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SHOP TALK

Section 1231 Property and Opportunity Zones: Gains People Play

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Sheldon I. Banoff, Suite 1900, 525 West Monroe Street, Chicago, Illinois 60661-3693, Sheldon.Banoff@kattenlaw.com; Richard M. Lipton, Suite 5000, 300 East Randolph Street, Chicago, Illinois 60601, Richard.Lipton@bakermckenzie.com; and Adam M. Cohen , 555 17th Street, Suite 3200, Denver, Colorado 80202, ACohen@hollandhart.com.

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Timing is everything, at least in comedy. In tax, it can be pretty important, too. Though, in many circumstances, tax is no laughing matter. However, with the recent final regulations governing investments in Qualified Opportunity Funds (QOFs) (85 Fed. Reg. 1866 (2020)) (the OZ Final Regs), there are some timing considerations to get even the stuffiest tax planner giggling. This Shop Talk article focuses on capital gains tax planning opportunities in conjunction with Section 1231 that are available to certain taxpayers with non-recaptured net Section 1231 losses.

Let's imagine a U.S. taxpayer, Zach Bayre, who owns a modestly profitable business. (For ease of discussion, we'll assume it is Mr. Bayre's sole proprietorship, but the analysis in this article also would apply to owners of flow-through entities, e.g., tax partnerships and S corporations.) Last year (2019), he sold only one business asset (Asset A) for $100,000, when it had a tax basis of $1.1 million. He has two more business assets that he wants to sell: Asset B having a value of $50,000 and a tax basis of $250,000 and Asset C having a value of $500,000 and a tax basis of $100,000. Each of these business assets (including Asset A, sold last year) has been held for over a year, is either real property or subject to depreciation, and is not intellectual property, inventory, or held for sale to customers in the ordinary course. None of these business assets, upon sale, will have any depreciation recapture.

Section 1231 generally will control Mr. Bayre's tax treatment from the sales of these assets. Section 1231(b)(1) defines "property used in the trade or business" as property just like these business assets (i.e., used in the trade or business, of a character which is subject to the allowance for depreciation or real estate, held for more than one year, and which is not inventory, held for sale to customers in the ordinary course or certain intellectual property). Section 1231(a)(3)(A) defines "[S]ection 1231 gain" as including recognized gain from the sale of such assets, and Section 1231(a)(3)(B) defines "[S]ection 1231 loss" as including recognized loss from the sale of such assets. Section 1231(a)(1) provides that, if

Section 1231 gains for the taxable year exceed Section 1231 losses, the gains and losses are treated as long-term capital gains and long-term capital losses. Section 1231(a)(2) provides, on the other hand, that if Section 1231 losses equal or exceed Section 1231 gains, the gains and losses are not treated as gains and losses from sales or exchanges of capital assets. Lastly, Section 1231(c)(1) provides that net Section 1231 gain is treated as ordinary income if the gain does not exceed the non-recaptured net Section 1231 losses (i.e., those losses that have not yet been taken into account under this rule from the five most recent preceding taxable years).

If Mr. Bayre sells Assets B and C this year (2020), he will have a $200,000 Section 1231 loss on Asset B and a $400,000 Section 1231 gain on Asset C. While Section 1231(a)(1) would provide that the gain and the loss are a long-term capital gain and a long-term capital loss, Section 1231(c)(1) will change those back to ordinary because of his non-recaptured net Section 1231 loss from 2019 of $1 million. Mr. Bayre will have to pay ordinary income rates on his $200,000 net gains from these sales in 2020.

Enter opportunity zones and the opportunity to generate generous tax treatment.

If a taxpayer like Zach Bayre invests in a QOF, the taxpayer may elect to defer (and reduce) a gain matching the amount of that investment. Section 1400Z provides that, if the investment is made within 180 days of the sale or exchange giving rise to the gain and if the gain is from a sale or exchange with an unrelated person, the gain is excluded from gross income for the year of the investment. Section 1400Z provides that the excluded gain will become income in the earlier of 2026 or when the opportunity zone

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investment is sold or exchanged. Section 1400Z generally causes an increase in basis (which can result in a corresponding reduction in the gain) by ten percent of the gain deferred under Section 1400Z, if the investment was held for at least five years. But how does this apply to Mr. Bayre?

The OZ Final Regs provide quite favorable rules when it comes to Section 1231 gain. Reg. 1.1400Z2(a)-1(b)(11)(iii) provides that a Section 1231 gain is *qualified* 1231 gain to the extent the gain exceeds any amount treated as ordinary income under the Section 1245 or Section 1250 depreciation recapture rules. The Preamble makes clear that the use of the article "a" before "[S]ection 1231 gain" and the absence of any reference to "net [S]ection 1231 gain" is intended to permit taxpayers to apply the opportunity zone rules to each sale or exchange. 85 Fed. Reg. at 1869. Reg. 1.1400Z2(a)-1(c)(1)(i) and (ii) state that, when the deferral ends, the gain is included in income "as if it were a [S]ection 1231 gain" that was recognized on the date of inclusion.

If Mr. Bayre makes a timely investment in a QOF with a proper election, he can reduce his taxes. Mr. Bayre will have a Section 1231 gain in 2020 from the sale of Asset C of $400,000. If he invests $400,000 in a QOF in 2020, within 180 days of that sale, and makes a proper election, that Section 1231 gain will no longer be included in income. At that point, Mr. Bayre will have a Section 1231 loss from the sale of Asset B of $200,000, which will be an ordinary loss under Section 1231(a)(2).

If Mr. Bayre can hold that QOF investment until 2026, assuming he has no further business asset sales for losses before then, Mr. Bayre can do even better. When Mr. Bayre includes the deferred income in 2026, it will still be Section 1231 gain. And, the five preceding taxable years (i.e., 2025, 2024, 2023, 2022 and 2021) do not include 2020 or 2019. So, in 2026, when Mr. Bayre has no Section 1231 losses, there also will be no non-recaptured Section 1231 loss. Mr. Bayre's Section 1231 gain will be taxed as long-term capital gain in 2026.

Let's work through the Bayre facts and compute his tax. We'll assume that for all years 2020-2026 Mr. Bayre's marginal ordinary tax rate is 37% and his marginal capital gains rate is 20%. Without his investment in the QOF, his gain on his sales of Assets B and C that generated $200,000 net Section 1231 gain to him will be characterized as ordinary income, due to his non-recapture Section 1231 loss in 2019, and his tax in 2020 would be $74,000 (i.e., $200,000 times 37%).

Let's assume that, instead, Mr. Bayre makes the $400,000 investment in the QOF in 2020 and holds it until at least 2026. He will have $200,000 of Section 1231 loss in 2020 that is ordinary and in 2020 can offset his other ordinary income (assuming he has sufficient Section 465 amounts at-risk and avoids other potential limitations) for a potential savings of $74,000. His initial basis in the QOF investment will be zero per Section 1400Z-2(b)(2)(B)(i). After holding the investment in the QOF for five years, Mr. Bayre's tax basis in the QOF will increase by 10% of the deferred gain (i.e., $40,000). Assuming that Mr. Bayre does not use that increased tax basis for other purposes (e.g., to support losses), in 2026, he will have a tax of $72,000 due to the deferral ending under Section 1400Z-2(b)(1) (i.e., the deferred gain of $400,000 less the basis of $40,000, multiplied by the assumed 20% tax rate). Instead of paying $74,000 in taxes in 2020, he will have decreased his overall taxes by $2,000 (without regard to present value considerations). The tax consequences with respect to his Section 1231 assets disposed of in 2020 will have improved Zach Bayre's financial situation by $76,000...no joke!

Readers, we welcome your comments, as always.