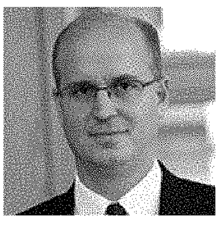
5-2019

Investing in a Qualified Opportunity Fund: A Viable Alternative to a Section 1031 Drop-Swap Cash-out

Bradley T. Borden

INVESTING IN A QUALIFIED OPPORTUNITY FUND: A VIABLE ALTERNATIVE TO A SECTION 1031 DROP-SWAP CASH-OUT



BRADLEY T. BORDEN is a Professor of Law at Brooklyn Law School of Special Counsel at Federman Steifman LLP. Professor Borden's research, scholarship, and teaching focus on taxation of real property transactions and flow-through entities (including tax partnerships, REITs, and REMICs). He teaches Federal Income Taxation, Partnership Taxation, Taxation of Real Estate Transactions, and Unincorporated Business Organizations, and he is affiliated with the Dennis J. Block Center for the Study of International Business Law. His work on flow-through and transactional tax theory appears in articles published in law reviews including Baylor Law Review, University of Cincinnati Law Review, Florida Law Review, Georgia Law Review, Houston Law Review, Iowa Law Review, Tax Lawyer, and Virginia Tax Review, among others. His articles also frequently appear in leading national tax journals including Journal of Taxation, Journal of Taxation of Investments, Real Estate Taxation, and Tax Notes.

Professor Borden has worked as a consultant to The Joint Committee on Taxation, Congress of the United States and often serves as an expert witness or consultant on major litigation matters that relate to real estate, flow-through taxation or legal malpractice. Before entering academia, he practiced tax law in the San Antonio, Texas law firm of Oppenheimer, Blend, Harrison & Tate, Inc. He is active in the American Bar Association Section of Taxation, is a past chair of its Sales, Exchanges & Basis Committee, and is a fellow of the American College of Tax Counsel.

In January 2019, Treasury published final regulations under Code section 199A, and in August 2018, it published proposed regulations under amended Internal Revenue Code (Code) section 168(k) (bonus depreciation). Both of these final and proposed regulations include rules that relate to Code section 1031 exchanges. In October 2018, Treasury published proposed regulations under Code section 1400Z-2. Those regulations do not directly address Code section 1031, but they require considering whether investing in a qualified opportunity fund (QOF) might be a viable alternative to a Code section 1031 drop-swap cash-out. This column examines the provisions related to Code section 1031 in final regulations under Code section 199A and proposed regulations under Code section 168(k) and the possible consequences of a QOF drop-swap cash-out.

CODE SECTION 199A REGULATIONS

Code section 199A provides a deduction equal to as much as 20 percent of the qualified business income of a qualified trade or business (QTB). That deduction is subject to limits. One limit is based solely on the amount of W-2 wages a QTB pays.[1] The other limit is based upon W-2 wages and the QTB's unadjusted basis immediately after acquisition (UBIA) of its qualified property.[2] The Code section 199A regulations address the effect Code section 1031 exchanges have on the UBIA of qualified replacement property.

Qualified property is depreciable property that meets certain use requirements during the property's depreciable period.[3] Because qualified property must be depreciable, Code section 199A UBIA does not include the basis of land. The depreciable period is the period ending on the later of 10 years after the date the property was first placed in service or the last full year of the property's recovery period.[4] The regulations provide rules for determining the depreciable period and the UBIA of replacement property acquired in a Code section 1031 exchange. The regulations adopt a step-in-the-shoes approach for both items.[5]

Regarding the depreciable period, the regulations provide that for the portion of the replacement property's UBIA that does not exceed the relinquished property's UBIA the depreciable period begins on the date the relinquished property was first placed in service.[6] For any portion of the replacement property's UBIA that exceeds the relinquished property's UBIA, the depreciable period begins on the date the replacement property is first placed in service.[7] A taxpayer with a long-term holding objective who relies upon the UBIA of its assets to qualify for the Code section 199A deduction would want the option of extending the depreciable period as long as possible to have the UBIA available to maximize the available Code section 199A deduction. By adopting the step-in-the-shoes approach, the regulations carry the depreciable period of the relinquished property over to the replacement property, which prohibits the exchanger from gaining additional depreciable period for like-kind property by doing an exchange. Exchangers also must determine the amount of UBIA they will have in qualified replacement property.

The regulations provide generally that the UBIA in property is its basis on the date it is placed in service determined under Code section 1012 or other applicable sections, including those in subchapter O.[8] Subchapter O includes Code section 1031, so the regulations would appear at first blush to use the Code section 1031(d) basis to determine the UBIA of replacement property, which is the rule that the proposed regulations had adopted.[9] If the UBIA of the replacement property were its basis determined under Code section 1031(d), most property owners would lose UBIA as a result of a Code section 1031 exchange because the Code section 1031(d) basis would take into account Code section 1016 adjustments, including depreciation deductions taken with respect to the relinquished property. Treasury recognized, however, that the loss of UBIA would deter exchangers from doing Code section 1031 exchanges and would cut against the general purpose of Code section 1031, which is to preserve the tax situation of a property owner who transfers property in exchange for like-kind property.[10] Simple calculations help illustrate the possible economic consequences of losing UBIA as part of a Code section 1031 exchange.

The potential economic effect of $1,000,000 of UBIA is described below.

The economic benefit provided by the [UBIA] of property is not large per dollar of [UBIA], but the limit will be relevant for many taxpayers. To appreciate the per dollar value of [UBIA], assume a taxpayer's taxable income is subject to the 37 percent top marginal rate, so the taxpayer would owe $370,000 of federal income tax on $1,000,000 of taxable income. The maximum QBI deduction on that $1,000,000 of tax- able income would be $200,000, which would reduce taxable income to $800,000. At 37 percent, the tax on that amount would be $296,000. If a taxpayer paid no wages, it would have to rely solely upon the [UBIA] of its property to qualify for the full $200,000 of the deduction. That would require that the property have [a UBIA] basis of at least $8,000,000 ($200,000 ÷ 2.5%). A $1,000,000 change in the [UBIA] of the property would reduce the deduction by $25,000 ($1,000,000 × 2.5%), which in turn would increase taxes by $9,250 ($25,000 × 37%). Thus, $1,000,000 of [UBIA] is worth $9,250 of tax savings, a paltry 0.925 percent economic benefit per dollar of [UBIA] that affects the deduction limit.[11]

Even though the effect per $1 million dollars of UBIA may seem paltry, a significant loss of UBIA on an exchange could affect a property owner's decision to hold or exchange property. Assume a property owner purchased residential rental property 15 years ago for $38,500,000. The owner apportioned $27,500,000 to the improvements and $11,000,000 to the land. The property owner qualified for $1,000,000 of depreciation deductions annually ($27,500,000 ÷ 27.5 years), so at the end of the 15th year, the property owner would have been allowed $15,000,000 of depreciation deduction, leaving it with an adjusted basis of $12,500,000 ($27,500,000 cost − $15,000,000 depreciation deductions). Assume further that the property is currently worth $45,000,000 and has a 4 percent cap rate, taking into account the Code section 199A deduction. That means that the property's net operating income is $1,800,000 ($45,000,000 × 4%). Also, assume the Code section 199A deduction equals the UBIA limit. The UBIA limit on the Code section 199A deduction is 2.5 percent of the $27,500,000 of the building's UBIA, or $687,500, so that is the amount of the Code section 199A deduction. If the property owner did a Code section 1031 exchange to acquire property with the same ratio of land-to-building value that the current property has, the UBIA of the building portion of the replacement property would be the exchanged basis, or $12,500,000. That amount would become the property's UBIA, and the UBIA limit would be $312,500 ($12,500,000 × 2.5%). That amount is $375,000 less than the amount of the Code section 199A deduction prior to the exchange ($687,500 − $312,500). If the property owner is in the 37 percent tax bracket, the loss of that deduction will increase the property owner's tax liability by $138,750 (which is 0.925% of the $15,000,000 decrease in UBIA) and reduce the net operating income by the same amount. Assume the replacement property's net operating income would be $1,800,000 if its UBIA were $27,500,000. The lost portion of the UBIA and resulting decrease of the deduction will increase the property owner's tax liability and reduce the net operating income to $1,661,250 ($1,800,000 – $138,750). The cap rate of the replacement property would therefore be 3.69 percent.

The loss of 31 basis points of cap rate could be significant enough to dissuade many property owners from doing exchanges, causing them to retain the current property and not do a Code sec. 1031 exchange. Although the effect of the lost UBIA may seem insignificant with respect to a single dollar of lost UBIA, the effect can become significant as the lost UBIA adds up. As the earlier column provided, "Despite that nominal benefit per dollar of [UBIA], large differences in the unadjusted basis can make a big difference in the amount of the allowable [Code section 199A]."[12] Treasury appeared to recognize the proposed regulations under Code section 199A, which adopted the Code section 1031(d) basis as the replacement property's UBIA,[13] could have a chilling effect on Code section 1031 exchanges because they would strip away UBIA. Because such a result is contrary to the general policy and practical effects of Code section 1031, Treasury abandoned that rule, and, in the final regulations, apparently interpreting the application of Code section 1031(d) as applying to the UBIA of the relinquished property.

Under the Code section 199A regulations, the UBIA of the replacement property generally is the UBIA of the relinquished property.[14] For instance, if a taxpayer purchased relinquished property for $100,000 (its UBIA) and later exchanged it for property of equal value worth $200,000 on the date of the exchange, the UBIA of the replacement property would be $100,000.

The UBIA of the replacement property must, however, account for any boot that is paid for a portion of the relinquished property's UBIA. The regulations implement this rule by providing that the UBIA of the replacement property is decreased by excess boot received as part of an exchange.[15] Excess boot equals the amount of money or the fair market value of non-like-kind property received by the taxpayer in the exchange reduced by the amount of appreciation in the relinquished property.[16] The appreciation in the relinquished property equals the excess of the property's fair market value on the date of the exchange over its fair market value when the taxpayer acquired it.[17] To illustrate, if the taxpayer purchased the relinquished property for $100,000 (its UBIA) and its fair market value on the date of the exchange was $175,000, the relinquished property's appreciation would be $75,000. If the taxpayer exchanges the relinquished property for replacement worth $120,000 and $80,000 of cash, excess boot would equal the $5,000 resulting from reducing the $80,000 of boot by the $75,000 of the relinquished property's appreciation. Thus, the UBIA of the replacement property would equal $95,000, the relinquished property's $100,000 UBIA decreased by the $5,000 excess boot.

If the taxpayer acquires more than one piece of qualified property as replacement property, the taxpayer must apportion the UBIA of the relinquished property between or among the replacement properties in proportion to their fair market values.[18] The UBIA of non-like-kind property received in an exchange is the fair market value of the non-like-kind property.[19] Similarly, if the taxpayer transfers property and cash for replacement property, the UBIA of the replacement property equal in value to the relinquished property will equal the UBIA of the relinquished property. The UBIA of the replacement property equal to the cash paid will equal the amount of cash paid, and the depreciable period for that portion of the replacement property will be the date the taxpayer places the replacement property in service.[20]

The regulations also include an anti-abuse rule, providing that if the principal purpose of doing an exchange is to increase UBIA, then the UBIA of the replacement is its basis under Code section 1031(d).[21]

BONUS DEPRECIATION PROPOSED REGULATIONS

The proposed regulations on bonus depreciation only apply to a few types of real property, so, because Code section 1031 applies only to real property following TCJA, the effect of proposed regulations on bonus depreciation on Code section 1031 exchanges will be limited. The proposed regulations provide that bonus depreciation applies to MACRS property (i.e., depreciable property placed in service after December 31, 1986[22]) that has a recovery period of 20 years or less,[23] depreciable water utility property,[24] and depreciable qualified improvement property purchased between September 27, 2017, and December 31, 2017, and placed in service after December 31, 2017.[25] This rule adopts the definition of qualified property in the bonus depreciation statute, recognizing qualified improvement property has a longer recovery period under the TCJA if acquired after December 31, 2017.[26] Qualified improvement property includes any improvement to the interior portion of nonresidential real property, if the improvements are placed in service after the building was placed in service.[27] Some commentators believe the limited qualified improvement property is a legislative error that Congress may correct.[28] With or without that change, bonus depreciation applies only to a few types of real property, but it may apply to some property acquired as part of a section 1031 exchange.

To qualify for bonus depreciation, property must also be original use property or meet the used property acquisition requirement.[29] The used property acquisition requirement applies to used property that the taxpayer has not owned previously.[30] The application of bonus depreciation to replacement property that is qualified replacement property depends upon whether the replacement property is original-use property or satisfies the used property acquisition requirement. If the qualified replacement property satisfies the original-use requirement, then both the exchanged basis and the excess basis of the replacement property qualify for bonus depreciation.[31] If the qualified replacement property satisfies the used property acquisition requirement, only the excess basis of the replacement property qualifies for bonus depreciation.[32]

DROP-SWAP CASH-OUTS WITH QOF INVESTMENTS

By enacting Code section 1400Z-2 Congress appears to have created a competitor to Code section 1031. Code section 1400Z-2 allows property owners to sell property and reinvest the gain realized on the sale in a QOF tax free.[33] The unrecognized gain is deferred and possibly excluded, and any post-investment gain can be excluded,[34] if the property owner holds the investment for 10 years.[35] A prior article compared the general tax benefits of Code section 1031 with the general tax benefits of Code section 1400Z-2.[36] This article considers one possible use of Code section 1400Z-2 to replace a Code section 1031 drop-swap cash-out, following the publication of the proposed regulations. In proposed regulations, Treasury indicated that Code section 1400Z-2 can apply at the partnership level or at the partner level.[37] Consequently, a tax partnership with members that have different reinvestment objectives might consider applying Code section 1400Z-2 to the gain the tax partnership might otherwise recognize to cash out one or more of the members. The parties should, however, compare the tax consequences of such a transaction with the tax consequences of allowing the members to apply Code. section 1400Z-2 separately. Consider a possible use of Code section 1400Z-2 for a drop-swap cash-out.

Assume that Poppy, Snowflake, and Scooby are equal members of Snopoby LLC, which owns real property with an adjusted basis of $75,000. Each member's basis in their respective Snopoby LLC interests is $25,000. Snopoby LLC has an offer from an unrelated party to purchase the real property for $150,000. Poppy wants to withdraw her share of the sales proceeds and is willing to pay any tax associated with her share of the property's unrealized gain, but Snowflake and Scooby want to reinvest together in other real estate. They could structure this split-up as a Code section 1031 drop-swap cash-out, using one of the various alternatives available for such a transaction, as presented in an earlier article.[38] They also could consider whether Code section 1400Z-2 provides any drop-swap cash-out alternatives. The proposed regulations indicate Snowflake and Scooby could structure a QOF reinvestment through Snopoby LLC or outside of it. Consider drop-swap cash-outs under both alternatives.

PARTNERSHIP-LEVEL QOF INVESTMENT

Code section 1400Z-2 defers eligible gain that an investor reinvests in a (QOF).[39] A tax partnership, including an LLC,[40] may reinvest eligible gain and elect to have the Code section 1400Z-2 deferral apply to the gain,[41] or it may allocate the gain to the members who can independently choose whether to reinvest it in a QOF.[42] If Snopoby LLC sells its real property for $150,000, it will recognize $75,000 of gain. To defer the entire amount of that gain under Code section 1031, it would have to reinvest the entire $150,000 of sale proceeds in like-kind property.[43] To defer the entire amount of that gain under Code section 1400Z-2, it has to reinvest only $75,000 in a QOF.[44] Poppy's share of the sale proceeds is $50,000, so Snopoby LLC could distribute $50,000 to Poppy and reinvest $75,000 in a QOF (QOF Investment") and defer all the $75,000 of gain. It would then have an additional $25,000 to reinvest according to Snowflake and Scooby's preference. Assume that Snowflake and Scooby cause Snopoby LLC to buy a Non-QOF Investment for $25,000.

When Snopoby LLC distributes the $50,000 of cash to Poppy, Poppy will recognize $25,000 of long-term capital gain,[45] the difference between the $50,000 cash she receives and her $25,000 basis in her Snopoby LLC interest.[46] If Snopoby LLC has a Code section 754 election in effect when it makes the distribution to Poppy and Poppy recognizes the gain, Code section 734(b) allows Snopoby LLC to adjust the basis of its assets by an amount that equal to the amount of gain that Poppy recognizes.[47] Code section 1400Z-2 could affect the manner in which Snopoby LLC would typically apportion that gain among its assets. The basis Snopoby LLC takes in QOF Investment is subject to the Code section 1400Z-2 basis rules. Those rules allow only for adjustments that reflect the 10 percent increase after five years,[48] the five percent increase after seven years,[49] and the adjustment to fair value upon sale of the investment after 10 years.[50] Because those rules appear not to allow for an adjustment to basis of the QOF investment under Code section 734(b), perhaps Snopoby LLC would apportion all of the Code section 734(b) adjustment to the Non-QOF Investment. If that is the correct application of the basis apportionment rules (which is not certain),[51] the Non-QOF Investment's basis would, therefore, become $50,000 ($25,000 cost + $25,000 Code section 734(b) adjustment). That property would have an immediate built-in loss following the basis adjustment.

The Code section 1400Z-2 cash-out appears to accomplish the parties' respective goals. Poppy receives her share of cash, and Scooby and Snowflake are able to reinvest proceeds tax free in other property. Poppy does not recognize gain on Snopoby LLC's sale of its property, but she does recognize her $25,000 share of Snopoby LLC's $75,000 pre-sale unrealized gain when she receives the $50,000 distribution. Assuming Snopoby LLC's real property was business-use property, and not inventory or an unrealized receivable, Poppy's gain should be long-term capital gain.[52] Her share of any of Snopoby LLC's unrealized unrecaptured Code section 1250 gain would carry over to the QOF Investment to be recognized by Snowflake and Scooby in the future.[53] The parties may consider adjusting the amount distributed to Poppy to account for the carryover of the unrealized unrecaptured Code section 1250 gain to the QOF investment. They also should consider other ways Code section 1400Z-2 may favor Poppy or Snowflake and Scooby.

Code section 1400Z-2 does not exclude the entire $75,000 of unrecognized gain, but it defers the gain until the earlier of December 31, 2026, or, if earlier, the date Snopoby LLC sells the QOF investment. If Snopoby LLC holds the QOF Investment for five years, 10 percent of the gain gets excluded through a basis adjustment to the QOF Investment.[54] Another five percent of the deferred gain gets excluded through an additional basis to the QOF Investment, if Snopoby LLC holds the QOF Investment for seven years.[55] If Snopoby LLC still holds the QOF Investment on December 31, 2026, it will recognize $63,750 of gain ($75,000 × 85%), which will be allocated to Snowflake and Scooby, as the members of the Snopoby LLC at that time. The basis of the QOF Investment also increases by the amount of that gain.[56] Snopoby LLC will exclude the post-investment gain on the disposition of the QOF Investment, if it holds the investment for 10 years (as the gain is excluded through an increase in the QOF Investment's basis to market value).[57] Thus, Snowflake and Scooby bear the tax cost of the gain recognition on December 31, 2026, but they stand to benefit from the exclusion of the post-investment gain recognition.

This structure also raises questions about the effects of the Code section 1400Z-2 basis increases of the QOF Investment have on the members' bases in their Snopoby LLC interests. When the basis in Snopoby LLC's QOF Investment increases, presumably the basis that each of Snowflake and Scooby have in their Snopoby LLC interests also will increase. The cumulative 15 percent basis increase that occurs over the first seven years of the QOF Investment will equal $11,250 ($75,000 × 15%). The basis increases exclude gain recognition from Snopoby LLC's computation of income, so Snowflake and Scooby should increase the bases they have in their respective interests in Snopoby LLC.[58] The statute does not clearly provide that the Code section 1400Z-2 basis adjustments of Snopoby LLC's assets should affect the members' bases in their interests in Snopoby LLC, but an IRS ruling suggests they should. The IRS has said "[i]n determining whether a transaction results in exempt income within the meaning of [Code section] 705(a)(1)(B) … the proper inquiry is whether the transaction has a permanent effect on the partnership's basis in its assets, without a corresponding current or future effect on its taxable income."[59] The Code section 1400Z-2 adjustments to Snopoby LLC's basis in its QOF Investment have a permanent effect on Snopoby LLC's basis in that asset. That adjustments eliminate cur- rent and future effects on Snopoby LLC's taxable income, so the adjustments appear to be the type to which Code section 705(a)(1)(B) should apply. Snowflake's and Scooby's respective basis adjustments in their interests in Snopoby LLC should equal one half of the $11,250 cumulative increase in the basis of the QOF Investment. Following those basis adjustments, the bases of Snowflake's and Scooby's interests in Snopoby LLC should be $30,625 ($25,000 original basis + 1/2 × $11,250 basis adjustment). When Snopoby LLC recognizes gain on December 31, 2026, it will allocate that gain equally to Snowflake and Scooby. That allocation will increase their respective bases in their Snopoby LLC interests by $31,875, which one-half of the $63,750 of gain Snopoby LLC recognizes on December 31, 2026. Following that allocation, their respective bases in their Snopoby LLC interests should be $62,500 ($30,625 + $31,875). Not surprisingly, that amount equals the members' original $25,000 basis plus one-half of the deferred $75,000 of gain. Each member's basis in Snopoby LLC equals the original $25,000 basis the member had in the interest plus the member's $5,625 share of the Code section 1400Z-2 basis adjustment plus the member's $31,875 share of recognized gain. Considering the tax consequences of liquidating Snopoby LLC at that time illustrates the appropriateness of these adjustments to the members' bases in Snopoby LLC.

Assume Snopoby LLC's Non-QOF Investment's value at the time of the liquidation equals its $25,000 cost basis and the QOF Investment's value at that time equals its $75,000 acquisition price. Upon liquidation at the time, Snopoby LLC would receive $100,000 of cash from selling the investments, which it would to distribute to Snowflake and Scooby in equal proportions. Because of the Code section 734(b) adjustment to the Non-QOF Investment, Snopoby LLC would recognize $25,000 of loss ($50,000 basis – $25,000 amount realized) on the liquidating disposition of that asset. Snopoby LLC would allocate that loss to the members equally—$12,500 to each of Snowflake and Scooby, reducing their respective bases in their Snopoby LLC interests from $62,500 to $50,000.[60] The $50,000 that each of Snowflake and Scooby would receive upon such a liquidation would equal their $50,000 bases they each have in their Snopoby LLC interests, so they would recognize no gain or loss on those distributions.[61] The $25,000 total loss that Snowflake and Scooby recognize on the liquidating disposition equals the amount of gain that Poppy recognized on her liquidating distribution. Considering the liquidation shows that over the life of Snopoby LLC, the numbers balance, i.e., the loss recognized by Snowflake and Scooby offset the earlier gain recognized by Poppy. Nonetheless, the character or type of income or loss may change as a result of the operations of the various basis and recognition rules, which creates some imbalance, which the law appears to overlook. Furthermore, the parties bearing the burden of Code section 1400Z-2 gain recognition and receiving the benefit of its exclusion may be affected by the operation of these rules.

Adjusting the members' bases in Snopoby LLC to reflect Code section 1400Z-2 basis adjustments of Snopoby LLC's QOF investment is in line with the purpose of subchapter K. The IRS has stated, "[A]djustments must also be made to reflect certain nontaxable events in the partnership. For example, a partner's share of nontaxable income (such as exempt income) is added to the basis of the partner's interest because, without a basis adjustment, the partner could recognize gain with respect to the tax-exempt income, for example, on the sale or redemption of the partner's interest, and the benefit of the tax-exempt income would be lost to the partner."[62] The law should allow members of tax partnerships to adjust their bases in partnerships that own QOF investments to ensure that Code section 1400Z-2 excludes the appropriate amount of gain.

If Snowflake and Scooby had not adjusted their bases to reflect their one-half share of the $11,250 15 percent basis adjustment to the QOF Investment, their bases in their Snopoby LLC interests immediately prior to the liquidating distribution would have been $44,375 ($25,000 original basis + $31,875 attributable to the December 31, 2026 gain—$12,500 loss on the liquidating disposition) after December 31, 2026. When they received the $50,000 liquidating distribution, they each would have recognized $5,625 of gain ($50,000 amount distributed—$44,375 basis in Snopoby LLC interest). The total gain recognized on the liquidating distribution would have been $11,250 ($5,625 recognized by Snowflake +$5,625 recognized by Scooby), which equals the 15 percent accumulated Code section 1400Z-2 basis adjustment during the first seven years Snopoby LLC held the QOF Investment. Failing to adjust the members' bases in their tax-partnership interests to reflect adjustments to the tax-partnership's QOF investment thus fails to complete the purpose of Code section 1400Z-2 to exclude that 15 percent of deferred gain.

Code section 1400Z-2 does not indicate the type of gain the basis adjustments offset. Without that guidance, uncertainty exists if the gain deferred under Code section 1400Z-2 is long-term capital gain that includes some combination of short-term capital gain, regular long-term capital gain, unrecaptured Code section 1250 gain, and collectibles gain. Taxpayers will prefer to use the basis adjustment to offset the gain that is subject to the highest tax rate. For instance, if gain from the sale of business-use property included both regular long-term capital gain and unrealized unrecaptured Code section 1250 gain, a taxpayer would prefer that the basis adjustment offsets the unrecaptured Code section 1250 gain. If the basis adjustment does not first offset unrecaptured Code section 1250 gain, the gain Snopoby LLC recognizes on December 31, 2026, could be unrecaptured Code section 1250 gain, with regular long-term gain being excluded through the basis adjustment. Having the first dollars of recognized gain be unrecaptured Code section 1250 gain would be consistent with Code section 1031 and other deferral provisions, such as Code section 453.[63] Consequently, taxpayers might expect the IRS to apply that rule to QOF investments. If members are allocated unrecaptured Code section 1250 gain and recognize a loss on a distribution, the loss on the distribution will be a long-term capital loss (assuming the distribute e member has held the interest for at least one year).[64] It will offset the regular long-term capital gain before offsetting uncaptured Code section 1250 gain.[65] Thus, if Snoflake and Snopoby have some long-term capital gain outside Snopoby LLC, they do not fully benefit from the gain exclusion, and benefit goes to Poppy, who did not recognize a share of the unrecaptured Code section 1250 gain.

In negotiating the terms of Poppy's cash-out, the parties will want to consider the effect of gain deferral and exclusion. The potential post-investment gain exclusion will be attractive to Snowflake and Scooby, but the benefit of that exclusion is speculative because it requires holding the property for 10 years, while the recognition of pre-investment deferred gain is almost ensured.[66] Barring significant decrease in the value of the QOF Investment that Snopoby LLC purchases, Snopoby LLC will recognize 85 percent of the deferred gain on December 31, 2026. As part of the negotiations to cash out Poppy, Snowflake and Scooby may take the position that she should accept less than the $50,000 that she would otherwise be entitled to because she will not be a part of Snopoby LLC when it recognizes the deferred gain. Consequently, that entire gain will be allocated to Snowflake and Scooby, and they will bear the tax burden of recognizing the gain. Poppy may counter that she will not benefit from the post-investment gain exclusion, so she should be entitled to the full $50,000, or some greater amount. To avoid these issues, the parties may decide to not elect to apply Code section 1400Z-2 at the Snopoby LLC level and allow the members to choose whether to apply it individually.

PARTNER-LEVEL QOF INVESTMENT

If Snopoby LLC does not reinvest the $75,000 of recognized gain in a QOF, the members may elect to do so individually. Under this scenario, Snopoby LLC would allocate $25,000 of the gain to each of Poppy, Snowflake, and Scooby. That would increase their bases in their respective Snopoby LLC interests from $25,000 to $50,000. When Snopoby LLC distributes $50,000 to Poppy, Poppy will recognize no gain or loss on that distribution. Snowflake and Scooby could reinvest their $25,000 shares of the recognized gain outside Snopoby LLC and defer that gain under Code section 1400Z-2, even if Snopoby LLC does not distribute cash to them equal to their shares of the gain.[67] If they use money outside of Snopoby LLC to reinvest the gain, they can reinvest the Snopoby LLC cash in any manner they choose. The proposed regulations do not flesh out how the parties would account for this type of situation, so consider one possibility.

If Snopoby LLC does not elect to reinvest the $75,000 of gain in a QOF, and it distributes $50,000 of cash to Poppy, it will have $100,000 of cash to reinvest in Non- QOF Investments and will take a $100,000 cost basis in that property. If Snowflake and Scooby each have $25,000, they can elect to invest those amounts together in a QOF. They each would take a zero basis in their respective QOF investments. Those investments would be subject to the 10 percent and fives percent basis adjustments after five and seven years, gain recognition on December 31, 2026, and gain exclusion upon sale at least 10 years following the investment. Under this scenario, they would not recognize any portion of Poppy's share of the pre-sale unrealized gain. Their reinvested gain should include only their shares of Snopoby LLC's unrealized unrecaptured Code section 1250 gain,[68] so it should not include Poppy's share of the gain. Presumably, their bases in Snopoby LLC would remain $50,000.

CONCLUSION

Commentators and practitioners are working to flesh out various aspects of recently published proposed regulations. As these parties and the government continue to study these new rules, undoubtedly the collective understanding of them will increase and tax-planning strategies will emerge and evolve. Code section 1031 is a part of those changes and its use and performance also will evolve.

Notes

1 See I.R.C. §199A(b)(2)(B)(i).

2 See I.R.C. §199A(b)(2)(B)(ii). Wage and UBIA amounts may come from sources beyond a QTB, if a taxpayer may aggregate QTBs. See Reg. §199A-4.

3 See I.R.C. §199A(b)(6)(A).

4 See I.R.C. §199A(b)(6)(B).

5 See REG-107892-18.

6 See Reg. §1.199A-2(c)(2)(iii)(A)(1).

7 See Reg. §1.199A-2(c)(2)(iii)(A)(2).

8 See Reg. §1.199A-2(c)(3)(i).

9 See Proposed Reg. §1.199A-2(c)(3), (4), Example 2.

10 See REG-107892-18 (citing Reg. §1.1002-1(c); Bradley T. Borden, The Like-Kind Exchange Equity Conundrum, 60 Fla. L. Rev. 643

11 See Bradley T. Borden, Code Sec. 1031 After the 2017 Tax Act, 21 J. Passthrough Ent. 17, 23 (May– June 2018).

12 See Bradley T. Borden, Code Sec. 1031 After the 2017 Tax Act, 21 J. Passthrough Ent. 17, 23 (May– June 2018).

13 See Proposed Reg. §1.199A-2(c)(3), (4), Example 2.

14 See Reg. §1.199A-2(c)(3)(ii)(A).

15 See id.

16 See Reg. §1.199A-2(c)(3)(ii)(B).

17 See id.

18 See Reg. §1.199A-2(c)(3)(ii)(A).

19 See id.

20 See Reg. §1.199A-2(c)(4), Example 4.

21 See Reg. §1.199A-2(c)(3)(vi).

22 See Proposed Reg. §1.168(k)-2(b)(2)(i)(A); Reg. §1.168(b)-1(a)(2).

23 See Proposed Reg. §1.168(k)-2(b)(2)(i)(A).

24 See Proposed Reg. §1.168(k)-2(b)(2)(i)(C).

25 See Proposed Reg. §1.168(k)-2(b)(2)(i)(D); Proposed Reg. §1.168(b)-1(a)(5)(i)(C).

26 See I.R.C. §168(c), (e)(6), (k)(2)(A)(i)

27 See I.R.C. §168(e)(5)(A). The definition also excludes any improvement escalator, and the internal structural framework of the building. I.R.C. §168(e)(5)(B). See also Proposed Reg. §1.168(b)-1(a)(5)..

28 See, e.g., George Moffa & Kyle Wissel, 100% Bonus Depreciation May Apply to Qualified Improvement Property Placed in Service Prior to January 1, 2018, Mazars Ledger (Aug. 10, 2018), available at https://mazarsledger.com/100-bonus-depre- ciation-may-apply-to-qualified-improvement-property-placed-in-service-prior-to-123117/ ("Of course, Congress may choose to correct this, as it

does appear the intention was to include [qualified improvement property] as bonus eligibility.").

29 See I.R.C. §168(k)(2)(A)(ii), (E)(ii); Proposed Reg. §168(k)-2(b)(1)(ii).

30 See I.R.C. §168(k)(2)(E)(ii)(I); Proposed Reg. §1.168(k)-2(b)(3)(iii)(A)(1).

31 See Proposed Reg. §1.168(k)-2(b)(f)(5)(iii)(A).

32 Id.

33 See I.R.C. §1400Z-2(a)(1)(A).

34 See I.R.C. §1400Z-2(a)(1)(B), (b).

35 See I.R.C. §1400Z-2(a)(1)(C), (c).

36 See Alan S. Lederman & Bradley T. Borden, Rolling Real Estate Gain into a Qualified Opportunity Fund: Comparison with §1031, 34 Tax Mgt. Real Est. J. 155 (Sept. 5, 2018).

37 See Proposed Reg. §1.1400Z-2(a)-1(c)(1)(i), (ii).

38 See Bradley T. Borden, I.R.C. §1031 Drop-Swap Cash-Outs and Unrecaptured Section 1250 Gain, 19 J. Passthrough Ent. 27 (Sept.–Oct. 2016).

39 See I.R.C. §1400Z-2(a)(1).

40 See Proposed Reg. §1.1400Z-2(d)-1(a)(1).

41 See Proposed Reg. §1.1400Z-2(a)-1(c)(1)(i)(A).

42 See Proposed Reg. §1.1400Z-2(a)-1(c)(2)(ii).

43 See I.R.C. §1031(a), (b).

44 See I.R.C. §1400Z-2(a)(1)(A).

45 See Code Secs. 731(a) (flush language), 741, this gain characterization assumes Snopoby LLC has no I.R.C. §751 assets.

46 See I.R.C. §731(a).

47 See I.R.C. §734(b)(1)(A); Reg. §1.734-1(b)(1)(i).

48 See I.R.C. §1400Z-2(b)(2)(B)(iii).

49 See I.R.C. §1400Z-2(b)(2)(B)(iv).

50 See I.R.C. §1400Z-2(c).

51 See Reg. §1.755-1.

52 See I.R.C. §731(a) (flush language); I.R.C. §741.

53 See Proposed Reg. §1.1400Z-2(a)-1(b)(5).

54 See I.R.C. §1400Z-2(b)(2)(B)(iii).

55 See I.R.C. §1400Z-2(b)(2)(B)(iv).

56 See I.R.C. §1400Z-2(b)(2)(B)(ii).

57 See I.R.C. §1400Z-2(c).

58 See I.R.C. §705(a)(1)(B).

59 See Rev. Rul. 96-10, 1996-1 CB 138.

60 See I.R.C. §705(a)(2)(A).

61 See I.R.C. §731(a)(2).

62 See Rev. Rul. 96-10, 1996-1 CB 138.

63 See Code Secs. 1(h)(6), 1031, 1250(d)(4); Bradley

T. Borden, Navigating the Confluence of Code Secs. 1031 and 1250, 19 J. Passthrough Ent. 25 (May–June 2016); Reg. §1.453-12(a); Bradley T. Borden, Code Sec. 1031 Drop-Swap Cash-Outs and Unrecaptured Section 1250 Gain, 19 J. Passthrough Ent. 27 (Sept.–Oct. 2016).

64 See Code Secs. 731(a) (flush language), 741.

65 See Bradley T. Borden & James M. Lowy, Maximizing Capital Gains in Real Estate Transactions, 74-8 New York University Annual Institute on Federal Taxation §8.01[1][a][ii] (2016).

The pre-investment deferred gain will be excluded only to the extent of the 15 percent basis adjustments and reduction in the value of the QOF investment. See I.R.C. §1400Z- 2(b)(2)(A)(i).

66 The pre-investment deferred gain will be excluded only to the extent of the 15 percent basis adjustments and red in the value of the QOF investment. See I.R.C. §1400Z-2(b)(2)(A)(i).

67 See Proposed Reg. §1.1400Z-2(a)-1(c)(2)(ii).

68 See I.R.C. §702(b) (allocated gain retains its character).