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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9151

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Additional Rules for Exchanges of Personal Property under Section 1031(a)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations replacing the use of the Standard Industrial Classification (SIC) system with the North American Industry Classification System (NAICS) for determining what properties are of a like class for purposes of section 1031 of the Internal Revenue Code (Code). The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the proposed rules section in this issue of the **Federal Register**. The final regulations consist of technical revisions to reflect the issuance of the temporary regulations.

DATES: Effective Date: These final and temporary regulations are effective August 12, 2004.

Applicability Date: For date of applicability, see §1.1031(a)-2T(d).

FOR FURTHER INFORMATION CONTACT: J. Peter Baumgarten, (202) 622-4920
(not a toll free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR Part 1 under section 1031(a) relating to the exchange of items of personal property that are within the same product class. Section 1031(a)(1) generally provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged solely for property of like kind to be held either for productive use in a trade or business or for investment. Thus, for a transaction to qualify as an exchange under section 1031, the transaction must constitute an exchange, the property relinquished and the property received in the exchange must be held for use in a trade or business or for investment, and the exchanged properties must be of like kind.

Section 1.1031(a)-2(a) provides that personal properties of a like class are to be considered of like kind for purposes of section 1031. Under §1.1031(a)-2(b), depreciable tangible personal property is of a like class to other depreciable tangible personal property if the exchanged properties are either within the same general asset class or within the same product class. The general asset classes are derived from Rev. Proc. 87-56 (1987-2 C.B. 674) (dealing with depreciation of personal property). Section 1.1031(a)-2(b)(2) adopts certain of those general asset classes to determine what property is of like kind for purposes of exchanging depreciable tangible personal property under section 1031, and identifies the types of personal property included in each general asset class listed.

Section 1.1031(a)-2(b)(3) provides, in part, that property within a product class consists of depreciable tangible personal property that is listed in a 4-digit product

class (or code) within Division D (pertaining to the manufacturing sector of the economy) of Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987) (SIC Manual). Section 1.1031(a)-2(b)(4) states that the SIC Manual generally is modified every 5 years and that the product classes for section 1031 purposes will follow the modifications of product classes in the SIC Manual.

Effective January 1, 1997, the Department of Commerce discontinued the SIC system set forth in the SIC Manual and adopted NAICS as set forth in Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 1997 (NAICS Manual). The NAICS Manual was updated in 2002. Copies of the NAICS Manual may be obtained from the National Technical Information Service of the Department of Commerce and may be accessed, with a more complete listing of manufactured products and manufacturing industries, on the internet at <http://www.census.gov/naics>.

Explanation of Provisions

As a result of the replacement of the SIC system with NAICS, these temporary regulations discontinue the use of SIC codes and adopt Sectors 31 through 33 of NAICS (pertaining to manufacturing) as the system for defining the product classes for purposes of like-kind exchanges of depreciable tangible personal property. Within NAICS, product classes are designated using 6-digit codes rather than the 4-digit codes assigned to product classes under the SIC system. However, properties within the same product class under the 4-digit SIC system generally will be of the same product class under the 6-digit NAICS. For example, under the SIC codes, dairy

equipment and haying machinery are within the same product class (SIC code 3523). Under NAICS, milking machines and haying machines are also within the same product class (NAICS code 333111).

The temporary regulations generally incorporate the provisions of §1.1031(a)-2(b)(3) relating to the use of product classes but substitute NAICS codes for SIC codes. For example, §1.1031(a)-2(b)(3) provides that, under the 4-digit SIC system, any 4-digit product class ending in 9 (a miscellaneous category) is not property within a product class. Similarly, the temporary regulations provide that any NAICS 6-digit product class ending in 9 is not property within a product class. Accordingly, such property, and property that is not listed in a 6-digit product class, cannot be of a like class to other property based on the 6-digit NAICS Manual classification. Taxpayers, however, may still demonstrate that these properties are of a like kind.

Comments are specifically requested regarding the continued utility of SIC codes and any potential problems in adopting the 6-digit NAICS codes in lieu of the 4-digit SIC codes, including specific examples of how a product class is narrowed if the 6-digit NAICS code is used and whether this would be a disadvantage to any class of taxpayers.

The temporary regulations incorporate the provisions of §1.1031(a)-2(b)(4) that permit taxpayers, in structuring like-kind exchanges, to rely on modifications to the product classes resulting from revisions to the NAICS Manual. The temporary regulations omit the provisions of §1.1031(a)-2(b)(4) that permit taxpayers to rely on modifications to the general asset classes in Rev. Proc. 87-56 for purposes of structuring like-kind exchanges. Under section 6253 of the Technical and

Miscellaneous Revenue Act of 1988 (Pub. L. 100-647, 102 Stat. 3342), the Commissioner may not modify the asset classes in Rev. Proc. 87-56 for depreciation purposes. However, the temporary regulations provide that the Commissioner may, through published guidance of general applicability, supplement, modify, clarify and update the rules for the classification of properties. Therefore, the Commissioner may determine through published guidance not to follow a general asset class or product class for purposes of identifying property of like class or may determine that other properties not listed within the same or in any product class or general asset class nevertheless are of a like class.

Effective Date

In general, the temporary regulations apply to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply the temporary regulations to transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation has not expired. The temporary regulations include a transition rule permitting taxpayers to treat properties within the same product classes under a 4-digit SIC code as properties of like class for transfers of property made by taxpayers on or before the date these temporary regulations are published as final regulations in the **Federal Register**. Comments are specifically requested on whether a longer transition period should be provided before the use of the SIC codes is discontinued.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not

required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Please refer to the cross-referenced notice of proposed rulemaking published elsewhere in this issue of the **Federal Register** for applicability of the Regulatory Flexibility Act (5 U.S.C. Chapter 6). Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these temporary regulations is J. Peter Baumgarten of the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury participated in their development.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

Part 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.1031(a)-2, paragraphs (b)(3) through (b)(6), paragraph (b)(7)

Example 3 and Example 4, are revised and paragraph (d) is amended by adding a sentence at the end to read as follows:

§1.1031(a)-2 Additional rules for exchanges of personal property.

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(b)(3) through (b)(6) [Reserved]. For further guidance, see §1.1031(a)-2T(b)(3) through (b)(6).

(b)(7) * * *

Example 3. [Reserved]. For further guidance see §1.1031(a)-2T(b)(2), Example 3.

Example 4. [Reserved]. For further guidance see §1.1031(a)-2T(b)(2), Example 4.

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(d) * * * For transfers of property made by taxpayers on or after January 1, 1997, see §1.1031(a)-2T(d).

Par. 3. Section 1.1031(a)-2T is added to read as follows:

§1.1031(a)-2T Additional rules for exchanges of personal property (temporary).

(a) through (b)(2) [Reserved]. For further guidance, see §1.1031(a)-2(a) through (b)(2).

(3) Product classes. Except as provided in paragraphs (b)(4) and (b)(5) of this section, or as provided by the Commissioner in published guidance of general applicability, property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 2002 (NAICS Manual), as periodically updated. Copies of the NAICS Manual may be obtained from the National Technical Information Service, an agency of the U.S. Department of Commerce, and may be accessed on the internet. Sectors 31 through 33 of the NAICS Manual contain listings of specialized industries for the manufacture of

described products and equipment. For this purpose, any 6-digit NAICS product class with a last digit of 9 (a miscellaneous category) is not a product class for purposes of this section. If a property is listed in more than one product class, the property is treated as listed in any one of those product classes. A property's 6-digit product class is referred to as the property's NAICS code.

(4) Modifications of NAICS product classes. The product classes of the NAICS Manual may be updated or otherwise modified from time to time as the manual is updated, effective on or after the date of the modification. The NAICS Manual generally is modified every five years, in years ending in a 2 or 7 (such as 2002, 2007, and 2012). The applicability date of the modified NAICS Manual is announced in the **Federal Register** and generally is January 1 of the year the NAICS Manual is modified. Taxpayers may rely on these modifications as they become effective in structuring exchanges under this section. Taxpayers may rely on the previous NAICS Manual for transfers of property made by a taxpayer during the one-year period following the effective date of the modification. For transfers of property made by a taxpayer on or after January 1, 1997, and on or before January 1, 2003, the NAICS Manual of 1997 may be used for determining product classes of the exchanged property.

(5) Administrative procedures for revising general asset classes and product classes. The Commissioner may, through published guidance of general applicability, supplement, modify, clarify, or update the guidance relating to the classification of properties provided in this paragraph (b). (See §601.601(d)(2) of this chapter) For example, the Commissioner may determine not to follow (in whole or in part) a general

asset class for purposes of identifying property of like class, may determine not to follow (in whole or in part) any modification of product classes published in the NAICS Manual, or may determine that other properties not listed within the same or in any product class or general asset class nevertheless are of a like class. The Commissioner also may determine that two items of property that are listed in separate product classes or in product classes with a last digit of 9 are of a like class, or that an item of property that has a NAICS code is of a like class to an item of property that does not have a NAICS code.

(6) No inference outside of section 1031. The rules provided in this section concerning the use of general asset classes or product classes are limited to exchanges under section 1031. No inference is intended with respect to the classification of property for other purposes, such as depreciation.

(7) Examples. The provisions of this paragraph (b) are illustrated by the following examples:

Example 1 and Example 2 [Reserved]. For further guidance, see §1.1031(a)-2(b)(7), Example 1 and Example 2.

Example 3. Taxpayer E transfers a grader to F in exchange for a scraper. Neither property is within any of the general asset classes. However, both properties are within the same product class (NAICS code 333120). The grader and scraper are of a like class and deemed to be of a like kind for purposes of section 1031.

Example 4. Taxpayer G transfers a personal computer (asset class 00.12), an airplane (asset class 00.21) and a sanding machine (NAICS code 333210), to H in exchange for a printer (asset class 00.12), a heavy general purpose truck (asset class

00.242) and a lathe (NAICS code 333210). The personal computer and the printer are of a like class because they are within the same general asset class; the sanding machine and the lathe are of a like class because they are within the same product class (although neither property is within any of the general asset classes). The airplane and the heavy general purpose truck are neither within the same general asset class nor within the same product class, and are not of a like kind.

(8) Transition rule. Properties within the same product classes based on the 4-digit codes contained in Division D of the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual (1987), will be treated as property of a like class for transfers of property made by taxpayers on or before the date these regulations are published as final regulations in the **Federal Register**.

(c) [Reserved]. For further guidance, see §1.1031(a)-2(c).

(d) Effective dates. This section applies to transfers of property made by taxpayers on or after August 12, 2004. However, taxpayers may apply this section to transfers of property made by taxpayers on or after January 1, 1997, in taxable years for which the period of limitation for filing a claim for refund or credit under section 6511 has not expired. For all other exchanges occurring prior to August 12, 2004 (see §1.1031(a)-2(d)).

Linda M. Kroening,
Acting Deputy Commissioner for Services and Enforcement.

Approved: July 28, 2004.

Gregory F. Jenner,
Acting Assistant Secretary of the Treasury.