(4)(ii) of this section.[30]

De Minimis Test

A partnership interest is a QPI under the *de minimis* test if the organization holds (directly or indirectly):

- No more than 2% of the profits interests and
- No more than 2% of the capital interests

during the organization's taxable year with which or in which the partnership taxable year ends.[31]

The profits interest is determined in the same manner as its distributive share of partnership taxable income. The regulation directs the organization to IRC §704(b), relating to the determination of the distributive share by the income or loss ratio, and Reg. §§1.704-1 through 1.704-4.[32]

The organization's capital interest is:

> …in the absence of a provision in the partnership agreement, an organization's capital interest in a partnership is determined on the basis of its interest in the assets of the partnership which would be distributable to such organization upon its withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.[33]

The average percentage interest is computed as follows:

> …[A]n organization determines its percentage interest by taking the average of the organization's percentage interest at the beginning and the end of the partnership's taxable year, or, in the case of a partnership interest held for less than a year, the percentage interest held at the beginning and end of the period of ownership within the partnership's taxable year.[34]

The regulation also generally allows the organization to rely on the K-1 received from the partnership for this information:

> …An organization may rely on the Schedule K-1 (Form 1065) (or its successor) it receives from the partnership if the form lists the organization's percentage profits interest or its percentage capital interest, or both, at the beginning and end of the year. However, the

[30] Reg. §1.512(a)-6(c)(8)(ii)
[31] Reg. §1.512(a)-6(c)(3)
[32] Reg. §1.512(a)-6(c)(5)(i)
[33] Reg. §1.512(a)-6(c)(5)(ii)
[34] Reg. §1.512(a)-6(c)(5)(iii)

> organization may not rely on the form to the extent that any information about the organization's percentage interest is not specifically provided.[35]

EXAMPLE REG. §1.512(A)-(C)(5)(IV) – WHEN K-1 FAILS TO SHOW SPECIFIC PERCENTAGE

If the Schedule K-1 (Form 1065) an organization receives from a partnership lists the organization's profits interest as "variable" but lists its percentage capital interest at the beginning and end of the year, the organization may rely on the form only with respect to its percentage capital interest.

EXAMPLE REG. §1.512(A)-6(C)(5)(III) – COMPUTING INTERESTS BASED ON K-1 NUMBERS PROVIDED

If an organization acquires an interest in a partnership that files on a calendar year basis in May and the partnership reports on Schedule K-1 (Form 1065) that the partner held a 3 percent profits interest at the date of acquisition but held a 1 percent profits interest at the end of the calendar year, the organization will be considered to have held 2 percent of the profits interest in that partnership for that year ((3 percent + 1 percent)/2).

For an indirectly-held interest, the regulation provides the following example of such an organization meeting the *de minimis* test:

EXAMPLE INDIRECTLY-HELD INTEREST AND DE MINIMIS TEST (REG. §1.512(A)-6(C)(2)(II)(B)

For example, if an organization directly holds 50 percent of the capital interests of a partnership and the directly-held partnership holds 4 percent of the capital and profits interest of lower-tier partnership A, the organization may aggregate its interest in lower-tier partnership A with its other QPIs because the organization indirectly holds 2 percent of the capital and profits interests of lower-tier partnership A (4 percent x 50 percent).[36]

Participation Test

An organization's interest in a partnership is treated as meeting the participation test if

- The organization holds, directly or indirectly, no more than 20% of the capital interest during the taxable year with which or in which the partnership's taxable year ends (computed in the same fashion as for the *de minimis* test) *and*
- The organization does not significantly participate in the partnership.[37]

For purposes of this test, the interests of the organization must be combined with certain related supporting organizations and related entities:

> When determining an organization's percentage interest in a partnership for purposes of paragraph (c)(4)(i) of this section, the

[35] Reg. §1.512(a)-6(c)(5)(iv)

[36] Reg. §1.512(a)-6(c)(2)(ii)(B)

[37] Reg. §1.512(a)-6(c)(4)(i)

> interests of a supporting organization (as defined in section 509(a)(3) and §1.509(a)-4), other than a Type III supporting organization (as defined in §1.509(a)-4(i)) that is not a parent of its supported organization, or of a controlled entity (as defined in section 512(b)(13)(D) and §1.512(b)-1(l)) in the same partnership will be taken into account. For example, if an organization owns 10 percent of the capital interests in a partnership, and its Type I supporting organization owns an additional 15 percent capital interest in that partnership, the organization would not meet the requirements of the participation test because its aggregate percentage interest exceeds 20 percent (10 percent + 15 percent = 25 percent).[38]

An organization will be treated as significantly participating in the partnership if:

- The organization, by itself, may require the partnership to perform, or may prevent the partnership from performing (other than through a unanimous voting requirement or through minority consent rights), any act that significantly affects the operations of the partnership;

- Any of the organization's officers, directors, trustees, or employees have rights to participate in the management of the partnership at any time;

- Any of the organization's officers, directors, trustees, or employees have rights to conduct the partnership's business at any time; *or*

- The organization, by itself, has the power to appoint or remove any of the partnership's officers or employees or a majority of directors.[39]

The regulations contain the following clarification for applying the participation test to indirectly held partnerships:

> For purposes of applying the participation test to a partnership, the term organization in paragraph (c)(4) of this section refers to the partnership that directly holds the indirectly held partnership interest being tested for QPI status. Additionally, the list of officers, directors, trustees, or employees of an organization found in paragraphs (c)(4)(iii)(B) and (C) includes a general partner that directly owns an interest in the lower-tier partnership.[40]

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[38] Reg. §1.512(a)-6(c)(4)(ii)

[39] Reg. §1.512(a)-6(c)(4)(iii)

[40] Reg. §1.512(a)-6(c)(2)(ii)(C)

Example of Indirect Partnership Interest Failing Both Tests

The regulations contain the following example of an indirect interest failing both tests:

EXAMPLE - REG. §1.512(A)-6(C)(2)(II)(D)

(I) Organization D is described in section 501(c) and is exempt from Federal income tax under section 501(a). Organization D owns 50 percent of the capital interest in Partnership A. Partnership A owns 30

Partnership B within the meaning of paragraph (c)(4)(iii) of this section. Further, Partnership B owns 15 percent of the capital interest in Partnership C, in which Partnership B does not significantly participate within the meaning of paragraph (c)(4)(iii) of this section. No other organizations related (within the meaning of paragraph (c)(4)(ii) of this section) to either Organization D or the partnerships owns an interest in any of the lower-tier partnerships.

(II) Neither the interest in Partnership A nor B is a QPI. Organization D's interest in Partnership A does not meet the requirements of either the de minimis test or the participation test because it owns 50 percent of the interest in the partnership. Organization D's indirect interest in Partnership B (50 percent of 30 percent, or 15 percent) does not meet the de minimis test. Additionally, because Partnership A owns greater than 20 percent interest in Partnership B, Partnership A's interest in Partnership B does not meet the participation test. However, Organization D's interest in Partnership C is a QPI because Partnership C meets the participation test. That is, Partnership B holds a 15 percent interest in Partnership C and does not significantly participate in Partnership C.[41]

One Year Relief for Increase in Organization's Interest

If an organization fails to meet either test in the tax year due to an increase in interest in the organization's current taxable year, it may be treated as meeting the requirement for the current year that it met in the prior taxable year if:

- The partnership interest met the requirements of the de minimis test or participation test, respectively, in the organization's prior taxable year without considering this relief provision;
- The increase in percentage interest is solely due to the actions of one or more partners other than the organization; and
- In the case of a partnership interest that met the requirements of the participation test in the prior taxable year, the interest of the partner or partners that caused the increase was not combined for the prior taxable year and is not combined for the taxable year of the change with the organization's partnership interest for purposes of the participation test.[42]

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[41] Reg. §1.512(a)-6(c)(2)(ii)(D)

[42] Reg. §1.512(a)-6(c)(6)

Special Rule for §501(c)(7), (9) or (17) Organizations

IRC §501(c)(7), (9) or (17) organizations are subject to a special rule at IRC §512(a)(3) for computing their unrelated business taxable income (UBTI). For such organizations, the UBTI from the investment activities includes any amount that:

- Would be excluded from the calculation of UBTI under section 512(b)(1), (2), (3), or (5) if the organization were subject to section 512(a)(1);
- Is attributable to income set aside (and not in excess of the set aside limit described in section 512(a)(3)(E)), but not used, for a purpose described in section 512(a)(3)(B)(i) or (ii); or
- Is in excess of the set aside limit described in section 512(a)(3)(E).[43]

Transition Rule for Certain Partnership Interests

A special rule applies for partnership interests that are not a QPI that were acquired prior to August 21, 2018:

> If a directly-held partnership interest acquired prior to August 21, 2018, is not a QPI, an organization may treat such partnership interest as a separate unrelated trade or business for purposes of section 512(a)(6) regardless of the number of unrelated trades or businesses directly or indirectly conducted by the partnership.[44]

EXAMPLE REG. §1.512(A)-6(C)(9)(I) – TEMPORARY TRANSITION RULE

If an organization has a 35 percent capital interest in a partnership acquired prior to August 21, 2018, it can treat the partnership as a single trade or business even if the partnership's investments generated UBTI from lower-tier partnerships that were engaged in multiple trades or businesses.

The transition rule will continue to apply even if the organization's percentage interest in the partnership changes before the end of the transition period.[45]

The transition rule can be relied upon until the first day of the first taxable year after the regulations are published in the *Federal Register*.[46] Assuming the regulations are published in December, 2020, for calendar year organizations, calendar year 2020 would be the last year this rule could be used.

A partnership must choose between using the transition rule or the look-through rule if a partnership interest qualifies to use both rules.[47]

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[43] Reg. §1.512(a)-6(c)(7)

[44] Reg. §1.512(a)-6(c)(9)(i)

[45] Reg. §1.512(a)-6(c)(9)(ii)

[46] Reg. §1.512(a)-6(c)(9)(iii)

[47] Reg. §1.512(a)-6(c)(9)(ii)

Qualifying S Corporation Interest

A similar provision applies to create a *qualifying S corporation interest* as applies to create a QPI. The regulations provide:

> …[A]n organization may aggregate its UBTI from an S corporation interest with its UBTI from other investment activities (described in paragraph (c)(1) of this section) if the organization's ownership interest in the S corporation meets the criteria for a QPI as described in paragraph (c)(2)(i) of this section (substituting "S corporation" for "partnership" and "shareholder" or "shareholders" for "partner" or "partners," as applicable, throughout paragraphs (c)(2)(i), (c)(3), (c)(4), (c)(5)(iii), (c)(5)(iv), and (c)(6) of this section; "no more than 2 percent of stock ownership" for "no more than 2 percent of the profits interest and no more than 2 percent of the capital interest" in paragraph (c)(3) of this section; "no more than 20 percent of stock ownership" in place of "no more than 20 percent of the capital interest" in paragraph (c)(4)(i) of this section; and "Schedule K-1 (Form 1120-S)" for "Schedule K-1 (Form 1065)" for purposes of paragraph (c)(5)(iv) of this section).[48]

The regulations also make use of the newly added shares of stock information to be added to the 2020 Schedule K-1s for S corporations for determining the ownership interest:

> Paragraphs (c)(5)(i) and (c)(5)(ii) do not apply for purposes of determining an organization's ownership interest in an S corporation; rather, the average percentage stock ownership determined under paragraph (c)(5)(iii) of this section applies for purposes of this paragraph (e)(2). For purposes of paragraph (c)(5)(iv) of this section, an organization can rely on the Schedule K-1 (Form 1120-S) (or its successor) it receives from the S corporation only if the form lists information sufficient to determine the organization's percentage of stock ownership for the year. A Schedule K-1 (Form 1120-S) that reports "zero" as the organization's number of shares of stock in either the beginning or end of the S corporation's taxable year does not list information sufficient to determine the organization's percentage of stock ownership for the year.[49]

The one year relief for an increase in the organization's interest also applies to an S corporation interest:

> The grace period described in paragraph (c)(6) of this section applies to changes in an exempt organization's percentage of stock ownership in an S corporation.[50]

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[48] Reg. §1.512(a)-6(e)(2)

[49] Reg. §1.512(a)-6(e)(2)

[50] Reg. §1.512(a)-6(e)(2)

Income from Controlled Entities

Reg. §1.512(a)-6(d) provides special rules for income from certain controlled entities.

For specified payments from controlled entities (within the meaning of IRC §512(b)(13)(D)), the following rules apply:

> If an organization (controlling organization) controls another entity (within the meaning of section 512(b)(13)(D)) (controlled entity), all specified payments (as defined in section 512(b)(13)(C)) received by a controlling organization from that controlled entity are treated as gross income from a separate unrelated trade or business for purposes of paragraph (a) of this section. If a controlling organization receives specified payments from two different controlled entities, the payments from each controlled entity are treated as a separate unrelated trade or business. For example, a controlling organization that receives rental payments from two controlled entities has two separate unrelated trades or businesses, one for each controlled entity. The specified payments from a controlled entity are treated as gross income from one trade or business regardless of whether the controlled entity engages in more than one unrelated trade or business or whether the controlling organization receives more than one type of specified payment from that controlled entity.[51]

As well, the following rules apply for controlled foreign corporations:

> All amounts included in UBTI under section 512(b)(17) are treated as income derived from a separate unrelated trade or business for purposes of paragraph (a) of this section.[52]

Income of an S Corporation

Unless an S corporation interest meets the requirements to be treated as a qualifying S corporation interest, discussed earlier, each S corporation interest is treated as an interest in a separate unrelated trade or business under IRC §512(a)(6).

> Except as provided in paragraph (e)(2) of this section, if an organization owns stock in an S corporation (S corporation interest), such S corporation interest is treated as an interest in a separate unrelated trade or business for purposes of paragraph (a) of this section. Thus, if an organization owns two S corporation interests, neither of which is described in paragraph (e)(2) of this section, the exempt organization reports two separate unrelated trades or businesses, one for each S corporation interest. The UBTI from an S corporation interest is the amount described in section 512(e)(1)(B).[53]

[51] Reg. §1.512(a)-6(d)(1)

[52] Reg. §1.512(a)-6(d)(2)

[53] Reg. §1.512(a)-6(e)(1)

Reporting Changes in Identification

If an organization changes the identification of separate trades or businesses it must report the changes as detailed in Reg. §1.512(a)-6(a)(3).

To report a change in identification, an organization must provide the following information for each separate change in identification:

- The identification of the separate unrelated trade or business in the previous taxable year;
- The identification of the separate unrelated trade or business in the current taxable year; and
- The reason for the change.[54]

A change in identification of a separate unrelated trade or business includes the changed identification of the separate unrelated trade or business with respect to a partnership interest that was incorrectly designated as a qualifying partnership interest (QPI).[55]

Allocation of Deductions

An organization must allocate deductions between separate unrelated trades or businesses using the method described in Reg. §1.512(a)-1(c).[56]

Those rules at Reg. §1.512(a)-1(c), as revised by these regulations, read:

> Where facilities are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses, depreciation and similar items attributable to such facilities (as, for example, items of overhead), shall be allocated between the two uses on a reasonable basis. Similarly, where personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities, expenses and similar items attributable to such personnel (as, for example, items of salary) shall be allocated between the two uses on a reasonable basis. The portion of any such item so allocated to the unrelated trade or business activity is proximately and primarily related to that business activity, and shall be allowable as a deduction in computing unrelated business taxable income in the manner and to the extent permitted by section 162, section 167, or other relevant provisions of the Code. Thus, for example, assume that X, an exempt organization subject to the provisions of section 511, pays its president a salary of $20,000 a year. X derives gross income from the conduct of unrelated trade or business activities. The president devotes approximately 10 percent of his time during the year to the unrelated

[54] Reg. §1.512(a)-6(a)(3)

[55] Reg. §1.512(a)-6(a)(3)

[56] Reg. §1.512(a)-6(f)

> business activity. For purposes of computing X's unrelated business taxable income, a deduction of $2,000 (10 percent of $20,000), would be allowable for the salary paid to its president.
>
> However, allocation of expenses, depreciation, and similar items is not reasonable if the cost of providing a good or service in a related and an unrelated activity is substantially the same, but the price charged for that good or service in the unrelated activity is greater than the price charged in the related activity and no adjustment is made to equalize the price difference for purposes of allocating expenses, depreciation, and similar items based on revenue between related and unrelated activities. For example, if a social club described in section 501(c)(7) charges nonmembers a higher price than it charges members for the same good or service but does not adjust the price of the good or service provided to members for purposes of allocating expenses, depreciation, and similar items attributable to the provision of that good or service, the allocation method is not reasonable.[57]

The last two sentences were added by the new regulations, and were significantly revised in the final regulations as compared to the proposed regulations.

Total UBTI

Total unrelated business taxable income (UBTI) for an organization with more than one trade or business is equal to

- The total of the UBTI computed with respect to each unrelated trade or business (treating any trade or business having a UBTI of less than zero as if it were zero)[58]
- Less
  - A charitable contribution deduction;
  - An NOL deduction for losses arising in years beginning before January 1, 2018; and
  - A specific deduction under IRC §512(b)(12) as applicable.[59]

Net Operating Losses

For taxable years beginning after December 31, 2017, an organization with more than one unrelated trade or business computes the NOL deduction separately for each unrelated trade or business.[60]

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[57] Reg. §1.512(a)-1(c)

[58] Reg. §1.512(a)-6(g)(2)

[59] Reg. §1.512(a)-6(g)(1)

[60] Reg. §1.512(a)-6(h)(1)

Pre-2018 Net Operating Losses

If an organization has net operating losses in years beginning prior to January 1, 2018, the organization first applies those losses against total UBTI before deducting any post-2017 NOLs with regard to a separate trade or business against that trade or business.[61] The regulation provides:

> Pre-2018 NOLs are taken against the total UBTI as determined under paragraph (g) of this section in a manner that allows for maximum utilization of post-2017 NOLs in a taxable year. For example, an organization could choose to allocate all of its pre-2018 NOLs to one of its separate unrelated trade or business or it could allocate its pre-2018 NOLs ratably among its separate unrelated trades or businesses, whichever results in the greatest utilization of the post-2017 NOLs in that taxable year.[62]

Organization Ceases to Conduct the Trade or Business

NOLs not absorbed by a trade or business that the organization ceases to conduct generally remain suspended. As the regulation provides:

> After offsetting any gain resulting from the termination, sale, exchange, or disposition of a separate unrelated trade or business, any NOL remaining is suspended. However, the suspended NOLs may be used if that previous separate unrelated trade or business is later resumed or if a new unrelated trade or business that is accurately identified using the same NAICS 2-digit code as the previous separate unrelated trade or business is commenced or acquired in a future taxable year.[63]

Treatment When the Identification of a Separate Unrelated Trade or Business Changes

The regulation provides generally the following rules when there is a change in the identification of a trade or business:

> For purposes of section 512(a)(6) and this section, a separate unrelated trade or business for which the appropriate identification (within the meaning of paragraph (a) of this section) changes is treated as if the originally identified separate unrelated trade or business is terminated and a new separate unrelated trade or business is commenced. None of the NOLs from the previously identified separate unrelated trade or business will be carried over to the newly identified separate unrelated trade or business.[64]

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[61] Reg. §1.512(a)-6(h)(1)

[62] Reg. §1.512(a)-6(h)(2)

[63] Reg. §1.512(a)-6(h)(3)

[64] Reg. §1.512(a)-6(h)(4)(i)

EXAMPLE REG. §1.512(A)-6(H)(4)(I)

If the nature of a separate unrelated trade or business changes such that it is more accurately described by another NAICS 2-digit code, the separate unrelated trade or business is treated as a new separate unrelated trade or business with no NOLs.

The regulations discuss how to handle the issue if the change in identification applies to all, or just part, of the prior unrelated trade or business:

> The change in identification may apply to all or a part of the originally identified separate unrelated trade or business. If the change in identification applies to the originally identified separate trade or business in its entirety, any NOLs attributable to that separate unrelated trade or business are suspended in accordance with paragraph (h)(3) of this section. If the change in identification applies to the originally identified separate unrelated trade or business in part, the originally identified separate unrelated trade or business that is not changing retains the full NOLs attributable to the originally identified separate unrelated trade or business, without allocation to the portion that became a newly identified separate unrelated trade or business.[65]

A similar treatment applies when a QPI becomes a non-QPI:

> This paragraph (h)(4) also applies to each QPI that becomes a non-QPI. In this case, any NOLs attributable to the QPI that became a non-QPI are retained with the organization's investment activities described in paragraph (c) of this section.[66]

However, if the change in identification is not related to a material change in the business (the organization had been using the wrong 2-digit NAICS code), the following rule applies:

> In the case of a separate unrelated trade or business that is accidentally identified using the wrong NAICS 2-digit code or if an organization has determined that a separate unrelated trade or business that has not materially changed is more accurately identified by another NAICS 2-digit code, any NOL attributable to the originally identified separate unrelated trade or business becomes an NOL of the newly identified separate unrelated trade or business.[67]

When a Change in Identification Takes Effect

A change in identification is treated as taking effect on the first day of the taxable year in which the change in identification is made, with the new unrelated trade or business

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[65] Reg. §1.512(a)-6(h)(4)(i)

[66] Reg. §1.512(a)-6(h)(4)(ii)

[67] Reg. §1.512(a)-6(h)(4)(ii)

treated as beginning on that first day of the taxable year (regardless of when the actual event leading to the change in identification takes place).[68]

Examples – Reg. §1.512(a)-6(h)(4)(iv)

The IRS provides a series of examples related to the change in identification of an unrelated trade or business.

EXAMPLE 1. ERRONEOUS CODE

(I) Organization G is described in section 501(c) and is exempt from Federal income tax under section 501(a). In addition to its investment activities, Organization G has two separate unrelated trades or businesses – Q and R – that are identified with different NAICS 2-digit codes. Both Q and R have NOLs carried over from post-2017 taxable years.

(II) In Year 2 (a post-2017 taxable year), Organization G realizes that it accidentally used the wrong NAICS 2-digit code to identify R. The NOLs attributable to R under the old NAICS 2-digit code become the NOLs of R under the new NAICS 2- digit code as of the first day of Year 2.

EXAMPLE 2. MATERIAL CHANGE

(I) Same facts as Example 1, except assume that, in addition to its investment activities, Organization G has three separate unrelated trades or businesses – Q, R, and S – that are identified with different NAICS 2-digit codes. Q, R, and S all have NOLs carried over from post-2017 taxable years.

(II) Organization G changes the NAICS 2-digit code identifying R to the same NAICS 2-digit code identifying S because the nature of the unrelated trade or business materially changed. Any post-2017 NOLs attributable to R are suspended (see paragraph (h)(4)(i) of this section). Organization G now has two separate unrelated trades or businesses – Q and S – as of the first day of Year 2.

EXAMPLE 3. PARTIAL MATERIAL CHANGE

(I) Same facts as Example 1, except assume that Organization G determines that a part of R has materially changed such that R should be identified as two separate unrelated trades or businesses – R1 and R2. R1 retains the NAICS 2-digit code originally identifying R, and R2 is identified with a new NAICS 2-digit code that is not the same NAICS 2-digit code identifying Q. R2 is treated as a new separate unrelated trade or business with no NOLs as of the first day of Year 2. Any post-2017 NOLs attributable to R remain with R1.

EXAMPLE 4. QPI TO NON-QPI

(I) Same facts as Example 1, but assume that Organization G has a partnership interest in T that was, for prior taxable years, a QPI included with Organization G's investment activities. In Year 3 (a post-2017 taxable year), Organization G acquires more than 20 percent of the capital interests in T. The grace period described in paragraph (c)(6) of this section does not apply because the increase in percentage interest was not due to the actions of other partners.

(II) T conducts two trade or business activities that are unrelated trade or business activities with respect to Organization G – T1 and T2. Both T1 and T2 will be treated as new separate

[68] Reg. §1.512(a)-6(h)(4)(iii)

unrelated trades or business as of the first day of Year 2. Organization G identifies T1 with the same NAICS 2-digit code used to identify Q and T2 with a NAICS 2-digit code that is different than the NAICS 2-digit codes used to identify Q and R. In addition to its investment activities, Organization G has three separate unrelated trades or businesses – Q, R, and T2. Any post-2017 NOLs attributable to the QPI remain with Organization G's other investment activities separate unrelated trade or business.

SECTION: 1031
FINAL REGULATION ISSUED DEFINING REAL PROPERTY FOR TCJA REVISION TO §1031

Citation: TD 9935, Reg. §1.1031-3, 11/23/20

The Tax Cuts and Jobs Act limited like-kind exchanges under §1031 to exchanges of real property effective January 1, 2018. The IRS issued proposed regulations in June 2020[69] to implement these revisions in §1031. In November 2020 the IRS finalized these regulations after making certain changes.[70]

Summary of Changes from the Proposed Regulations

The preamble to the final regulations contains the following overview of the key changes found in the final regulations as compared to the proposed regulations issued five months earlier. First, it notes that the final regulations modify the definition of real property to now refer to the appropriate state and local law definition of real property:

> The final regulations retain the basic approach and structure of the proposed regulations, with certain revisions. In particular, the final regulations revise the definition of "real property" in the proposed regulations to provide that property is classified as real property for section 1031 purposes if, on the date it is transferred in an exchange, the property is real property under the law of the State or local jurisdiction in which that property is located.[71]

The final regulations also remove the "purpose or use test" that was found in the proposed regulations from the definition of real property:

> The final regulations also revise the proposed definition of real property to eliminate, with regard to both tangible and intangible properties, any consideration of whether the particular property contributes to the production of income unrelated to the use or occupancy of space (referred to as the "purpose or use test," as

[69] REG-117589-18, June 11, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-11530.pdf (retrieved June 12, 2020)

[70] TD 9935, November 24, 2020 (Pre-release version posted on IRS website), https://www.irs.gov/pub/irs-drop/td_9935.pdf (retrieved November 24, 2020)

[71] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, I. Overview

> defined in part II.B.1 of this Summary of Comments and Explanation of Revisions).[72]

The final regulations continue to contain a warning that these rules apply solely for purposes of §1031, and do not impact other provisions of the IRC:

> Finally, in §1.1031(a)-3(a)(7), the final regulations retain the language of the proposed regulations clarifying that the rules of these final regulations apply only for purposes of section 1031 and that no inference is intended with respect to the classification or characterization of property for other purposes of the Code.[73]

Key Revisions to Real Property Definitions for §1031

The proposed regulations in most cases ignored whether state and local law considered something to be real property, aiming for a standard federal definition to be applied in most cases. However, this attracted a number of comments arguing against this approach:

> Commenters generally critiqued the apparent scope of the application of State and local law in the proposed regulations for purposes of defining real property. These commenters contended that, prior to enactment of the TCJA, State and local law classification of a property often was the determining factor in characterizing property as real or personal under section 1031. With regard to the Conference Report Example, the commenters asserted that the reference to "shares in a mutual ditch, reservoir, or irrigation company" merely constituted a set of examples that Congress provided to broadly indicate that real property eligible for like-kind treatment under law prior to enactment of the TCJA will continue to be eligible following the TCJA's amendment to section 1031. Consequently, the commenters recommended that the final regulations conform to that intent by expanding the rules to rely significantly, or wholly, on State-law classifications for all assets, rather than limiting such reliance to shares in a mutual ditch, reservoir, or irrigation company. Additionally, commenters suggested that the final regulations should include multiple examples of instances in which taxpayers may rely on State or local law for purposes of classifying property as real or personal.[74]

Thus, the IRS describes the following changes found in the final regulations:

> …[T]he final regulations provide generally that property is real property for purposes of section 1031 if, on the date it is transferred in an exchange, that property is classified as real property under the law of the State or local jurisdiction in which that property is located (State

[72] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, I. Overview

[73] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, I. Overview

[74] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, II. Definition of Real Property, A. State or local law definitions of real property, 2. Consideration of Comments and Revision of "Real Property" Definition

> and local law test). The State and local law test applies to both tangible and intangible property classifications.[75]

While this is true in most cases, the IRS did exclude some property from the definition to be consistent with prior law:

> However, consistent with Congressional intent that "real property eligible for like-kind exchange treatment" under the law in effect prior to enactment of the TCJA will continue to be eligible for like-kind exchange treatment after enactment of the TCJA, property ineligible for like-kind exchange treatment prior to enactment of the TCJA remains ineligible, including real property that was excluded from the application of section 1031. See Conference Report at 396, fn. 726. Prior to amendment by the TCJA, former section 1031(a)(2) explicitly excluded certain assets from the application of section 1031. Accordingly, the final regulations exclude from the definition of real property the intangible assets listed in section 1031(a)(2) prior to its amendment by the TCJA, regardless of the classification of the property under State or local law, because such property never was "real property eligible for like-kind exchange treatment" prior to enactment of the TCJA. Conference Report at 396, fn. 726 (emphasis added).
>
> In summary, under the final regulations, property is classified as real property for purposes of section 1031 if the property is (i) so classified under the State and local law test, subject to certain exceptions, (ii) specifically listed as real property in the final regulations, or (iii) considered real property based on all the facts and circumstances under the various factors provided in the final regulations. A determination that property is personal property under State or local law does not preclude the conclusion that property is real property as specifically listed in §1.1031(a)-3(a)(2)(ii) or (a)(2)(iii)(B) or as real property under the factors listed in §1.1031(a)-3(a)(2)(ii)(C) or (a)(2)(iii)(B).[76]

Definition of Real Property for §1031

The regulations add new Reg. §1.1031-3, Definition of Real Property.

The new regulation begins by defining *real property* as:

- Land;
- Improvements to land;

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[75] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, II. Definition of Real Property, A. State or local law definitions of real property, 2. Consideration of Comments and Revision of "Real Property" Definition

[76] TD 9935, November 24, 2020, Summary of Comments and Explanation of Revisions, II. Definition of Real Property, A. State or local law definitions of real property, 2. Consideration of Comments and Revision of "Real Property" Definition

- Unsevered natural products of land; and
- Water and airspace adjacent to land.[77]

Property that is real property under state or local law where the property is located is real property for purposes of §1031[78] except for certain intangible assets described in Reg. §1.1031(a)-3(a)(5).

Such intangible assets that are *not* real property are:

- Stock (other than stock in a cooperative housing corporation and shares in a mutual ditch, reservoir or irrigation company), bonds or notes;
- Other securities or evidence of indebtedness;
- Interests in a partnership (other than those with a valid election under IRC §761(a) to be excluded from subchapter K);
- Certificates of trust or beneficial interests; and
- Choses in action.[79]

Conversely, the regulation holds that the following intangible interests will qualify as real property:

> Intangible assets that are real property for purposes of section 1031 and this section include the following items: fee ownership; co-ownership; a leasehold; an option to acquire real property; an easement; stock in a cooperative housing corporation; shares in a mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A) of the Code if, at the time of the exchange, such shares have been recognized by the highest court of the State in which the company was organized, or by a State statute, as constituting or representing real property or an interest in real property; and land development rights. Similar interests are real property for purposes of section 1031 and this section if the intangible asset derives its value from real property or an interest in real property and is inseparable from that real property or interest in real property.[80]

The regulation also makes clear that these definitions are *solely* for the purposes of §1031 and do not apply to other provisions in the IRC:

> 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

[77] Reg. §1.1031(a)-3(a)(1)

[78] Reg. §1.1031(a)-3(a)(1), (a)(6)

[79] Reg. §1.1031(a)-3(a)(5)

[80] Reg. §1.1031(a)-3(a)(5)

> sections 1245 and 1250. 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 under this section. Also, a taxpayer transferring relinquished property that is section 1245 property in a section 1031 exchange is subject to the gain recognition rules under section 1245 and the regulations under section 1245, notwithstanding that the relinquished property or replacement property is real property under this section. In addition, the taxpayer must follow the rules of section 1245 and the regulations under section 1245, and section 1250 and the regulations under section 1250, based on the determination of the relinquished property and replacement property being, in whole or in part, section 1245 property or section 1250 property under those Code sections and not under this section.[81]

Reg. §1.1031-3(a) continues by providing detailed definitions of various classes of assets.

Distinct Asset

Several of the definitions reference a *distinct asset*, a term defined in the regulations. The regulations provide:

> For this section, a distinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure. Buildings and other inherently permanent structures are distinct assets. Assets and systems listed as a structural component in paragraph (a)(2)(iii)(B) of this section are treated as distinct assets.[82]

The regulation provides the following test to determine if an item is a distinct asset for the purposes of these regulations:

> The determination of whether a particular separately identifiable item of property is a distinct asset is based on all the facts and circumstances. In particular, the following factors must be taken into account--
>
> > (A) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;
> >
> > (B) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;
> >
> > (C) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and

[81] Reg. §1.1031(a)-3(a)(7)

[82] Reg. §1.1031(a)-3(a)(4)(i)

> (D) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset..[83]

Improvements to Land

Improvements to land include:

- Inherently permanent structures and
- Structural components of inherently permanent structures.[84]

Inherently Permanent Structures

The regulation defines *inherently permanent structures* as "any building or other structure that is a distinct asset" that is permanently affixed to real property and "will ordinarily remain affixed for an indefinite period of time."[85]

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.[86]

The regulations provide that buildings include the following distinct assets if permanently affixed:

- Houses
- Apartments
- Hotels and motels:
- Enclosed stadiums and arenas
- Enclosed shopping malls
- Factories and office buildings
- Warehouses
- Barns
- Enclosed garages

[83] Reg. §1.1031(a)-3(a)(4)(ii)
[84] Reg. §1.1031(a)-3(a)(2)(i)
[85] Reg. §1.1031(a)-3(a)(2)(ii)(A)
[86] Reg. §1.1031(a)-3(a)(2)(ii)(B)

- Enclosed transportation stations and terminals and
- Stores.[87]

Other inherently permanent structures include the following items 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 platforms, derricks, oil and gas storage tanks; and grain storage bins and silos.[88]

The regulation provides the following guidance to determine if an asset is permanently affixed:

> Affixation to real property may be accomplished by weight alone. If property is not listed as an inherently permanent structure in paragraph (a)(2)(ii)(B) or (C) of this section, the determination of whether the property is an inherently permanent structure under paragraph (a)(2)(ii) of this section is based on the following factors--
>
> > (1) The manner in which the distinct asset is affixed to real property;
> >
> > (2) Whether the distinct asset is designed to be removed or to remain in place;
> >
> > (3) The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;
> >
> > (4) Any circumstances that suggest the expected period of affixation is not indefinite; and
> >
> > (5) The time and expense required to move the distinct asset.[89]

Structural Components

A *structural component* is a distinct asset "that is a constituent part of, and integrated into, an inherently permanent structure."[90] The regulation notes that "[i]f interconnected assets work together to serve an inherently permanent structure (for example, systems

[87] Reg. §1.1031(a)-3(a)(2)(ii)(B)

[88] Reg. §1.1031(a)-3(a)(2)(ii)(C)

[89] Reg. §1.1031(a)-3(a)(2)(ii)(C)

[90] Reg. §1.1031(a)-3(a)(2)(iii)(A)

that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component."[91]

The regulation provides the following additional detailed rules for structural components:

- If a distinct asset is customized, the customization does not affect whether the distinct asset is a structural component.
- Tenant improvements to a building that are inherently permanent or otherwise classified as real property are real property.
- Property produced for sale, such as bricks, nails, paint, and windowpanes, that is not real property in the hands of the producing taxpayer or a related person, but that may be incorporated into real property by an unrelated buyer, is not treated as real property by the producing taxpayer.[92]

So long as the following items are a constituent part of and integrated into a inherently permanent item, they are treated as structural components for purposes of §1031:

- 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;

[91] Reg. §1.1031(a)-3(a)(2)(iii)(A)
[92] Proposed Reg. §1.1031(a)-3(a)(2)(iii)(A)

- Fire escapes;
- Security systems;
- Humidity control systems; and
- Other similar property.[93]

For other items not included in the list, the regulation provides the following test to be used to determine if the item is a structural component:

> If a component of a building or inherently permanent structure is a distinct asset and is not listed as a structural component in this paragraph (a)(2)(iii)(B), the determination of whether the component is a structural component under this paragraph (a)(2)(iii) is based on the following factors--
>
> > (1) The manner, time, and expense of installing and removing the component;
> >
> > (2) Whether the component is designed to be moved;
> >
> > (3) The damage that removal of the component would cause to the item itself or to the inherently permanent structure to which it is affixed; and
> >
> > (4) Whether the component is installed during construction of the inherently permanent structure.[94]

Unsevered Natural Products of Land

Real property for §1031 purposes includes *unsevered products of land* which is defined to include:

- Growing crops plants, and timber;
- Mines;
- Wells; and
- Other natural deposits.[95]

The regulation goes on to note that "[n]atural 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."[96]

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[93] Reg. §1.1031(a)-3(a)(2)(iii)(B)
[94] Reg. §1.1031(a)-3(a)(2)(iii)(B)
[95] Reg. §1.1031(a)-3(a)(3)
[96] Reg. §1.1031(a)-3(a)(3)

Examples

The regulation provides a series of twelve examples of applying these rules, found at Reg. §1.031-3(b). Advisers should look at these examples to become comfortable with how the IRS sees these rules being applied in specific situations. As is always true, pay special attention to the facts in each example that the IRS references in making the determination of whether the item is or is not real property.

The topics covered by the examples are:

- Example 1: Natural products of land
- Example 2: Water space superjacent to land
- Example 3: Indoor sculpture (an interesting example as it shows how an item not attached to other real property can nevertheless become real property due to its weight and the impracticality of moving the object)
- Example 4: Bus shelters (an illustration of the opposite conclusion to Example 3, the shelters in this case are found not to be real property)
- Example 5: Industrial 3D Printer (this example now arrives at a different result than it did in the proposed regulations. The final regulations no longer remove machinery from the category of real property so long as it meets the other requirements for property not specifically listed as a structural component. Also, now old example 6 is deleted, as it no longer matters if a generator supplies power to the entire building or just the 3D printer)
- Example 6 (previously 7 in the proposed regulations): Raised flooring for Industrial 3D Printer (continuing with the 3D printer issue, this example finds the raised flooring for the 3D printer is not real property given the facts of the example)
- Example 7 (previously 8 in the proposed regulations): Steam Turbine (another reversal of position vs. the same example in the proposed regulations, this time the IRS finding the turbine is real property.)
- Example 8 (previously 9 in the proposed regulations): Partitions (while a conventional partition system is found to be real property, a modular partition system is found not to be real property)
- Example 9 (previously 10 in the proposed regulations): Pipeline transmission system (the pipeline and isolation valves are found to be real property, but meters are not)
- Example 10 (new with the final regulations): State or local law determination of property. Illustrates that if an item is listed in the regulations as real property (cell towers in this case), it is not relevant if state law provides they are not real property.
- Example 11: Land use permit. (a right to use land owned by the Federal government to put up a cell tower is found to be real property)

- Example 12: License to operate a business. (even though limited to a particular location, this license is not real property).

Incidental Personal Property Safe Harbor

In addition to the definition of real property, the IRS addressed concerns about the receipt of incidental amounts of personal property by a qualified intermediary destroying a like-kind exchange based on existing rules. As the IRS described the issue in the preamble to the proposed regulations:

> The Treasury Department and the IRS are aware that taxpayers have questioned the effect of the receipt of personal property that is incidental to the taxpayer's replacement real property in an intended section 1031 exchange. For example, taxpayers have asked whether an exchange fails to meet the requirements of §1.1031(k)-1(g)(6)(i) if funds from the transfer of relinquished property held by the qualified intermediary are used to acquire an office building, including the personal property in the office building. Taxpayers and qualified intermediaries are concerned that a taxpayer would be considered to be in constructive receipt of all of the exchange funds held by the qualified intermediary if the taxpayer is able to direct the qualified intermediary to use those funds to acquire property that is not of a like kind to the taxpayer's relinquished property. Under §1.1031(k)-1(a), if a taxpayer actually or constructively receives the funds held by a qualified intermediary before receiving the replacement property, the transaction is a sale and not a section 1031 like-kind exchange.[97]

The preamble goes on to describe the solution provided for this issue, creating a special rule allowing the receipt of such property to be disregarded if the receipt of personal property is incidental to the overall exchange of real property:

> In response to these inquiries, the proposed regulations add to the items in §1.1031-1(g)(7) that are disregarded in determining whether the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. The proposed regulations provide that personal property that is incidental to replacement real property is disregarded in determining whether a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by a qualified intermediary are expressly limited as provided in §1.1031(k)-1(g)(6). Personal property is incidental to real property acquired in an exchange if, in standard commercial transactions, the personal property is typically transferred together with the real property, and the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property. This incidental property rule in the proposed regulations is based on the existing rule in §1.1031(k)-1(c)(5), which provides that certain

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[97] REG-117589-18, SUPPLEMENTARY INFORMATION, Explanation of Provisions, Section II

> incidental property is ignored in determining whether a taxpayer has properly identified replacement property under section 1031(a)(3)(A) and §1.1031(k)-1(c).[98]

The proposed regulations would insert the following into existing Reg. §1.1031(k)-1(g)(7):

> (iii) Personal property generally resulting in gain recognition under section 1031(b) that is incidental to real property acquired in an exchange. For purposes of this paragraph (g)(7), personal property is incidental to real property acquired in an exchange if--
>
>> (A) In standard commercial transactions, the personal property is typically transferred together with the real property; and
>>
>> (B) The aggregate fair market value of the property described in paragraph (g)(7)(iii)(A) of this section transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property or properties received in the exchange.[99]

The IRS provided the following example of the application of this provision:

EXAMPLE (REG. §1.1031(K)-1(G)(8)(VII))

Example 6. ((A) In 2020, B transfers to C real property with a fair market value of $1,100,000 and an adjusted basis of $400,000. B's replacement property is an office building and, as a part of the exchange, B also will acquire certain office furniture in the building that is not real property, which is industry practice in a transaction of this type. The fair market value of the real property B will acquire is $1,000,000 and the fair market value of the personal property is $100,000..

(B) In a standard commercial transaction, the buyer of an office building typically also acquires some or all of the office furniture in the building. The fair market value of the personal property B will acquire does not exceed 15 percent of the fair market value of the office building B will acquire. Accordingly, under paragraph (g)(7)(iii) of this section, the personal property is incidental to the real property in the exchange and is disregarded in determining whether the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or non-like-kind property are expressly limited as provided in paragraph (g)(6) of this section. Upon the receipt of the personal property, B recognizes gain of $100,000 under section 1031(b), the lesser of the realized gain on the disposition of the relinquished property, $700,000, and the fair market value of the non-like-kind property B acquired in the exchange, $100,000.

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[98] REG-117589-18, SUPPLEMENTARY INFORMATION, Explanation of Provisions, Section II

[99] Reg. §1.1031(k)-1(g)(7)(iii)