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INSIGHT: Tax Insight: The Impact of TCJA on Cost Segregation and Like-Kind Exchange



BY SO SUM LEE

Like-kind exchange has been a popular tax deferral tool for decades. Under tax code Section 1031, a taxpayer can defer tax on gain from the sale of a business or investment property if it is exchanged for like-kind property. Real property is generally like-kind to all real property while personal property has slightly more stringent requirements.

In terms of like-kind exchange, it is generally accepted that the definition of real property by state law is followed. As such, fixtures identified under cost segregation, though being depreciated under [Section 1245](#) as personal property, are still considered real property for [Section 1031](#) purposes. With the implementation of new tax laws under the Tax Cuts and Jobs Act (TCJA), the definition of real vs. personal property quickly became a heated debate amongst experts. Many were left wondering what impact the Tax Cuts and Jobs Act had on cost segregation and Section 1031 Exchange.

Like-Kind Exchange

The concept of tax-deferred, like-kind exchange dates back to the 1920s. However, the present-day definition of like-kind exchange was introduced in the 1950s. Pursuant to Section 1031, a taxpayer can defer tax on gain from the sale of a business or investment property if it is being exchanged for like-kind property. Both personal and real property qualified for tax deferral treatment under pre-2018 Section 1031.

Real property is generally like-kind to all other real property whether or not improved. Personal property must be of like-kind and like-class in order to qualify for tax-deferral treatment. When exchanging multiple properties, Treasury Regulation Section 1031(j)-1 requires taxpayers to group multiple properties into ex-

change groups of like-kind or like-class. Gain or loss is then calculated for each exchange group.

Cost Segregation Studies

The primary goal of cost segregation is to identify all property-related costs that can be depreciated faster (typically with a five, seven or 15-year tax life). The secondary goal (as a result of the more recently issued Tangible Property Regulations) of cost segregation is to establish the depreciable tax value for each major building component that is likely to be replaced in the future. Examples include the roof, windows, doors, bathroom fixtures, HVAC, and so on. When a component is replaced, the tax preparer needs this information to claim a “retirement loss” or “partial disposition” deduction for the remaining depreciable basis left on that component.

A cost segregation study is also a natural launch point for exploring other related opportunities such as assessing the potential for deducting current year repairs, retirements, and removal costs; identifying special property like qualified leasehold improvements, qualified retail improvement property, qualified restaurant property, and qualified improvement property; as well as discovering green building deduction and credit opportunities.

Interaction of Cost Segregation with Like-kind Exchange

Although the TCJA removed personal property from qualifying for Section 1031, footnote 726 of the Committee Report states “It is intended that real property eligible for like-kind exchange treatment under present

law will continue to be eligible for like-kind exchange treatment under the provision.” Given this clarification, we believe that Congress intended the treatment under pre-TCJA law regarding real property exchange to continue to apply.

The Internal Revenue Service has taken the position that federal income tax law, rather than state law, controls whether exchanged properties are of like-kind for Section 1031 purposes. All facts and circumstances should be considered in determining whether properties are of the same nature and character. However, despite the fact that generally, state law does not control the definition, there have been several court cases in which state laws have been respected.

In [*Morgan v. Commissioner*](#), the U.S. Supreme Court deferred to state law to determine the classification of property rights as real or personal. In [*Commissioner v. Crichton*](#), the U.S. Court of Appeals for the Fifth Circuit determined that a mineral right was real property under Louisiana state law and therefore was of like-kind to other real property. In [*Peabody Natural Resources Co. v. Commissioner*](#), the U.S. Tax Court determined that coal supply contracts constituted real property interests under New Mexico law and therefore were of like-kind to a gold mine.

Depreciation classification plays no role under state law in determining whether a property is real or personal property. Fixtures such as wall coverings, carpeting, and special purpose wiring affixed to the building are considered real property under state law. However, this property can be depreciated under Section 1245 as personal property even though under state law such property is considered real property. Further, Treas.

Reg. 1.263A-8(c)(1) provides that real property includes land, unsevered natural products of land, buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. Treas. Reg. 1.263A-8(c)(3) further provides that inherently permanent structures include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time. Property may constitute an inherently permanent structure even though it is not classified as a building for purposes of former Section 48(a)(1)(B) and Treas. Reg. 1.48-1. We believe the portion of the building cost that is segregated out and depreciated under Section 1245 will fit into this category.

While we believe that TCJA would not impact the Section 1031 exchange treatment for real estate as it is now, there are some considerations to make when parsing cost segregation with like-kind exchange. For example, tax preparers should be aware of different property groups and values to avoid Section 1245 and/or [Section 1250](#) recapture. An experienced advisor will know how to navigate these complexities and provide guidance for those looking to utilize this sophisticated tax strategy.

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