www.ascsp.org

August 6, 2020

Edward C. Schwartz, Esq.
Internal Revenue Service
Associate Chief Counsel (Income Tax & Accounting)
Attn: CC:ITA:B05
1111 Constitution Ave., N.W.
Washington, D.C. 20224
edward.c.schwartz@irscounsel.treas.gov

RE: Comments for Proposed Regulations 1.1031(a)-3 (REG-117589-18)

Dear Mr. Schwartz:

The American Society of Cost Segregation Professionals (ASCSP) wishes to commend the Treasury Department (Treasury) and the Internal Revenue Service (IRS) for the thoughtful effort clearly reflected in Proposed Regulations 1.1031(a)-3 (REG-117589-18) defining real property for purposes of Internal Revenue Code Section 1031. ASCSP was established to serve as the voice of cost segregation professionals and to address the need for education, credentials, technical standards and a code of ethics within the industry. From this perspective, ASCSP offers the following comments and suggestions concerning these Proposed Regulations.

Cost segregation is the process of identifying personal property assets that are grouped with real property assets and separating out personal assets for cost recovery reporting purposes. A cost segregation study identifies and reclassifies personal property assets to shorten the applicable depreciation periods, allowing faster recovery of allocable cost than would be available under the 27.5 or 39 year recovery period normally allocable to residential or non-residential real property. This approach has been addressed and approved in a number of published court cases[1] as well as published guidance from the Internal Revenue Service.[2]

Many taxpayers engaging ASCSP-member professionals to undertake cost segregation studies do so with respect to property which is relinquished or replacement property in a like-kind exchange undertaken pursuant to Internal Revenue Code Section 1031. Because the analyses undertaken by ASCSP members relating to Section 168 classification necessarily intersect with analysis of what constitutes real property for purposes of Section 1031, this is an important topic for the ASCSP and for taxpayers who request cost segregation studies from its members.

As amended by the Tax Cuts and Jobs Act (TCJA), Section 1031(a) provides that no gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment if the relinquished property is exchanged solely for real property of a like-kind that is to be held either for productive use in a trace or business or for investment. The TCJA did not change Section 1031(b), providing that a taxpayer must recognize gain on the receipt of money and non-like-kind property in an exchange.

[1] See, e.g. Hospital Corporation of America v. Commissioner, 109 T.C 21 (1997); Whiteco Industries, Inc. v. Commissioner, 65 T.C. 664 (1975).
[2] IRS Cost Segregation Audit Techniques Guide.

Summary

1. ASCSP concurs with the conclusion expressed in Section 1.1031(a)-3(a)(6) of the Proposed Regulations that the definition of real property for purposes of Section 1031 need not and should not be identical to the definitions under Sections 48, 856 or 897 ("Other Sections") because of the different policies underlying those Sections of the Code.

2. ASCSP believes that although the purpose and use of assets may appropriately be taken into account for purposes of the Other Sections, particularly those relating to the investment tax credit and real estate investment trusts, the purpose and use of assets is not an appropriate point of reference in the context of Section 1031 exchanges. Instead, assets should be treated as real property eligible for a like-kind exchange if the assets are inherently permanent (or constitute a structural component of an asset that is inherently permanent) without regard to their purpose or use.

3. As a corollary to the foregoing, ASCSP believes that machinery that is inherently permanent has been and should continue to be treated as real property without regard to its purpose or use.

4. ASCSP disagrees with the IRS position that state law not be taken into account for purposes of defining "real property" for purposes of Section 1031, since ASCSP believes Congress intended that substantial prior case law that has relied upon state law for this purpose should not be ignored. In light of Congress' stated intent that the scope of real property not be narrowed as a result of the TCJA, ASCSP is concerned that the wholesale disregard of state law classification of property may cause the definition of real property in the Proposed Regulations, when finalized, to be subject to challenge on the grounds that they are inconsistent with Congress' stated intent. To address this issue, ASCSP recommends that the definition of real property be revised to include (1) land, (2) inherently permanent structures, (3) any structural component of inherently permanent structures, and (4) any asset that is treated as real property under applicable state law.

5. ASCSP recognizes that not all interests in real property are like-kind to each other and that federal law properly governs the test of what is like-kind for purposes of Section 1031 since state law does not normally address this question.

The Proposed Regulations

Prior to the TCJA, both real property and personal property were subject to like-kind exchange treatment under Section 1031(a), except for excluded classes of property described in Section 1031(a)(2). Real property and personal property were, however, not regarded as being "like-kind" to each other and therefore an exchange of real property for personal property (or vice versa) was outside the scope of Section 1031. As a result of TCJA, like-kind exchanges were limited to real property, which meant that there was added significance to the scope of the definition of real property for purposes of Section 1031. The legislative history to the TCJA provides that real property eligible for like-kind exchange treatment under pre-TCJA law should continue to be eligible for like-kind exchange treatment after the enactment of the TCJA.

There are numerous other definitions provided for "real property" or parallel concepts in other regulations interpreting other Sections of the Code, all referred to in the Supplementary Information released concurrently with the Proposed Regulations. In particular, Reg. 1.263(a)-2(b) provides a definition for purposes of determining whether expenditures can be deducted or must be capitalized under Section 263(a). Reg. 1.263A-8(c) provides a definition for purposes of determining is treated as inventory for purposes of Section 263A. Reg. 1.856-10 provides a definition of real property for purposes of determining whether a

corporation is a REIT. Reg. 1.897-1(b) provides a definition for purposes of Section 897's characterization of whether gain or loss by a foreign owner or real property is income effectively connected to U.S. trade or business The Proposed Regulations explicitly state that they do not rely upon any of these regulations because, in the view of ASCSP, Treasury and IRS properly concluded that "*it would not be appropriate to adopt wholesale as the definition of real property for purposes of Section 1031 an existing definition of real property from another Section of the Code or regulations due to the varying purposes of each of the provisions of the Code and the intent of Congress that real property eligible for like-kind exchange treatment under pre TCJA law should continue to be eligible for like-kind exchange treatment in years beginning after 2017* [emphasis added].

Under the Proposed Regulations real property includes land and improvements to land, unsevered crops and other natural products of land, and water and air space superjacent to land. Improvements to land include inherently permanent structures and the structural components of inherently permanent structures. The Proposed Regulations provide that local law definitions generally are not controlling in determining the meaning of the term "real property" for purposes of Section 1031.

The Proposed Regulations provide that each distinct asset must be 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. The Proposed Regulations also provide a list of structures that qualify as inherently permanent structures. If property is not included in the list of inherently permanent structures, the Proposed Regulations provide multiple factors that must be used to determine whether the property is an inherently permanent structure for purposes of Section 1031.

Under the Proposed Regulations, property that is in the nature of machinery or is essentially an item of machinery or equipment is generally labeled on a *per se* basis as not an inherently permanent structure and not real property under Section 1031. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the machinery is real property if it serves the inherently permanent structure and does not produce or contribute to the production of income other than for the use or occupancy of space. Structural components of inherently permanent structures are improvements to land and thus real property for purposes of Section 1031. A structural component is any distinct asset that is a constituent part of, and integrated into, an inherently permanent structure. If interconnected assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset component that may qualify as a structural component. For example, a gas line that provides fuel to a building's heating system comprises a part of the structural component that is the heating system, and therefore qualifies as real property for Section 1031 purposes. However, if the purpose of a gas line is to provide fuel to business equipment in a building, such as fryers and ovens in a building utilized as a restaurant, the gas line is not a constituent part of an inherently permanent structure and therefore not real property for Section 1031 purposes.

The Proposed Regulations define real property only for purposes of Section 1031. Consequently, the Proposed Regulations expressly provide that no inference should be drawn from the Section 1031 definition of real property for any purpose outside of Section 1031, including for the classification of property for depreciation, whether depreciation recapture applies, or defining an asset for disposition purposes under Section 168 and the regulations under Section 1031(b).

Further, the Proposed Regulations do not address the separate question of what interests in real property are like-kind to other interests in real property, as this issue has always been associated with Section 1031 and was not modified or addressed by the TCJA.

Discussion

ASCSP's members are professionals well versed in the distinctions between real property and personal property for purposes of Section 168. The Tax Court has mandated that the touchstone for these distinctions be found in Regulations and interpretations of tax law developed under prior law for purposes of determining whether acquisition of property was eligible for investment tax credit under Section 38. Thus, ASCSP's members spend considerable time focused on the classification of qualifying tangible property under Reg. 1.48-1(c) and -1(d)(1) compared to the definition of non-qualifying building and structural components under Reg. 1.48-1(e). Where their clients are real estate investment trusts, ASCSP's members must also take into account the provisions of Reg. 1.856-10, making the distinction between real property that can be held by a REIT to produce income and personal property that cannot.

However, along with Treasury and the IRS, ASCSP also recognizes that the definitions of real property for purposes of Sections 38, 263, 856, 897 or 1250 do not provide the appropriate framework for the definition of real property for purposes of Section 1031. The definition in Reg. 1.48-1 applicable to Section 38, expressly says ""property may be personal property for the investment tax credit even though under local law the property is considered to be a fixture and therefore real property" The Congressional history relating to the investment tax credit clearly established Congress' intent to broadly define property associated with productive activities as personal property in order to encourage its acquisition and use. This broad approach, intended to create specific economic incentives, is at the heart of the broad personal property classifications utilized by the Tax Court in the *Hospital Corporation of America* case. It is completely independent of and, in some ways inconsistent with, the broad approach to real property historically applicable to Section 1031.

ASCSP also notes that Reg. 1.856-10, issued to define what a real estate investment trust can call real estate for purposes of the asset tests applicable to REITs is focused on the passive nature of a REIT's investment and sources of income on which double taxation can be avoided via the dividends paid deduction, whereas the scope of "real property" for purposes of the like-kind exchange rules has historically been much broader.

ASCSP believes that a very broad definition of real property for purposes of Section 1031 would be most consistent with the legislative history of the TCJA, which stated that the revisions to Section 1031 were not intended to narrow the scope of real property that qualified for a like-kind exchange. Indeed, as discussed below, one of ASCSP's concerns about the Proposed Regulations is that, in some limited circumstances, the Proposed Regulations would not treat as real property assets that historically have been so treated for purposes of Section 1031. ASCSP would like to see the Proposed Regulations adopt a definition of real property that is as broad as permissible under the legislative history.

ASCSP believes that a broad definition will be helpful not only to its members but also the general public. Section 1031 was intended to foster sales and other transfers of real property so as to prevent the "lock down" impact of taxation on assets; a continuing investment in real property without intervening tax consequences is helpful to the liquidity of the real estate markets. Because real estate is often a major component of the wealth of both businesses and individuals, any limitation on like-kind exchanges of real estate will necessarily result in reduced liquidity in the real estate market.

Thus, for a variety of reasons, ASCSP believes that the definition of real property for purposes of Section 1031 should be as broad as possible, and any reliance on the definition of real property under other provisions in the Code would not be appropriate. As noted, the Proposed Regulations correctly adopt this approach in the language of Prop. Regs 1.1031(a)-3(a)(6).

ASCSP believes that the definition of real property should include land and improvements to land, with improvements to land being defined as inherently permanent structures and the structural components of inherently permanent structures. Thus, ASCSP agrees, for example, that for purposes of Section 1031, an office building is not limited to the land and four walls but also includes all of the structural components of the building, such as elevators, escalators, trash chutes, heating and cooling systems, etc. ASCSP believes that all inherently permanent structures should be treated as real estate, without regard to the function of such structures. This determination should be a facts and circumstances test that takes into account the nature of structures and the components thereof to determine whether or not they are inherently permanent. Until IRS released CCA 201238027, the function of an asset was never associated with determination of whether or not it was real property for Section 1031 purposes or was "like-kind" to other real property as long as the asset was permanently affixed to other real property and the taxpayer's interest in the asset consisted of permanent and complete ownership.

This long-standing approach is not taken in the Proposed Regulations. Under the Proposed Regulations, each distinct asset must be considered to determine whether it is an inherently permanent structure (or a component thereof), but assets that could be moved in theory are not treated as inherently permanent. A "Five-Factor Test" is established in Prop. Regs 1.1031(a)-3((a)(2)((ii)(C) that will require taxpayers to undertake potentially laborious analyses of the classification of assets that have historically be treated as real property. Similarly, the Proposed Regulations provides that property that is in the nature of machinery or is essentially an item of machinery or equipment is generally not an inherently permanent structure and not real property for purposes of Section 1031 if such machinery or equipment is used in the production of income.

ASCSP respectfully disagrees with this approach. We believe that the appropriate test is whether an asset is inherently permanent – if it is, it should be treated as real property for purposes of Section 1031 without regard to its purpose or use. Thus, for example, the cooling units and piping in a refrigerated warehouse are inherently permanent and should be treated as part of the real property, without regard to the fact that the cooling units and piping are part of an income-generating structure. Likewise, the Proposed Regulations specifically provide that a gas line used to provide heat within a building is treated as part of the real property, whereas a gas line used to provide gas to fryers in the building is not; we believe that both should be treated as part of the real property if they are inherently permanent parts of the structure. Another example is the wiring that is placed inside a trading floor to allow the user of the floor to operate; we believe that such wiring is an inherently permanent part of the structure and should be treated as real property. Similarly, all of the electronic systems in a data center should be treated as part of the real estate, even if such systems could theoretically be removed because they are inherently part of that data center.

In this regard, ASCSP has also considered whether the characterization of an asset for state law should be relevant for purposes of applying Section 1031. We are aware that there are numerous prior authorities in which state law was taken into account[3], and we are also aware that the legislative history to the TCJA states that the definition of real property under Section 1031 as amended was not intended to be narrower than prior law. On the other hand, ASCSP is sympathetic to the drafters' desire to avoid being bound by state law in all situations, e.g., the determination whether the exchange of one multistate gas pipeline for another effectively identical pipeline qualifies under Section 1031 should not depend upon differences in classification of the pipeline from state-to-state. To address this issue, reflected in 1.1031(a)-3(c) Example 10, we have a specific recommendation, discussed below.

[3] See, e.g. Oregon Lumber Company vs Commissioner, 20 T.C. 192 (1953); Fleming vs Commissioner, 24 T.C. 818 (1955); Koch vs. Commissioner, 356 U.S. 260 (1958); Peabody Natural Resources Co. vs Commissioner, 126 T.C. 261 (2006),

Upon reflection, ASCSP believes that the total disregard of state law is not consistent with prior authorities, nor is such approach consistent with our view that the Proposed Regulations should adopt a broad definition of "real property" in accordance with the legislative history of the TCJA. Instead, ASCSP believes that the Proposed Regulations should adopt an approach under which any asset (other than land, which is per se real property) is treated as real property for purposes of Section 1031 if the asset is (1) an inherently permanent structure, (2) a structural component of an inherently permanent structure, or (3) treated as real property under applicable state law. Under this approach, even if an interstate gas pipeline were treated as personal property under the law of State A but real property under the law of State B, the pipeline would be treated as real property for purposes of Section 1031 because it is inherently permanent. Likewise, if the machinery inside a power generating station in State C is treated as real property under state law in State C, such machinery would be treated as real property for purposes of Section 1031 without regard to whether it is inherently permanent or a structural component of inherently permanent property. We also believe that any asset which is essentially the same as an asset treated as real property under the foregoing test should be treated as real property for purposes of Section 1031, because such assets would certainly be like-kind and one of the assets was real property (so that both should be treated as real property for purposes of Section 1031).

The approach that ASCSP has suggested would ensure compliance with the legislative history's command that the definition of "real property" should not be narrowed as a result of the amendment of Section 1031 in the TCJA. This approach would also avoid future litigation concerning whether regulations that disregard state law classification are invalid because prior authorities had taken state law into account and the TCJA did not override such authorities. Thus, ASCSP believes that its proposed definition of real property would be more consistent with the purpose and intent of Section 1031.

Moreover, ASCSP notes that the application of federal, not state, law would continue to apply in determining whether interests in real property were of like-kind. Analysis of this question is properly the subject of federal guidance and with respect to real property has focused on whether the duration and extent of an interest was sufficiently comparable; starting with the conclusion in Treas. Reg 1.1031(a)-1(c), that a leasehold interest in real estate with a term of 30 years or more is like-kind to a fee interest in real estate without regard to whether the real estate is improved or unimproved. and also illustrated by the *Fleming* and *Koch* cases, cited in footnote 3 above. ASCSP notes that clients of its members are typically dealing with outright ownership of assets, so where real property assets are involved the issue of what is "like-kind" normally has not been present under current law

To apply the principles expressed above, ASCSP would like to offer specific comments on some of the Examples contained in the Proposed Regulations, as we think they illustrate the flaws inherent in the limitations to the definition of real property represented by the proposal

We agree with the conclusion in Example 3 concerning the indoor sculpture, focusing on the historical criteria of permanent affixation and expectation of indefinite maintenance in place of the sculpture.

We also agree that the factual description of removeable and reusable bus shelters in Example 4 dictates the conclusion expressed, that these assets are not real property. However, we note that if any of the elements of the Five Factor Test associated with a real property classification were present, we likely would feel differently.

We disagree with the conclusion in Example 5 because the printer was designed to remain in place indefinitely. We agree that the generator described in this example should be treated as real property, but for the reasons discussed above disagree with the premise that the purpose and use of the generator dictates

its classification as real or personal property for Section 1031 purposes. We believe that the generator is inherently permanent and, therefore, should be treated as part of the real property. For the same reason, we disagree with the analysis and conclusion in Example 6.

We understand the conclusion reached in Example 7 concerning the raised flooring, based on the stated facts providing that this is not an inherently permanent structure, although the question is a close one because "flooring" is often treated as part of a building. The stated facts indicate that the raised flooring in this example was not specifically designed for this particular building. In this regard, the raised flooring appears to be more similar to the movable Modular Partition System in Example 9 (see discussion below), and it would therefore fall outside the scope of real property. We do recommend that in issuing Final Regulations, Treasury and IRS add a clarification to Example 7 to reflect that the raised flooring is modular in nature because if the raised flooring were custom designed for the building, we believe that it should be treated as real property because it would not be similar to a modular partition system. We also note that, despite acceptance of the conclusion that installation during construction of the building (thus passing one of the Five Factor Test elements) may not be sufficient, the example illustrates the potential for controversy and disagreement between IRS and taxpayers on how to apply the Five Factor Test, when some of the factors indicate that an asset is real property and some do not. Will a majority of factors criteria be applied? At the least, clarification is in order.

We emphatically disagree with the conclusion in Example 8 concerning a steam turbine. The turbine is inherently permanent and will never be moved. The fact that the turbine is used to generate electricity that produces income should not result in characterization of the turbine as real property for purposes of Section 1031; by the same token, a dam should be treated as real property, even if the dam holds back water that is used for the production of income. Nuclear reactors and containment vessels similarly are used for the production of income but are definitely real property if the test is properly focused on whether or not the asset is inherently permanent.

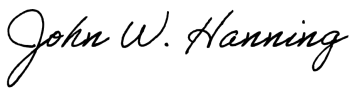
We think the different classifications applied to the contrasting examples of Conventional Partition Systems versus Modular Partition Systems found in Example 9, while not unreasonable, illustrates the difficulties with the approach to definition taken in the Proposed Regulations. In our experience, it would be highly unusual for the seller or purchaser of a building that included modular partition systems being conveyed with the building and its underlying land to arrive at a separate value assigned to such systems unless they have or will undertake a cost segregation study. But by classifying these assets as personal property, if the seller intends that the property be relinquished property or the purchaser is acquiring the property as replacement property in a like-kind exchange, they will be forced to undertake such a study since the value of the systems may create immediate recognition of gain under Section 1031(b). While this may provide more business for ASCSP members, we are not sure it represents sound tax policy.

Example 10 is challenging and we think takes an incorrect approach to the facts it presents. We understand the interest of Treasury and IRS in classifying the same assets, effectively identical pipeline transmission systems, as capable of being exchanged where subject to different classification as real property or personal property by different state laws. This was previously addressed in CCA 201238027 by concluding that identical assets were *per se* like-kind regardless of state law classification. Unfortunately, with Section 1031 limited to real property, the prior approach can no longer work, so the solution of Example 10 and the Proposed Regulations is to ignore state law and simply define buried pipeline as real property. While convenient, we think this is unnecessary. We think that the issue of differing state law definitions can be easily solved without jettisoning any reference to state law in evaluating what is real property for purposes of Section 1031 by concluding that under Section 1031 identical assets (like buried pipelines) that are real property for state law applicable to either the relinquished or replacement assets are real property for Section

1031 purposes. We also believe that the same principle should apply to classification of meters and compressors described in this example. That is, assuming these assets are not regarded as fixtures for state law purposes in either state where the pipelines are located, they would not constitute real property. This appears to us to be the case based on the example's description of these items as being removable and reusable and not time-consuming or expensive to install or remove.

On behalf of the American Society of Cost Segregation Professionals and the real estate investors that we serve, we appreciate your attention to this important matter. As such, we strongly urge you to revisit your position to ensure these regulations are as consistent with Congressional intent to drive further investment and growth. We look forward to working with you on this matter. We also would be pleased to participate in a public hearing on the Proposed Regulations to answer any questions you may have about our comments or to discuss our positions. Should you have any questions, please contact John W. Hanning at (678) 996-5791.

Very truly yours,



John W. Hanning
ASCSP President - Certified Member #C0139-10
info@ASCSP.com

cc: John P. Moriarty, Esq.
Associate Chief Counsel (IT&A)

Stephen J. Toomey
Senior Counsel

Amy J. Pfalzgraf, Esq.
Senior Counsel

Suzanne R. Sinno, Esq.
Attorney