Bloomberg Tax

Tax Management
Real Estate Journal™

Investing §1231 Gain in Qualified Opportunity Funds

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INTRODUCTION

Section 1231 gain is neither (or either) fish nor fowl—it can be capital gain in some situations and ordinary income in others—but under the most recent round of qualified opportunity fund proposed regulations, it is unquestionably foul. At least the provision in the proposed regulations related to §1231 gain is foul. This article suggests that the Treasury Department should consider revising the provision in the proposed regulations related to §1231 gain to allow taxpayers to invest §1231 gain as it is realized. The change could be additive, allowing taxpayers to elect to wait until the end of the year to invest net §1231 gain as provided in the proposed regulations.[1]

Section 1400Z-2(a), as added by the Tax Cuts and Jobs Act of 2017, provides that taxpayers can defer recognition of gain by reinvesting that gain in a qualified opportunity fund (QOF) within 180 days after recognizing it. Treasury has published two rounds of proposed regulations under §1400Z-2. In the first round of proposed regulations published on October 19, 2018, Treasury took the position that §1400Z-2(a) applies only to capital gain.[2] By limiting the application of §1400Z-2 to capital gains, Treasury appears to have felt constrained with respect to how they would apply the rules to §1231 gain.

THE NET §1231 GAIN PROVISION

Treasury published the second round of proposed regulations on April 17, 2019 (the ''2019 proposed regulations''). In the 2019 proposed regulations, Treasury provided that eligible gain would include only net §1231 gain for the taxable year, i.e., the net amount is determined by a taxpayer taking into account ''the capital gains and losses for a taxable year on all of the taxpayer's section 1231 property'' (the ''net §1231 gain provision'').[3] That provision would allow calendar year taxpayers to invest net §1231 gain in QOFs during the 180-day period beginning on December 31 of the taxable year during which the gain is realized. Were this provision law, it would be problematic for a number of reasons.

Distortion of Taxpayer Behavior

First, the net §1231 gain provision distorts taxpayer behavior in a manner that Congress did not appear to intend. The 2019 proposed regulations provide that taxpayers can only invest §1231 gain in QOFs during the 180-day period beginning on December 31. Taxpayers who wish to invest §1231 gain in a QOF would be discouraged from making such investments during the second half of a taxable year, if the net §1231 gain provision were to become law. Instead, taxpayers with §1231 gain would delay acquiring property until December 31 or later. Distorting behavior in that manner distorts real estate values and favors taxpayers who have gains from dispositions of other property. Imagining December 31 of this year with frantic efforts to invest net §1231 gains before the clock strikes midnight to preserve the possibility of excluding the maximum 15% of deferred gain gives fresh meaning to auld lang syne.

Another potential distortive effect of the net §1231 gain provision is that it could encourage taxpayers to create structures that they would not consider otherwise. For instance, if a taxpayer has §1231 gain in

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[1] All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

[2] *See* Prop. Reg. §1.1400Z2(a)-1(b)(2)(i)(A).

[3] *See* Prop. Reg. §1.1400Z2(a)-1(b)(2)(iii) (''The only gain arising from section 1231 property that is eligible for deferral under section 1400Z-2(a)(1) is capital gain net income for a taxable year.'').

July of 2019 and wishes to invest that gain in opportunity zone property in August of 2019, the taxpayer may cause a related party (if the related party does not exist, the taxpayer could form it) to invest in the amount of the gain in a QOF that owns the opportunity zone property in 2019. Then in early 2020, when that §1231 gain would become eligible gain under the net §1231 gain provision, the taxpayer could buy the QOF interest from its related party. Alternatively, the taxpayer could make a loan to a QOF in 2019 equal to the amount of anticipated net section §1231 gain, make the investment in the QOF in 2020, and receive a repayment of the loan following the investment. These are clunky workarounds for the taxpayer to invest §1231 gain.

The taxpayer would not consider these workarounds but for the net §1231 gain provision. Taxpayers who consider a workaround may be concerned that the IRS would challenge it for lacking a business purpose of economic substance. For instance, the IRS might treat the related-party's contribution as a contribution by the taxpayer. If the IRS does not challenge the workaround, then the IRS would be approving a structure that is substantively equivalent to an investment of §1231 gain based upon the realization date. If the IRS approves the transaction in substance, it might as well approve it explicitly through its published regulations.

Tacit approval of the workaround allows taxpayers to use §1231 gain to buy into a QOF at any time during a taxable year, but workarounds can put taxpayers at a disadvantage. For instance, if a taxpayer has to wait until December 31 to contribute §1231 gain to a QOF, then the taxpayer's 10-year clock begins on that date. If the gain was realized in early 2019, the delay could extend the termination of the 10-year period for almost an extra year, e.g., from early 2029 until the end of 2029.

Unfairness

Second, the net §1231 gain provision is unfair along multiple dimensions. For instance, if Treasury adopts the net §1231 gain provision and seeks to enforce it retroactively to the date §1400Z-2 was enacted, then investments of §1231 gains in QOFs that occurred prior to the publication of the 2019 proposed regulations would not qualify for QOF tax benefits. Because §1231 gains qualify for favorable gain treatment under the statute, investors of such gains had no reason to anticipate that the 2019 proposed regulations would disqualify those gains. Depriving such taxpayers from the benefits of §1400Z-2 would be patently unfair.

Treasury has published ''Opportunity Zones Frequently Asked Questions'' (the FAQ), providing that §1231 gain invested in a QOF in 2018 can qualify for QOF tax benefits, if the amount of §1231 gain invested in 2018 was less than the taxpayer's net §1231 gain for 2018. That relief does not extend to all §1231 gains realized in 2018 or to §1231 gain recognized in 2019 prior to the publication of the 2019 proposed regulations. Thus, the provision in the FAQ does not solve the unfairness inherent in the net §1231 gain provision; in fact, it exacerbates the unfairness.

Additionally, if the net §1231 gain provision only applies to §1231 gains realized after the publication of the 2019 proposed regulations, then Treasury would treat gain realized prior to the publication of the proposed regulations differently from gain realized prior to the publication. The different treatment of the same type of gain based upon a randomly selected date is unfair. To the extent the 2019 proposed regulations only apply after they are finalized, they would treat gains realized prior to their date of finalization differently from gains realized after their date of finalization. Using the date the 2019 proposed regulations are finalized as the date the net §1231 gain provision applies would provide preferential treatment to taxpayers who ignored the net §1231 gain provision and those who invested prior to the publication of the 2019 proposed regulations. Treating taxpayers who disregarded the 2019 proposed regulations differently from those who complied with them is unfair, and drawing a line based upon a future date that taxpayers are unaware of and cannot plan towards is also unfair.

Questionable Validity

Third, the net §1231 gain rule is inconsistent with the plain language of §1400Z-2(a). The plain language of §1400Z-2 applies to gain from the sale of any property. Section 1231(a)(1) addresses §1231 gains and §1231 losses. Section 1231(a)(1)(3)(A) defines §1231 gain to include gain recognized on the sale of business-use property held for more than one year. Section 1231(a)(1) and §1231(a)(2) characterize §1231 gain based upon whether the §1231 gains for any taxable year exceed §1231 losses for such taxable year. Section 1231 does not adopt a netting approach after it determines the character of the gains and losses; it requires taxpayers to determine the character of both §1231 gains and §1231 losses and to report the full amounts of each. Thus, if a taxpayer's §1231 gains exceed the taxpayer's §1231 losses, all of the §1231 gains are capital gains, not just the portion of the §1231 gains that exceeds the §1231 losses. Because §1231 does not apply a netting approach, the total §1231 gains are used to determine the amount of a taxpayer's gross income for purposes of determining

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whether the taxpayer must file a tax return.[4] If §1231 gains and losses are characterized as long-term capital gains and losses, then they factor into the computation of net capital gain and the computation of capital loss limitations under §1211. The net amount is, however, used to determine the amount of §1231 gain treated as unrecaptured §1250 gain for purposes of applying the appropriate rate to long-term capital gains.[5] Thus, with that limited exception, the law disaggregates §1231 gains and losses after comparing them for purposes of determining their character. The 2019 proposed regulations are inconsistent with the plain language of §1400Z-2 and tax law's general treatment of §1231 gains.

The net §1231 gain provision's inconsistency with the plain language of the statute calls the validity of the net §1231 gain provision into question.[6] If a taxpayer were to rely upon the plain language of the statute and apply §1400Z-2 to §1231 gain, a court would be compelled to rule in favor of the taxpayer and declare the regulation invalid.[7] Some observers may worry that if they ignore the net §1231 gain rule then they cannot rely upon some other aspect of the rules.[8] While not unreasonable, that view must be tempered. Treasury cannot in good faith adopt rules that are inconsistent with the plain language of a statute and compel compliance with that rule by making the application of other reasonable interpretations of the statute conditioned upon compliance with the inconsistent rule. Nonetheless, the net §1231 gain provision puts tax advisors in a bind.

When advising clients with respect to the net §1231 gain provision, tax advisors must remember that tax law is more than simply words on paper. Even though the 2019 proposed regulations present the net §1231 gain provision, tax advisors must remember that this is a proposed regulation, and that, even if present in the final regulations, it is inconsistent with the statute and therefore not valid. Tax advisors have an ethical responsibility to appreciate this distinction and discuss it with their clients. For instance, assume that in July 2019, Bart notifies the tax advisor that he has recognized gain on the sale of business-use property and is under contract to close on property in a qualified opportunity zone that he wants to acquire in a QOF. The seller is primed to sell and will not wait until December 31 to sell the property. To acquire the opportunity zone property, Bart must acquire the property prior to December 31. At this point, the tax advisor, relying on the plain language of the statute, might inform Bart to move forward with the purchase of the property in the opportunity zone with the plan to structure and treat the purchase as an investment in a QOF. The advisor should also inform Bart of the net §1231 gain provision. The return preparer would have to be on board with this treatment.

The net §1231 gain provision puts practitioners in an extremely challenging position. The statute clearly provides a basis for investing the §1231 gain in a QOF within 180 days after realizing it. Advisors cannot tell clients that the 2019 proposed regulations only allow the net §1231 gain for the year to be deferred through the QOF rules during the 180-day period beginning on December 31. If an advisor were to give that advice to Bart and consequently Bart did not structure the acquisition of the property in a QOF, Bart would very displeased with the advisor, assuming Bart would have made the investment otherwise. Practitioners would appear to have an obligation to share with clients the nuances of jurisprudence, explain how regulations are not valid if they are inconsistent with a statute, and help clients make informed tax-planning decisions and tax-reporting positions. In most situations, such discussions will undoubtedly cause clients' heads to spin, discouraging practitioners from sharing such details with clients.

Inconsistent Treatment of §1231 Gain

The treatment of §1231 gain under the net §1231 gain provision is different from the treatment of §1231

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[4] *See* §6012(a)(1)(A) (requiring individuals to file tax returns only if their gross income for the taxable year exceeds the exemption amount).

[5] *See* §1(h)(6)(B).

[6] Even though the §1400Z-2 caption and legislative history refer to capital gain, the actual language of the statute states the law. *See* §7806(b); *Farr v. Commissioner*, 33 B.T.A. 557 (1935) (''The heading of a section may be considered as an aid to the interpretation of the text, when the text is ambiguous, but may not be used to limit or set at naught the plain meaning of the text.'') *But see Estate of Flanagan v. Commissioner*, 18 T.C. 1241 (1952); PLR 9040045 (''Where the text of a statute is ambiguous, the title or caption of the provision and its legislative history may be used as an aid to interpreting the statute.''); *Chevron USA, Inc. v. Natural Res. Def. Council, Inc*., 467 U.S. 837, 842–43 (1984) (''First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.'').

[7] The judiciary is the final authority on issues of statutory construction and must reject administrative constructions that are contrary to clear congressional intent. If a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect.'' *Chevron*, 467 U.S. at 843, n.9 (1984)(citations omitted).

[8] ''This section applies to eligible gains that would be recognized in the absence of deferral on or after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations. An eligible taxpayer, however, may rely on the proposed rules in this section with respect to eligible gains that would be recognized before that date, but only if the taxpayer applies the rules in their entirety and in a consistent manner.'' *See* Prop. Reg. §1.1400Z2(a)-1(e).

ISSN 8755-0628

gain under other deferral rules. For instance, §1031 and §1033 do not treat §1231 gain differently from other gain. A taxpayer who sells business-use real property can structure the disposition as part of a §1031 exchange and defer recognition of the §1231 gain. In fact, the taxpayer can convert the unrecognized §1231 gain of the business-use real property into capital gain by reinvesting that unrecognized §1231 gain in investment real estate. Any §1231 loss that the taxpayer recognizes in the year of the §1031 exchange would be unaffected by the deferral of the §1231 gain. The same holds true with respect to §1231 gain deferred under §1033. Although the justification for deferral under §1031 and §1033 may differ from the purpose for allowing deferral under §1400Z-2, those appear to be differences without distinction and do not justify netting §1231 gain for purposes of §1400Z-2.

THE FIX

Taxpayers have relied upon the net §1231 gain provision and have deferred investment until the 180-day period beginning on December 31, 2019. Treasury cannot in good faith finalize the QOF regulations without allowing taxpayers to invest net §1231 gain in QOFs during the 180-day period beginning on December 31, 2019. Treasury should, however, make that an expansive, not restrictive rule. It could accomplish that expansion by allowing taxpayers to elect to invest §1231 gain within 180 days after realization or wait until the end of the taxable year and invest only the net §1231 gain during the 180-day period beginning on December 31, 2019. A less expansive approach would allow taxpayers to invest §1231 gain within 180 days after realization with the prospect of any §1231 loss recognized during the year converting an eligible QOF investment into a noneligible investment.

With little explanation from Treasury relating to the net §1231 gain provision, one is left to speculate why it included the provision in the 2019 proposed regulations. Treasury may have been concerned that if §1231 losses for the year exceeded the amount of §1231 gain then the gain would not be a capital gain for the year. Allowing the investment of a gain that, if recognized, would not be capital gain could appear to be inconsistent with Treasury's definition of eligible gain, which only includes capital gains. By limiting the definition of eligible gain to only capital gains, Treasury may now feel constrained to ensure that §1231 gain that would be characterized as ordinary income should be excluded from favorable QOF treatment. To avoid the problems that result from the net §1231 gain provision and the definition of eligible gain, Treasury could consider adopting a definition of eligible gain that includes any gain that is not ordinary income under §64. Ordinary income, under that definition, ''includes any gain from the sale or exchange of property which is neither a capital asset nor a property described in section 1231(b).''[9] Adopting a definition of eligible gain that excludes ordinary income would obsolete the need for the net §1231 gain provision, other than as an ameliorative provision to serve taxpayers who have planned their affairs in reliance upon it.

Another possible reason for including the net §1231 gain provision in the 2019 proposed regulations is that Treasury has an aversion to deferring §1231 gain when a taxpayer has §1231 loss that will be an ordinary deduction absent the recognition of the §1231 gain. The recapture rule in §1231(c) goes part of the way in addressing that concern. Any ordinary loss that the taxpayer recognizes as a result of the deferral of the §1231 gain carries over for up to five years to characterize future §1231 gain as ordinary income. The concern about freeing up ordinary losses could be ameliorated if Treasury could extend the recapture rule out to the end of December 2026, when the taxpayer would recognize at least a portion of the deferred §1231 gain, but the plain language of §1231(c) does not appear to provide any wiggle room for extending that recapture rule beyond five years. Similarly, the plain language of §1400Z-2 does not provide any wiggle room for a rule that only includes net §1231 gain in the definition of eligible gain.

CONCLUSION

Section 1231 gains and losses are unique. In the opportunity zone context, they have created something of a problem for Treasury, which in turn has created problems for taxpayers. Treasury will undoubtedly revisit the net §1231 gain provision when it issues final opportunity zone regulations. The source of the problems related to §1231 appear to stem from the proposed regulations published in 2018, which limited the definition of eligible gain to capital asset, contrary to the plain language of the statute (perhaps in drafting the language of the statute, Congress recognized this issue and modified the language of the statute, but failed to correct the caption). The best way forward in this area appears to be modifying the definition of eligible gain to incorporate concepts from §64 and treating §1231 gain the same way other nonrecognition provisions treat it and the same way the proposed regulations treat regular capital gain. That change would solve many of the problems emanating from the net §1231 gain provision, but the fix would also require addressing taxpayers who have made deci-

[9] *See* §64.

ISSN 8755-0628

sions based upon the 2019 proposed regulations. Those taxpayers should have the opportunity to rely upon the net §1231 gain provision, at least during the first half of 2020. After that, a general rule that incorporates the concepts from §64 should apply.

ISSN 8755-0628