



SECTION 1031 & COST SEGREGATION STUDIES

Recently, the Tax Cuts & Jobs Act altered the qualifying property types for §1031 exchanges. For exchanges completed after 12/31/17, no gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment. See P.L. 115-97, Sec. 13303(c)(1) and IRC Sec. 1031(a)(1).

Therefore, **personal property no longer qualifies for gain deferral under §1031**. But how do you determine if property is real or personal? Some commentators have tried to advance the theory that state laws control, but we strongly disagree, and so does the IRS.

Internal Legal Memorandum 201238027 provides that federal income tax law, not 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. §§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. §1250 is also highly relevant.

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.**

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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.

This definition is supported by other sections of the IRC. For example, §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 is substantially similar to the implicated definition for real property in §1.48-1(c).

When a cost segregation analysis on a property is performed, the express claim is made 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 bldg. or any other inherently permanent structure. Therefore, they are personal property and are ineligible for deferral under §1031.

While it is possible that Treasury could issue regulations under §1031 with a unique definition for “real property,” it would be a departure from their historical understanding of the issue, and no such departure has been signaled by anyone in a position to make such a change. We caution that while the current administration may not be motivated in auditing taxpayer positions on this issue, it appears that significant changes to tax policy could occur in the near-term. Should more progressive politicians take control of the executive and legislative branches of the Federal government, it is reasonable to assume that they would take a very aggressive stance on policing this issue as part of their efforts to raise Federal revenues.

You may be asking yourself if it still make sense to use a cost segregation study now that personal property no longer qualifies for gain deferral. While we are admittedly biased, our answer is that it does if it made sense before. Remember, cost segregation is a tool to accelerate depreciation deductions, so it's always been a tool to use for properties intended to be held for the medium- to long-term. Those properties will still show strong positive net present value from the earlier recognition of the deductions, even after offsetting the NPV of any future gain realized on the disposition of the personal property.

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Additionally, when you work with Scarpello Consulting for the initial cost segregation of the property, it is a straightforward process for us to update that study to reflect the physical condition of the property at the time of subsequent disposition. Because the personal property assets will physically deteriorate much faster than the real property assets, the updated cost segregation study will allocate a lower % of the sales proceeds to the personal property, thereby reducing the gain realized on their disposition.

When you couple that with the fact that the appreciation of the land is what usually drives most of the appreciation in the overall property, you can see that any future gain from the disposition of the personal property can be properly minimized to reduce the potential impact of the exclusion of personal property from §1031.

If you have any questions about this white paper, or any other issues regarding fixed assets, please visit www.scarpelloconsulting.com, call our offices at (877) 410-5040, or email our tax director. You can also review our other white papers on our website.

Additionally, our cost segregation estimates are complementary, so if you would like to investigate the potential benefits for specific properties, please do not hesitate to contact us for a no obligation benefit analysis.

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Start your cost segregation study today
Contact us: 877.410.5040



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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.