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LIFE SAVERS FOR ADVERSE TAX REFORM

Opportunity Zone Investing and Other Options

By Philip R. Hirschfeld

President Biden's tax reform proposals target many tax benefits associated with real estate investing. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 28, 2021) [hereinafter Green Book]. If adopted, the ability to effectuate tax-free like-kind exchanges may be significantly reduced, and the maximum long-term capital gains rates on sales may rise from 20 percent to 43.4 percent (marginal rate of 39.6 percent plus net investment income tax (NIIT) of 3.8 percent). Id. at 84, 61. If all or part of these proposals are adopted, planning options such as investing in qualified opportunity zone funds (QOFs), refinancing existing real estate, or entering into partnership mixing-bowl transactions may become more valuable, and should be explored by real estate investors seeking to cash out of their investments.

Philip R. Hirschfeld is an associate at Cole Schotz P.C. in New York, New York, and is the chair of the Section's Taxation of Real Estate Committee.

Tax Reform Proposals Affecting Real Estate

Like-kind exchanges (LKEs) have been part of the Internal Revenue Code since 1921. I.R.C. § 1031. Their usage became limited by the 2017 Tax Cuts and Jobs Act (the 2017 Tax Act), which restricted LKEs to sales of business or investment real estate. I.R.C. § 1031(a)(1). As a result, the ability to effectuate LKEs for tangible personal property (such as

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a company jet or business machinery) was eliminated.

To fund his proposed American Families Plan, which will provide for child-care credits, family plan leave, and education benefits, President Biden has proposed limiting the exclusion from tax for LKEs to $500,000 per year for any taxpayer or $1 million for married couples filing joint returns. The proposal would be effective for exchanges completed after December 31, 2021. Green Book, *supra*, at 84.

The LKE proposal's effective date presents a concern for like-kind exchanges commenced during the last half of 2021. Most LKEs are completed on a deferred basis—in which the relinquished property is sold and the replacement property is acquired at a later date, which is the earlier of 180 days after the sale of the relinquished property or the filing date for the tax return for the year including that sale date. I.R.C. § 1031(a)(3). If the legislation is adopted with the proposed effective date, then taxpayers commencing an LKE in 2021 will need to complete it by December 31, 2021 in order to avoid being subjected to this limitation.

The LKE proposal allows for gain exclusion of up to $500,000 for each taxpayer. Because a partnership that owns real estate is not a taxpayer, this limitation should, if adopted, be applied at the partner level rather than at the partnership level, assuming the LKE is not further modified. An S corporation is usually not a taxpayer except in unusual cases; for example, tax may be owed by an S corporation that was previously a C corporation and then sells, within five years, property owned on the date of conversion. I.R.C. § 1374. If LKE legislation becomes law, clarification should be made that any limitation will be applied at the S corporation shareholder level, and similar treatment should also be afforded other pass-through entities (such as REITs) so that the $1 million/$500,000 allowable exclusion is applied to each owner rather than the entity itself.

In any LKE, gain may be recognized if the exchange cannot find replacement property within 180 days or upon the receipt of cash, which is referred to as taxable boot, along with eligible replacement property. If the LKE spans two years and all applicable LKE safe harbor regulations are complied with (e.g., by use of a qualified intermediary to hold the cash), any gain would be recognized under the installment method, which results in gain recognition in the second year. Temp. Reg. § 15A.453-1(b)(3)(i); Reg. § 1.1031(k)-1(g)(3), (4).

The LKE proposal states that gain in excess of the maximum $1 million/$500,000 gain exclusion amount would be recognized by the taxpayer in the taxable year in which "the taxpayer transfers the real property subject to the exchange." Green Book, *supra*, at 84. If a taxpayer enters into a deferred exchange that straddles two taxable years, the gain would be triggered in the first taxable year when the relinquished property is transferred, rather than the second year when the exchange is completed. Unless this result is changed in any legislation, taxpayers doing LKEs with gain in excess of the maximum $1 million/$500,000 exclusion amount will need to pay the tax in the year of sale even though they do not receive the replacement property until the second year.

Apart from changes to LKEs, the Green Book includes a proposal to increase the maximum individual income tax rate from 37 percent to 39.6 percent, which was the maximum rate before the 2017 Tax Act. *Id*. at 60. The Green Book also proposes to increase the long-term capital gains rate from 20 percent to the maximum ordinary income tax rate (proposed to be 39.6 percent) for taxpayers having more than $1 million of adjusted gross income per year. *Id*. at 61. As a result, the gain that formerly escaped taxation under the LKE rules may become subject to tax at a 39.6 percent rate, and also be subject to the 3.8 percent NIIT.

The Green Book proposes to tax unrealized appreciation in real estate or other assets owned at death. Certain exclusions would be added—for example, transfers between spouses would be excluded and a $1 million per person limitation from taxation of resulting gains would be added. Transfers to spouses that are not subject to tax will cause the surviving spouse to get a carryover basis rather than a step-up in tax basis as exists under current law. *Id*. at 62–64.

These proposals have made investors jittery about the future treatment of gain on sale of real estate. As a result, taxpayers may be searching for possible avenues for relief if their fears about tax reform become a reality and all or some of these proposals are adopted.

QOFs as an Investment Option

Taxpayers that may be subject to higher taxes on capital gains can defer taxation of those gains until 2026 if they timely invest those gains into a QOF. I.R.C. § 1400Z-2(a)(1). If that investment is made before the end of 2021, 10 percent of that gain would be forgiven. *Id.* § 1400Z-2(b)(2)(B)(iii). While that still leaves 90 percent of the gain to be taxed in 2026, the QOF offers the ability to avoid paying any tax on a sale of the real estate owned by the fund or the interest in the QOF if it is sold 10 years or more after the gains are first invested in the QOF. *Id.* § 1400Z-2(c). Unlike LKEs, elimination of gain does not require finding a suitable replacement property and the need to invest all the sales proceeds to acquire that property. The cash from the sale can be used for any purpose.

Use of leverage by a QOF substantially magnifies the tax savings on a later sale. If investors contribute $2 million to a QOF that incurs $8 million of debt to buy and improve the real estate, and that $10 million investment grows in value by only six percent per year, then after 10 years, the real estate will be worth more than $17.9 million. On a sale after 10 years, the $7.9 million economic gain will not be taxed. In addition, the taxable gain on sale is greater than $7.9 million because each year, depreciation deductions taken with respect to the property reduce the basis of the property. Those depreciation deductions gave a current benefit to the QOF investors, which is not then recaptured on a sale after 10 years. If a taxpayer passes away before 10 years, their heirs can step into their shoes and eliminate tax on a sale 10 years or more after the original capital gain was invested in the fund.

Some investors may believe that a QOF must be structured as a traditional investment vehicle created by an investment manager and others who may charge fees that can reduce their economic yield. However, a QOF includes any partnership formed between two or more investors to invest in an opportunity zone. Two investors or a family group can pool their resources to invest in an opportunity zone as long as they have competent advisers who can ensure they comply with the technical qualification requirements that apply throughout the life of the fund.

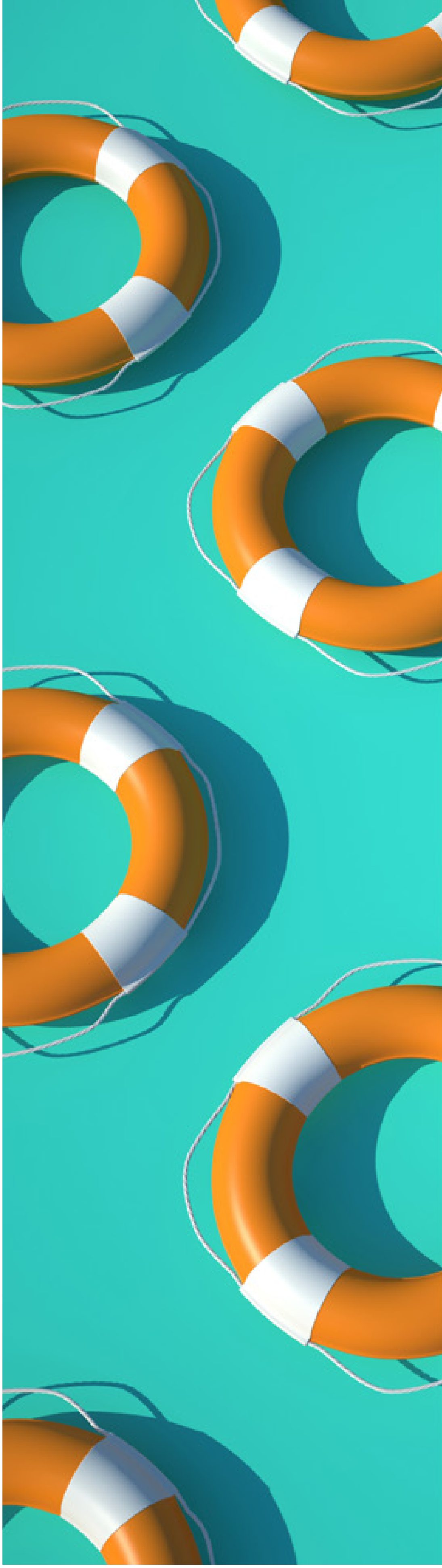
Some investors may believe that investments can only be made in economically blighted areas where the chance for economic reward from operations and sale may be remote. However, there are more than 5,700 opportunity zones around the nation, and many have already started the transition to highly promising and profitable sites.

Some investors may think the technical requirements for operating a QOF can become overwhelming. However, in principle, a fund that buys existing real estate must improve it by investing cash greater than the purchase price of the building over a 30-month period, which gives them time to complete their project. The QOF will usually form a subsidiary partnership to acquire the real estate and construct the improvements to allow it to retain cash for working capital, but the added burden of having a second partnership and an added tax filing is usually manageable with the right set of tax accountants.

Some investors may fear that Congress may also scrap opportunity zone benefits. However, no proposal has yet been made to eliminate them. While some criticism has been leveled as to whether the QOF program is producing as many new jobs as expected, the program's focus on aiding communities in need makes the chance of elimination seem small, especially compared to other more visible targets such as LKEs and capital gain preferential taxation.

The only caveat is for an investor who has a capital gain subject to tax under existing law that is invested in a QOF, and then the capital gains tax rate increases. Taxation of the capital gain is deferred until 2026, at which time it may then be taxed at higher rates. While a hypothetical higher tax rate could undercut the benefit of tax deferral, the tax exclusion on the sale of an interest in a QOF or the sale by a QOF of zone property after 10 years becomes even more valuable because it eliminates taxation at higher rates. An investor should balance these considerations to determine what their best option is.

The bottom line is that the closer we get to tax reform becoming a reality, the more prices may climb in opportunity



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zones. As a result, now may be the time to consider investing in a QOF, whether formed by an investment manager or by a small group of investors.

Refinancing as an Alternative to a Taxable Sale

Another way to alleviate the pressure of tax reform on a sale is to consider ways to try to cash out while not recognizing capital gain. When real estate values climb, refinancing existing debt and obtaining added cash is not a taxable event to the owner because the taxpayer still owns the property, and the expectation is the debt will become due and payable at some future date.

If a partnership owns the property, incurs debt, and then distributes borrowed funds to the partners, the partners are only taxable on that distribution if the distribution exceeds their outside basis for their partnership interest. *Id*. § 731(a)(1). When the property is held by a partnership, added partnership debt allows the partners to increase their basis for their partnership interests. *Id*. § 752(a). That increase in tax basis can offset the reduction in tax basis resulting from a cash distribution, so the partners' basis remains unchanged, and the cash distribution is tax-free. Ultimately, when the debt is paid down, the partners may be subject to taxation. The step-up in basis at death is a way to eliminate the prospect of paying tax when the debt is paid off, but that tax planning option is also under siege.

Partnership Mixing Bowl Transactions

Another way to try to eliminate tax is to consider doing a partnership "mixing bowl transaction." One example of a mixing bowl transaction involves two parties who have property they would like to exchange, when the exchange would be taxable because LKE treatment may not be available.

Instead of doing a taxable exchange, each party becomes a partner of a new partnership, and each party contributes their property to the partnership. The two-person partnership then serves as the mixing bowl that now owns and operates both properties. After a set time, the partnership may dissolve and distribute the property contributed by each partner to the other partner.

A mixing bowl transaction is built upon the fundamental tax principles that contributions of property by partners to partnerships and distributions of property by partnerships to partners are generally tax-free events. *Id*. §§ 721, 731. Based on these principles, the mixing bowl transaction potentially allows for tax-free treatment on formation of the mixing bowl and tax-free treatment on later distributions of property when the mixing bowl is broken up and the partnership dissolved. As a result, there is the potential for exchanging one property for another property in a tax-free manner if done through a partnership mixing bowl.

The step transaction doctrine afforded the IRS a basis to challenge each mixing bowl transaction by asserting that the overall transaction should be recast as a deemed taxable exchange. *See, e.g., Smith*, 78 T.C. 350 (1982). The step transaction doctrine is a subjective test, which can be difficult to prove and especially time-consuming. Rather than litigating every case based on step transaction principles, the IRS needed objective criteria to battle these mixing bowl transactions, which came in a series of amendments to the Internal Revenue Code.

Congress first adopted a disguised sale of property rule, which gave the IRS regulatory authority to write regulations recharacterizing a contribution of property to a partnership and a later distribution of other property to the contributing partner as a deemed taxable sale of the property. I.R.C. § 707(a)(2). The resulting regulations created a rebuttable presumption that a distribution made within two years of the contribution would be a taxable sale. Reg. § 1.707-3. Despite these changes, many taxpayers decided to stay together for more than two years before they took action to break up their mixing bowl, which left the IRS back to relying on difficult-to-prove subjective assertions to combat these patient taxpayers.

Congress then followed up by adding two new statutory provisions. These rules required the partners to stay together in their mixing bowl partnership for more than seven years in order to get tax-free treatment on contributions and distributions of property that are part of their mixing bowl transaction. If the contributed property is distributed to another partner within seven years of the date of contribution, then the contributing partner may recognize gain relating to the contributed property. I.R.C. § 704(c)(1)(B). Alternatively, the contributing partner may recognize gain when the originally contributed property is retained by the partnership, but other property is

distributed to the contributing partner within seven years of the initial contribution. *Id*. § 737.

These added rules put a damper on mixing bowl transactions but did not eliminate them. While the parties need to stay partners for at least seven years before seeking to dissolve their arrangement to escape taxation on an otherwise taxable property transaction, that patience may be rewarded if LKEs and capital gains benefits are eliminated. Furthermore, in the interim, the parties could choose to allocate disproportionately distributions and related taxable income or loss from the properties to reflect better their ultimate business goal.

For example, if A owns Building X and B owns Building Y and both buildings have equal value, the mixing bowl partnership resulting from a contribution of Building X and Building Y will make A and B equal partners. A and B must wait seven years before A can get Building Y and B can get Building X. In the interim, 50 percent of all cash flow and taxable income and loss from both properties may be allocated to A and 50 percent to B. However, to better reflect the business goal of A getting Property Y and B getting Property X, the parties can provide that 80 percent of all cash flow and taxable income or loss from Building Y is allocated to A and 20 percent to B and 80 percent of all cash flow and taxable income or loss from Building X is allocated to B and 20 percent to A. The goal is to move closer to the business deal of A getting Property Y and B getting Property X, but to not move too close, to avoid allowing the IRS to collapse the overall deal and assert that a deemed taxable sale of the properties occurred. For example, allocating 99 percent of cash flow and taxable income or loss from one property to A and 1 percent to B is very aggressive and may cross the line by causing a deemed taxable exchange to be made upon formation of the mixing bowl.

Conclusion

The Green Book proposals have been met with opposition from various groups that cross over political party lines. As a result, it is far from certain how and when any legislation may shape up and whether it may pass both houses of Congress. Nonetheless, the possible planning options discussed above such as investing in QOFs, refinancing, or entering into mixing bowl transactions add to the options currently available for taxpayers wishing to cash out of their real estate investments in a more tax-efficient manner. ■