



DEFINING REAL AND PERSONAL PROPERTY Our Response To An Article Published In Accounting Today

In a recent article in Accounting Today, “The cost seg/1031 exchange combo is even more important under tax reform” the author discussed his views on the interplay between a cost segregation study and §1031 as amended by the TCJA.

Julio Gonzalez, the owner/founder of Engineered Tax Services, makes the claim that “Section 1031 does not turn on the distinction between Sections 1245 and 1250 property. Instead, it looks to **state** real estate definitions to determine what is defined as real or personal property.” He later adds, “[w]hen a Section 1031 exchange occurs in the future, the classification of real versus personal property will turn on state law definitions.”

Scarpello Consulting disagrees with this statement and would like to alleviate any questions or concerns that these statements may have created. The following is our position on this topic, which includes documentation that supports our stance.

SCARPELLO CONSULTING’S STANCE

Unfortunately, §1031 and its regulations are silent as to the definition of real property. However, according to Internal Legal Memorandum 201238027, federal income tax law, rather than the various state laws, controls whether exchanged properties are of like kind for purposes of §1031.

State law property classifications, while relevant for determining if property is real or personal property, are not determinative of whether properties are of the same nature and character. See §1.1031(a)-1(b) for the definition of “like kind.” §§48, 263A, and 1245 of the Internal Revenue Code and the regulations thereunder are informative as to whether property is real or personal for federal income tax purposes.

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ADDITIONAL CODES THAT ARE RELEVANT IN DEFINING PERSONAL PROPERTY

Treas. Reg. §1.1250-1(e)(3) defines “real property” as any property which is not personal property within the meaning of §1.1245-3(b).

§1.1245-3(b) of the regulations provides that the term “personal property” means (1) tangible personal property (as defined in §1.48-1(c), relating to the definition of “section 38 property” for purposes of the investment credit), and (2) intangible personal property.

§1.48-1(c) of the regulations provides that the term “tangible personal property” means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building.

Therefore, by negative implication, real property is any land and improvements thereto, such as buildings or other inherently permanent structures, including items which are structural components of such buildings or structures. See also, §1.263(a)-2(b)(3).

§1.263A-8(c)(1) of the regulations provides, in part, that real property includes land, unsevered natural products of land, buildings, and inherently permanent structures. This definition tracks very closely with the §1.48-1(c) definition for tangible personal property.

HOW SCARPELLO CONSULTING REGARDS PERSONAL PROPERTY

When Scarpello Consulting performs a cost segregation analysis on a property, we make the express claim that the assets reclassified to a shorter recovery period, other than the land improvements, Qualified Leasehold Improvement Property, Qualified Restaurant Property, Qualified Retail Improvement Property, and Qualified Improvement Property (which are all still real property), are not structural components of the building or any other inherently permanent structure. Therefore, they are personal property and are ineligible for deferral under §1031.

Therefore, it is our opinion that the commentators raising questions regarding the controlling law are either trying to grasp at straws to sow confusion or are flat out wrong because this is a long-settled issue.

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While it is possible that Treasury could issue regulations under §1031 with a definition for “real property” grounded in state law classifications, it would be a departure from the Treasury Department’s and IRS’s historical understanding of the issue, and no such departure has been signaled by anyone in a position to make such a change.

A NOTE ON SHORTER-LIFE ASSETS

The Accounting Today article seems to be of the opinion that the shorter-life assets will have zero FMV at the time of a future exchange because they have been fully depreciated for tax purposes. See the statement “[w]hen a Section 1031 exchange occurs in the future... the Section 1245, or short-life, property should be fully depreciated and not considered part of the Section 1031 exchange.”

While Scarpello Consulting’s cost segregation studies for relinquished properties can be readily updated at the time of exchange to help determine the relative fair market values of the real and personal property, and this revaluation will often result in a decrease to the relative value of the personal property to the real property due to the personal property generally having a much shorter economic useful life than the real property, short of a prior full or partial disposition of the personal property, the personal property will usually retain some value and would therefore impact the deferral of gain and the recapture of prior depreciation deductions.

So, while it is possible to minimize the gain realized on the disposition of the personal property through a smaller allocation of the consideration received (or through disposition planning coordinated with the buyer (i.e., the seller can perform any planned demolition, take dispositions under §1.168(i)-8, and expense their demo costs under §1.263(a)-3(g)(2))), you must still allocate the consideration received for the relinquished property between the real and personal property.

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What is your cost segregation question?

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Launched in 2001, Scarpello Consulting provides cost segregation services that allow clients to maximize their depreciation deductions while minimizing audit risk. The firm works with Fortune 500 companies and some of the largest national CPA firms through their multiple offices in Omaha, NE, Overland Park, KS, Sarasota, FL, and Denver, CO.