Current Federal Tax Developments

Week of June 15, 2020

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ACCOUNTING
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CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JUNE 15, 2020
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Kaplan Financial Education

Contents

Section: PPP Loan SBA IFR Modifies Original April 4 IFR, Clarifies that PPPFA Does Not Create a Cliff Test for Use of Loan Proceeds 1

Section: PPP Loan SBA Announces That, Despite Language in PPPFA, No 60% Cliff on Forgiveness on PPP Loans 6

Section: 170 Tax Treatment for Programs for Donation of Employee Leave Time Value to COVID-19 Charities Described in IRS Notice 8

Section: 213 Proposed Regulations Issued on Definition of Medical Expenses for Health Care Sharing Ministries and Direct Primary Care Arrangements 9

Section: 1031 Proposed Regulations Issued Defining Real Property for Post-TCJA Like-Kind Exchanges 16

SECTION: PPP LOAN
SBA IFR MODIFIES ORIGINAL APRIL 4 IFR, CLARIFIES THAT PPPFA DOES NOT CREATE A CLIFF TEST FOR USE OF LOAN PROCEEDS

Citation: RIN 3245-AH49, "Business Loan Program Temporary Changes; Paycheck Protection Program – Revisions to

First Interim Final Rule," Small Business Administration, June 10, 2020

The SBA released the first PPP loan guidance to modify prior guidance due to the passage of the Paycheck Protection Program Flexibility Act (PPPFA) in a new interim final rule (IFR).[1] The new rule modifies the interim final rule originally published on April 2, 2020 to deal with certain provisions changed by the PPPFA.

Loan Forgiveness

A key area of concern when the Act was passed involved Section 3(b) of the Act which provided, in part:

> To receive loan forgiveness under this section, an eligible recipient shall use at least 60 percent of the covered loan amount for payroll costs, and may use up to 40 percent of such amount for any payment of interest on any covered mortgage obligation (which shall not include any prepayment of or payment of principal on a covered mortgage obligation), any payment on any covered rent obligation, or any covered utility payment.

The provision appeared to create a cliff for forgiveness—if the borrower failed to use 60% of the loan *proceeds* to pay payroll costs during the covered period, none of the amount borrowed would be forgiven. However, the Treasury Secretary and SBA Administrator issued a joint statement on June 8, 2020 that indicated guidance would be issued that eliminate this cliff test.

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[1] RIN 3245-AH49, "Business Loan Program Temporary Changes; Paycheck Protection Program – Revisions to

First Interim Final Rule," Small Business Administration, June 10, 2020, https://home.treasury.gov/system/files/136/PPP-IFR-Revisions-to-First-Interim-Final-Rule.pdf (retrieved June 11, 2020)

The IFR contains this promised relief from a cliff test. In Section 1.d of the IFR, the SBA explains the interpretation the agency will take of the above provision, and why they are not using the apparently required cliff test:

> While the Flexibility Act provides that a borrower shall use at least 60 percent of the PPP loan for payroll costs to receive loan forgiveness, the Administrator, in consultation with the Secretary, interprets this requirement as a proportional limit on nonpayroll costs as a share of the borrower's loan forgiveness amount, rather than as a threshold for receiving any loan forgiveness.

The SBA justifies this position by finding it is not consistent with other provisions of the PPPFA:

> This interpretation is consistent with the new safe harbor in the Flexibility Act. The new safe harbor provides that if a borrower is unable to rehire previously employed individuals or similarly qualified employees, the borrower will not have its loan forgiveness amount reduced based on the reduction in full-time equivalent employees. It would be incongruous to interpret the Flexibility Act's 60 percent requirement as a threshold for receiving any loan forgiveness, because in some cases it would directly conflict with the flexibility provided by the new safe harbor.

As well, the 60% rule was enacted in response to the SBA's prior 75% rule which did not contain a cliff test:

> Further, the 60 percent requirement in the Flexibility Act was enacted against the backdrop of SBA's existing rules governing the PPP, which Congress was aware of and which provided for proportional reductions in loan forgiveness for borrowers that used less than 75% of their loan amount during the eight-week covered period for payroll costs.

The SBA indicates that such a view is more in line with the general purpose of the Act.

> In addition, this interpretation of the 60 percent requirement under the Flexibility Act is most consistent with Congress's purpose in that legislation – namely, to increase the flexibility provided to borrowers related to PPP loan forgiveness.

Based on the above justification, the SBA modified Part III.2.o of the April 2 IFR to read as follows:

> *o. Can my PPP loan be forgiven in whole or in part?*
>
> Yes. The amount of loan forgiveness can be up to the full principal amount of the loan and any accrued interest. An eligible borrower will not be responsible for any loan payment if the borrower uses all of the loan proceeds for forgivable purposes as described below and employee and compensation levels are maintained or, if not, an applicable safe harbor applies. The actual amount of loan forgiveness

> will depend, in part, on the total amount of payroll costs, payments of interest on mortgage obligations incurred before February 15, 2020, rent payments on leases dated before February 15, 2020, and utility payments for service that began before February 15, 2020, over the loan forgiveness covered period.

The SBA modifies the law, adding the word "full" before loan forgiveness in order to eliminate the cliff effect:

> However, to receive full loan forgiveness, a borrower must use at least 60 percent of the PPP loan for payroll costs, and not more than 40 percent of the loan forgiveness amount may be attributable to nonpayroll costs.

The guidance contains the following examples of the application of this reduced forgiveness:

> For example, if a borrower uses 59 percent of its PPP loan for payroll costs, it will not receive the full amount of loan forgiveness it might otherwise be eligible to receive. Instead, the borrower will receive partial loan forgiveness, based on the requirement that 60 percent of the forgiveness amount must be attributable to payroll costs. For example, if a borrower receives a $100,000 PPP loan, and during the covered period the borrower spends $54,000 (or 54 percent) of its loan on payroll costs, then because the borrower used less than 60 percent of its loan on payroll costs, the maximum amount of loan forgiveness the borrower may receive is $90,000 (with $54,000 in payroll costs constituting 60 percent of the forgiveness amount and $36,000 in nonpayroll costs constituting 40 percent of the forgiveness amount).

The practical effect of this is to modify the maximum forgiveness amount calculation on the PPP loan forgiveness application. Originally a borrower was to divide total payroll costs paid by 0.75 to obtain the ceiling on forgiveness based on the use of funds for payroll costs requirement. Now the borrower will instead divide payroll costs by 0.60 to obtain that ceiling.

Covered Period

Section 1.a of the IFR updates the covered period under CARES Act §1102 for the loans themselves, providing:

> Section 3(a) of the Flexibility Act amended the definition of "covered period" for a PPP loan from "the period beginning on February 15, 2020 and ending on June 30, 2020" to "the period beginning on February 15, 2020 and ending on December 31, 2020." Therefore, Part III.2.g.iii. of the First Interim Final Rule (85 FR 20811, 20813) is revised by striking "June 30, 2020" and replacing it with "December 31, 2020". Section 3(d) of the Flexibility Act provides that this amendment shall be effective as if included in the CARES Act, which was signed into law on March 27, 2020.

Since the CARES Act used the term "covered period" multiple times in the Act to describe different periods, the IFR clarifies that this definition does not affect the forgiveness covered period under CARES Act §1106:

> This amendment by the Flexibility Act applies to the definition of "covered period" that appears in section 1102 of the CARES Act, governing loan use, loan eligibility, and related requirements. It does not alter the meaning of "covered period" that appears in section 1106 of the CARES Act governing loan forgiveness, which is addressed by a different provision of the Flexibility Act.

Maturity Date for PPP Loans

The PPPFA modified the rules on maturity dates for PPP loans, mandating a minimum five-year period maturity date on loans made on or after the effective date of the PPPFA (June 5, 2020). The IFR explains the new provision in Section 1.b modifying Part III.2.j of the April 2 IFR:

> For loans made before June 5, 2020, the maturity is two years; however, borrowers and lenders may mutually agree to extend the maturity of such loans to five years. For loans made on or after June 5, the maturity is five years. Section 2 of the Paycheck Protection Program Flexibility Act of 2020 (Flexibility Act) amended the CARES Act to provide a minimum maturity of 5 years for all PPP loans made on or after its enactment.

The SBA has decided to define the date the SBA approves a loan as the date a loan is made:

> The Administrator, in consultation with the Secretary, determined that the date SBA assigns a loan number to the PPP loan provides an efficient, transparent, and auditable means of determining when a PPP loan is "made" that provides certainty to lenders.

While the law still allows a maximum 10-year maturity, the SBA has decided to provide for only the single five-year maturity on these new loans:

> While the CARES Act provides that a loan will have a maximum maturity of up to ten years from the date the borrower applies for loan forgiveness, the Administrator, in consultation with the Secretary, determined that a five-year loan term is sufficient in light of the temporary economic dislocations caused by the coronavirus. Specifically, the considerable economic disruption caused by the coronavirus is expected to abate well before the five-year maturity date such that borrowers will be able to resume business operations and pay off any outstanding balances on their PPP loans.

Deferral Period Modification

The PPPFA changed the period during which a borrower will not be required to make payments on a PPP loan to be delayed until the date the borrower receives a decision on whether and to what extent the loan will be forgiven. However, the PPPFA

provides a borrower who fails to apply for such forgiveness within 10 months of the end of the forgiveness covered period under CARES Act §1102 (as modified by PPPFA) will be required to start making payments at the end of that 10 month period.

The IFR discusses this provision at Section 1.c of the IFR, which modifies Part III.2.n of the April 2 IFR to provide the following guidance:

> If you submit to your lender a loan forgiveness application within 10 months after the end of your loan forgiveness covered period, you will not have to make any payments of principal or interest on your loan before the date on which SBA remits the loan forgiveness amount on your loan to your lender (or notifies your lender that no loan forgiveness is allowed).

The guidance continues, describing the nature of the forgiveness (§1106) covered period under the new law:

> Your "loan forgiveness covered period" is the 24-week period beginning on the date your PPP loan is disbursed; however, if your PPP loan was made before June 5, 2020, you may elect to have your loan forgiveness covered period be the eight-week period beginning on the date your PPP loan was disbursed. Your lender must notify you of remittance by SBA of the loan forgiveness amount (or notify you that SBA determined that no loan forgiveness is allowed) and the date your first payment is due. Interest continues to accrue during the deferment period.

The SBA in a footnote reminds the reader that the end of the forgiveness covered period can be no later than December 31, 2020 per section 3(b)(1) of the PPPFA.

The guidance provides the following information for borrowers who do not make an application by the date 10 months after the end of the §1106 covered period.

> If you do not submit to your lender a loan forgiveness application within 10 months after the end of your loan forgiveness covered period, you must begin paying principal and interest after that period. For example, if a borrower's PPP loan is disbursed on June 25, 2020, the 24-week period ends on December 10, 2020. If the borrower does not submit a loan forgiveness application to its lender by October 10, 2021, the borrower must begin making payments on or after October 10, 2021.

Other Changes

The IFR also makes changes necessary for consistency with the other modifications to the provisions in the April 2, 2020 IFR that discusses acceptable uses of PPP loan funds and the certifications a borrower is to make.

SECTION: PPP LOAN
SBA ANNOUNCES THAT, DESPITE LANGUAGE IN PPPFA, NO 60% CLIFF ON FORGIVENESS ON PPP LOANS

Citation: "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, 6/8/20

Treasury Secretary Steven Mnuchin and SBA Administrator Jovita Carranza have issued a joint statement that provides certain details about the SBA's planned implementation of changes found in the Paycheck Protection Program Flexibility Act signed into law on June 5, 2020.[2]

The release describes the following guidance the SBA expects to release on the changes made by this law.

60% Rule for Payroll

Senator Rubio had expressed concern that the language of the Paycheck Protection Program Flexibility Act could cause businesses that spent less than 60% of the proceeds on payroll costs to end up with no debt forgiveness. The language of the bill certainly seemed to lead to this result.

However, the announcement indicates that the SBA guidance will provide that a minimum of 60% of the amount forgiven must consist of payroll costs, rather than providing that if less than 60% of the loan proceeds are used for payroll costs there would be no forgiveness of the loan.

The statement provides that the change will:

> Lower the requirements that 75 percent of a borrower's loan proceeds must be used for payroll costs and that 75 percent of the loan forgiveness amount must have been spent on payroll costs during the 24-week loan forgiveness covered period to 60 percent for each of these requirements. If a borrower uses less than 60 percent of the loan amount for payroll costs during the forgiveness covered period, the borrower will continue to be eligible for partial loan forgiveness,

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[2] "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, June 8, 2020, https://home.treasury.gov/news/press-releases/sm1026#.Xt5OGz-FqJc.mailto (retrieved June 8, 2020)

> subject to at least 60 percent of the loan forgiveness amount having been used for payroll costs.

End of Loan Application Program

Senator Johnson of Wisconsin had initially withheld his support until he received assurance that the intent of the bill was not to extend the period when loans would be approved past June 30, 2020. The statement provides: "the new rules will confirm that June 30, 2020, remains the last date on which a PPP loan application can be approved."

Extension of the Covered Period

The statement addresses the new extended covered period for expending funds qualifying for forgiveness, indicating that the provision will:

> Extend the covered period for loan forgiveness from eight weeks after the date of loan disbursement to 24 weeks after the date of loan disbursement, providing substantially greater flexibility for borrowers to qualify for loan forgiveness. Borrowers who have already received PPP loans retain the option to use an eight-week covered period.

Safe Harbors Added by PPPFA

The PPPFA adds two new safe harbors that protect borrowers against reductions in the forgiveness amount in certain circumstances. The statement describes the first safe harbor related to being unable to return to the same level of activity, noting that the rules will:

> Provide a safe harbor from reductions in loan forgiveness based on reductions in full-time equivalent employees for borrowers that are unable to return to the same level of business activity the business was operating at before February 15, 2020, due to compliance with requirements or guidance issued between March 1, 2020 and December 31, 2020 by the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration, related to worker or customer safety requirements related to COVID–19.

The second safe harbor deals with employers that are unable to rehire employees they had on staff on February 15. The rules will:

> Provide a safe harbor from reductions in loan forgiveness based on reductions in full-time equivalent employees, to provide protections for borrowers that are both unable to rehire individuals who were employees of the borrower on February 15, 2020, and unable to hire similarly qualified employees for unfilled positions by December 31, 2020.

Loan Maturity Set to Five Years

The statement also provides details for the new loan maturity rules, indicating the rules will:

> Increase to five years the maturity of PPP loans that are approved by SBA (based on the date SBA assigns a loan number) on or after June 5, 2020.

Extension of Deferral Period

Finally, the statement discusses the new extension of the deferral period. The new rules will:

> Extend the deferral period for borrower payments of principal, interest, and fees on PPP loans to the date that SBA remits the borrower's loan forgiveness amount to the lender (or, if the borrower does not apply for loan forgiveness, 10 months after the end of the borrower's loan forgiveness covered period).

SECTION: 170
TAX TREATMENT FOR PROGRAMS FOR DONATION OF EMPLOYEE LEAVE TIME VALUE TO COVID-19 CHARITIES DESCRIBED IN IRS NOTICE

Citation: Notice 2020-46, 6/11/20

The IRS has released guidance for employers who have established programs that allow employees to donate the value of their vacation, sick, or personal leave to be paid by the employer to a §170(c) organization providing COVID-19 relief in Notice 2020-46.[3]

The Notice describes the programs as follows:

> Under leave-based donation programs, employees can elect to forgo vacation, sick, or personal leave in exchange for cash payments that the employer makes to charitable organizations described in section 170(c) of the Code (section 170(c) organizations).

The Notice provides the following tax treatment for employees for these payments.

> Cash payments an employer makes to section 170(c) organizations in exchange for vacation, sick, or personal leave that its employees elect to forgo will not be treated as wages (or compensation, as applicable) to the employees or otherwise be included in the gross income of the

[3] Notice 2020-46, June 11, 2020, https://www.irs.gov/pub/irs-drop/n-20-46.pdf (retrieved June 11, 2020)

> employees if the payments are: (1) made to the section 170(c) organizations for the relief of victims of the COVID-19 pandemic in the affected geographic areas; and (2) paid to the section 170(c) organizations before January 1, 2021. Similarly, employees electing to forgo leave will not be treated as having constructively received gross income or wages (or compensation, as applicable). The amount of cash payments to which this guidance applies should not be included in Box 1, 3 (if applicable), or 5 of the Form W-2. Electing employees may not claim a charitable contribution deduction under section 170 with respect to the value of forgone leave.

Similarly, the Notice provides the following treatment for the employer.

> An employer may deduct these cash payments under the rules of section 170 or the rules of section 162 if the employer otherwise meets the respective requirements of either section.

SECTION: 213
PROPOSED REGULATIONS ISSUED ON DEFINITION OF MEDICAL EXPENSES FOR HEALTH CARE SHARING MINISTRIES AND DIRECT PRIMARY CARE ARRANGEMENTS

Citation: REG-109755-19, 6/8/20

The IRS has issued proposed regulations that would revise Reg. §1.213-1 to allow medical deductions in certain cases for payments for direct primary care arrangements and healthcare sharing ministry memberships.[4]

The preamble states:

> …[T]he Treasury Department and the IRS propose that expenditures for direct primary care arrangements and health care sharing ministry memberships are amounts paid for medical care as defined in section 213(d), and that amounts paid for those arrangements may be deductible medical expenses under section 213(a). The proposed regulations also clarify that amounts paid for certain arrangements and programs, such as health maintenance organizations (HMO) and certain government-sponsored health care programs, are amounts paid for medical insurance under section 213(d)(1)(D).[5]

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[4] REG-109755-19, June 8, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-12213.pdf?utm_campaign=pi+subscription+mailing+list&utm_source=federalregister.gov&utm_medium=email (retrieved June 12, 2020)

[5] REG-109755-19, June 8, 2020, SUPPLEMENTARY INFORMATION, Explanation of Provisions

Direct Primary Care Arrangements

The proposed regulations provide that a *direct primary care arrangement* would be treated as expenses paid for medical care under IRC §213(d), making them deductible under IRC §213(a).[6] The IRS defines such an arrangement as follows:

> A "direct primary care arrangement" is a contract between an individual and one or more primary care physicians under which the physician or physicians agree to provide medical care (as defined in section 213(d)(1)(A)) for a fixed annual or periodic fee without billing a third party.[7]

A *primary care physician* is defined in the following sentence in the regulation:

> A "primary care physician" is an individual who is a physician (as described in section 1861(r)(1) of the Social Security Act) who has a primary specialty designation of family medicine, internal medicine, geriatric medicine, or pediatric medicine.[8]

The IRS discusses in the preamble the treatment of direct primary care arrangements under current law and the IRS proposed change:

> Direct primary care arrangements, as defined in the proposed regulations, may encompass a broad range of facts. Depending on the facts, a payment for a direct primary care arrangement may be a payment for medical care under section 213(d)(1)(A) or, as discussed below, may be a payment for medical insurance under section 213(d)(1)(D). For example, payments for a direct primary care arrangement that solely provides for an anticipated course of specified treatments of an identified condition, or solely provides for an annual physical examination, are payments for medical care under section 213(d)(1)(A). However, so long as a direct primary care arrangement meets the definition set forth in the proposed regulations, amounts paid for the arrangement will qualify as an expense for medical care under section 213(d), regardless of whether the arrangement is for medical care under section 213(d)(1)(A) or medical insurance under section 213(d)(1)(D).[9]

While this proposal is limited to primary care arrangements, the IRS in the preamble asks for comments on other types of health care arrangements, suggesting the final

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[6] Proposed Reg. §1.213-1(e)(1)(v)(A)

[7] Proposed Reg. §1.213-1(e)(1)(v)(A)

[8] Proposed Reg. §1.213-1(e)(1)(v)(A)

[9] REG-109755-19, June 8, 2020, SUPPLEMENTARY INFORMATION, Explanation of Provisions, 3.

guidance may allow for these other types of arrangements to be considered medical expenses:

> In addition, the Treasury Department and the IRS understand that other types of medical arrangements between health practitioners and individuals exist that do not fall within the definition of direct primary care. For example, an agreement between a dentist and a patient to provide dental care, or an agreement between a physician and a patient to provide specialty care, would not be a direct primary care arrangement but nonetheless may be the provision of medical care under section 213(d). The Treasury Department and the IRS request comments on whether the final regulations should clarify the treatment of other types of arrangements that are similar to direct primary care arrangements but do not meet the definition in the proposed regulations.[10]

Health Care Sharing Ministries

The preamble describes the current definition of a health care sharing ministry, found in IRC §5000A(d)(2)(B)(ii):

> For the purposes of section 213, the proposed regulations define a health care sharing ministry as an organization: (1) which is described in section 501(c)(3) and is exempt from taxation under section 501(a); (2) members of which share a common set of ethical or religious beliefs and share medical expenses among members in accordance with those beliefs and without regard to the State in which a member resides or is employed; (3) members of which retain membership even after they develop a medical condition; (4) which (or a predecessor of which) has been in existence at all times since December 31, 1999, and medical expenses of its members have been shared continuously and without interruption since at least December 31, 1999; and (5) which conducts an annual audit which is performed by an independent certified public accounting firm in accordance with generally accepted accounting principles and which is made available to the public upon request.[11]

The proposed regulations use this definition to add health care ministries to the list of medical insurance contracts and programs, providing:

> (2) Health care sharing ministries. — Amounts paid for membership in a health care sharing ministry that shares expenses for medical care, as defined in section 213(d)(1)(A), are payments for medical insurance

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[10] REG-109755-19, June 8, 2020, SUPPLEMENTARY INFORMATION, Explanation of Provisions, 1.

[11] REG-109755-19, June 8, 2020, SUPPLEMENTARY INFORMATION, Explanation of Provisions, 2.

> under section 213(d)(1)(D). A health care sharing ministry is an organization:
>
> > (i) Which is described in section 501(c)(3) and is exempt from taxation under section 501(a);
> >
> > (ii) Members of which share a common set of ethical or religious beliefs and share medical expenses among members in accordance with those beliefs and without regard to the State in which a member resides or is employed;
> >
> > (iii) Members of which retain membership even after they develop a medical condition;
> >
> > (iv) Which (or a predecessor of which) has been in existence at all times since December 31, 1999, and medical expenses of its members have been shared continuously and without interruption since at least December 31, 1999; and
> >
> > (v) Which conducts an annual audit which is performed by an independent certified public accounting firm in accordance with generally accepted accounting principles and which is made available to the public upon request.[12]

While the existing definition found at IRC §5000A is being used in this regulation, the IRS does ask for comments in the preamble on this definition of a health care sharing ministry.[13]

Additional Clarification on Medical Insurance

The IRS has decided to rewrite Reg. §1.213-1(e)(4), which defines health insurance, in its entirety. The purpose appears primarily to clarify the rule and incorporate subregulatory guidance the IRS had issued over the years.

The general definition of insurance, found at Proposed Reg. §1.213-1(e)(4)(i)(A)(1), provided in the new proposed regulations reads as follows:

> In determining whether a contract constitutes an "insurance" contract under section 213(d)(1)(D), it is irrelevant whether the benefits are payable in cash or in services. For example, amounts paid for hospitalization insurance, for membership in an association furnishing cooperative or so-called free-choice medical service, for group hospitalization and clinical care, or for membership in a health maintenance organization (HMO) are payments for medical insurance under section 213(d)(1)(D).

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[12] Proposed Reg. §1.213-1(e)(4)(i)(A)(2)

[13] REG-109755-19, June 8, 2020, SUPPLEMENTARY INFORMATION, Explanation of Provisions, 2.

The proposed regulations also explicitly add references to various government programs, providing at Proposed Reg. §1.213-1(e)(4)(i)(A)(3):

> Government-sponsored health care programs. Amounts paid for coverage under government-sponsored health care programs may be amounts paid for medical insurance under section 213(d)(1)(D). Taxes imposed by any governmental unit that fund such a program, however, do not constitute amounts paid for medical insurance. The following government-sponsored health care programs are medical insurance under section 213(d)(1)(D):
>
>> (i) The Medicare program under Title XVIII of the Social Security Act (42 U.S.C. 1395c and following sections), including Parts A, B, C, and D;
>>
>> (ii) Medicaid programs under title XIX of the Social Security Act (42 U.S.C. 1396 and following sections);
>>
>> (iii) The Children's Health Insurance Program (CHIP) under title XXI of the Social Security Act (42 U.S.C. 1397aa and following sections);
>>
>> (iv) Medical coverage under chapter 55 of title 10, U.S.C., including coverage under the TRICARE program; and
>>
>> (v) Veterans' health care programs under chapter 17 or 18 of Title 38 U.S.C.

The revision also adds rules that apply to insurance contracts that cover more than just medical care at Proposed Reg. §1.213-1(e)(4)(i)(B):

> Insurance contract covering more than medical care. Amounts are paid for medical insurance under section 213(d)(1)(D) only to the extent that such amounts are paid for insurance covering expenses of medical care referred to in paragraph (e)(1) of this section or for any qualified long-term care insurance contract as defined in section 7702B(b). Amounts will be considered payable for other than medical insurance under a contract if the contract provides for the waiver of premiums upon the occurrence of an event. In the case of an insurance contract under which amounts are payable for other than medical insurance (as, for example, a policy providing an indemnity for loss of income or for loss of life, limb, or sight) –
>
>> (1) No amount shall be treated as paid for medical insurance under section 213(d)(1)(D) unless the charge for such insurance is either separately stated in the contract or furnished to the policyholder by the insurer in a separate statement,
>>
>> (2) The amount taken into account as the amount paid for such medical insurance shall not exceed such charge, and

> (3) No amount shall be treated as paid for such medical insurance if the amount specified in the contract (or furnished to the policyholder by the insurer in a separate statement) as the charge for such insurance is unreasonably large in relation to the total charges under the contract. In determining whether a separately stated charge for insurance covering expenses of medical care is unreasonably large in relation to the total premium, the relationship of the coverage under the contract together with all of the facts and circumstances shall be considered.

Direct Primary Care Arrangements and HSAs

In the preamble, the IRS discusses the interaction between direct primary care arrangements and HSAs, noting that most often the direct primary care arrangement will be disqualifying coverage for an HSA.

> The Treasury Department and the IRS understand that direct primary care arrangements typically provide for an array of primary care services and items, such as physical examinations, vaccinations, urgent care, laboratory testing, and the diagnosis and treatment of sickness or injuries. This type of DPC arrangement would constitute a health plan or insurance that provides coverage before the minimum annual deductible is met, and provides coverage that is not disregarded coverage or preventive care. Therefore, an individual generally is not eligible to contribute to an HSA if that individual is covered by a direct primary care arrangement. [14]

The IRS does discuss a limited exception where coverage by a direct primary care arrangement would not bar contributions to an HSA if an individual otherwise has a qualifying high deductible health plan.

> However, in the limited circumstances in which an individual is covered by a direct primary care arrangement that does not provide coverage under a health plan or insurance (for example, the arrangement solely provides for an anticipated course of specified treatments of an identified condition) or solely provides for disregarded coverage or preventive care (for example, it solely provides for an annual physical examination), the individual would not be precluded from contributing to an HSA solely due to participation in the direct primary care arrangement.[15]

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[14] REG-109755-19, June 8, 2020, SUPPLEMENTARY INFORMATION, Explanation of Provisions, 5.

[15] REG-109755-19, June 8, 2020, SUPPLEMENTARY INFORMATION, Explanation of Provisions, 5

But the IRS notes that even in this case, if an employer pays the direct primary care arrangement fee, the program would still be disqualifying coverage.

> If the direct primary care arrangement fee is paid by an employer, that payment arrangement would be a group health plan and it (rather than the direct primary care arrangement), would disqualify the individual from contributing to a HSA.[16]

Health Care Sharing Ministries, HRAs and HSAs

The IRS also provided additional commentary in the preamble for the interaction of health care sharing ministries and HRAs and HSAs.

For health reimbursement arrangements (HRAs), the preamble has the following guidance:

> Under the regulations authorizing individual coverage HRAs, health care sharing ministries cannot integrate with an individual coverage HRA. However, under these proposed regulations, an HRA, including an HRA integrated with a traditional group health plan, an individual coverage HRA, a QSEHRA, or an excepted benefit HRA, may reimburse payments for membership in a health care sharing ministry as a medical care expense under section 213(d).[17]

However, membership in a health care sharing ministry will bar any contribution to a health savings account (HSA):

> Because the proposed regulations provide that health care sharing ministries are medical insurance under section 213(d)(1)(D) that is not permitted insurance, membership in a health care sharing ministry would preclude an individual from contributing to an HSA.[18]

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[16] REG-109755-19, June 8, 2020, SUPPLEMENTARY INFORMATION, Explanation of Provisions, 5

[17] REG-109755-19, June 8, 2020, SUPPLEMENTARY INFORMATION, Explanation of Provisions, 6

[18] REG-109755-19, June 8, 2020, SUPPLEMENTARY INFORMATION, Explanation of Provisions, 6

SECTION: 1031
PROPOSED REGULATIONS ISSUED DEFINING REAL PROPERTY FOR POST-TCJA LIKE-KIND EXCHANGES

Citation: Proposed Reg. §1.1031-3, REG-117589-18, 6/11/20

The Tax Cuts and Jobs Act limited like-kind exchanges under §1031 to exchanges of real property effective January 1, 2018. The IRS has issued proposed regulations,[19] upon which taxpayers may rely,[20] to implement these revisions in §1031.

Real Property Definition Needed Specifically for §1031

The most significant item covered in these regulations is the definition of what is considered real property for like-kind exchanges under §1031. The preamble notes:

> The determination of whether property is real property has taken on additional significance as a result of the TCJA amendments limiting like-kind exchange treatment under section 1031 to exchanges of real property. Prior to enactment of the TCJA, neither the Code nor the Income Tax Regulations provided a definition of the term "real property" for purposes of section 1031. The Treasury Department and the IRS have determined that regulations providing guidance on whether property is real property under section 1031 are needed because taxpayers need certainty regarding whether any part of the replacement property received in an exchange is non-like-kind property subject to the gain recognition rules of section 1031(b).[21]

The preamble notes that there are many different definitions of real property in the IRC, but these existing individual definitions have various differences due to the specific issues each section deals with. Thus, the IRS concludes that a §1031 specific definition of real property is necessary to determine whether an asset is real property for a like-kind exchange:

> …[I]nstead of a wholesale adoption of an existing real property definition used in another Code or regulations section, these proposed regulations incorporate certain aspects from existing regulatory definitions of real property that are consistent with the legislative history underlying the TCJA amendment to section 1031 indicating that real property eligible for like-kind exchange treatment under pre-

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

[20] REG-117589-18, SUPPLEMENTARY INFORMATION, Proposed Applicability Date

[21] REG-117589-18, SUPPLEMENTARY INFORMATION, Explanation of Provisions, Section I.A.

TCJA law should continue to be eligible for like-kind exchange treatment after the enactment of the TCJA. See, for example, §§1.263(a)-3(b)(3) and 1.856-10 defining the term "real property" to mean land and improvements to land such as buildings and other inherently permanent structures, and their structural components, and providing that local law is not controlling for purposes of determining whether property is real property under that section; §1.263A-8(c) providing that real property includes unsevered natural products of land such as growing crops and plants, mines wells and other natural deposits; and §1.856-10(c) providing, in relevant part, that the term "land" includes "water and air space superjacent to land.[22]

Definition of Real Property for §1031

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

The regulation begins by defining *real property* as:

- Land;
- Improvements to land;
- Unsevered natural products of land; and
- Water and airspace adjacent to land.[23]

This includes interests in real property such as:

- Fee ownership;
- Co-ownership;
- A leasehold;
- An option to acquire real property;
- An easement; or
- A similar interest.[24]

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[22] REG-117589-18, SUPPLEMENTARY INFORMATION, Explanation of Provisions, Section I.A.

[23] Proposed Reg. §1.1031(a)-3(a)(1)

[24] Proposed Reg. §1.1031(a)-3(a)(1)

However, the regulation points out that local law definitions are not controlling for purposes of §1031—this is a federal tax law definition specific to §1031.[25]

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 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.[26]

Proposed 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:

> 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.[27]

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[25] Proposed Reg. §1.1031(a)-3(a)(1)

[26] Proposed Reg. §1.1031(a)-3(a)(6)

[27] Proposed Reg. §1.1031(a)-3(a)(4)(i)

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
> >
> > (D) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.[28]

Improvements to Land

Improvements to land include:

- Inherently permanent structures and
- Structural components of inherently permanent structures.[29]

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."[30]

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.[31]

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[28] Proposed Reg. §1.1031(a)-3(a)(4)(ii)

[29] Proposed Reg. §1.1031(a)-3(a)(2)(i)

[30] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(A)

[31] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(B)

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
- Enclosed transportation stations and terminals and
- Stores.[32]

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 drilling platforms, derricks, oil and gas storage tanks; grain storage bins and silos; and enclosed transportation stations and terminals.[33]

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 this paragraph (a)(2)(ii)(C), the determination of whether the property is an

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[32] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(B)

[33] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(C)

> inherently permanent structure under this paragraph (a)(2)(ii) 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.[34]

Machinery is generally not considered part of real property, as it is not normally an inherently permanent structure.[35] However, the regulation does provide an exception:

> 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 provided 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.[36]

Structural Components

A *structural component* is a distinct asset "that is a constituent part of, and integrated into, an inherently permanent structure."[37] The regulation notes that "[i]f 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 that may be a structural component."[38]

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.

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[34] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(C)

[35] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(D)

[36] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(D)

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

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

- 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.[39]

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;
- Fire escapes;
- Security systems;
- Humidity control systems; and
- Other similar property.[40]

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

[40] Proposed Reg. §1.1031(a)-3(a)(2)(iii)(B)

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.

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.[41]

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."[42]

Intangible Assets

In certain cases, an intangible asset can be treated as real property for §1031 purposes. The regulation provides:

> To the extent an intangible asset derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the

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[41] Proposed Reg. §1.1031(a)-3(a)(3)

[42] Proposed Reg. §1.1031(a)-3(a)(3)

> production of income other than consideration for the use or occupancy of space, the intangible asset is real property or an interest in real property. Real property includes shares in a mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A) if, at the time of the exchange, the 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.[43]

The regulation devotes a more detailed discussion to the issue of when licenses and permits will be deemed to be real property for §1031 purposes, with the following qualifying as real property:

> A license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold or easement generally is an interest in real property under this section.[44]

But the guidance finds the following licenses and permits are not real property for §1031 purposes:

> However, a license or permit to engage in or operate a business on real property is not real property or an interest in real property if the license or permit produces or contributes to the production of income other than consideration for the use and occupancy of space.[45]

Examples

The regulation provides a series of twelve examples of applying these rules, found at Proposed 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)

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[43] Proposed Reg. §1.1031(a)-3(a)(5)(i)

[44] Proposed Reg. §1.1031(a)-3(a)(5)(ii)

[45] Proposed Reg. §1.1031(a)-3(a)(5)(ii)

- 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 (in this case the example illustrates how the 3D printer in question, despite being impractical to move, does not qualify as real property but a generator supplying electricity to the entire building does)
- Example 6: Generator for Industrial 3D Printer (changes the facts in Example 5 so that the generator solely supports the 3D printer and thus ceases to be real property)
- Example 7: 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 8: Steam Turbine (again the item is found to be part of machinery and not real property, even though it has certain attributes, including being permanently affixed, that might lead an adviser to believe it would qualify as real property)
- Example 9: Partitions (while a conventional partition system is found to be real property, a modular partition system is found not to be real property)
- Example 10: Pipeline transmission system (the pipeline and isolation valves are found to be real property, but meters are not)
- 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 describes the issue in the preamble:

> 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.[46]

The preamble goes on to describe the solution proposed 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 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).[47]

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

> (iii) Personal property 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 incidental personal property transferred with the real property does not exceed 15

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

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

> percent of the aggregate fair market value of the replacement real property.[48]

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

EXAMPLE (PROPOSED 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 other 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.

[48] Proposed Reg. §1.1031(k)-1(g)(7)(iii)