# The Tax Cuts and Jobs Act of 2017 and Internal Revenue Code Section 1031[1]

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*How does one manage an Internal Revenue Code Section 199A qualified business deduction for income generated by investment property acquired through an Internal Revenue Code Section 1031 exchange?*

Pursuant to the Tax Cuts and Jobs Act of 2017 (the "JOBS Act"), tax rates for individuals on business income earned through tax "pass-through" entities (i.e. partnerships, limited liability companies, sole proprietorships and S corporations) have been meaningfully reduced by two changes: (i) first, a 2.6% reduction in the top marginal income rate (from 39.6% to 37%); and (ii) second, a potential further reduction to 29.6% for certain income that is qualified business income ("QBI"). Together, these two rate reductions for ordinary income represent a 10% reduction from the pre-JOBS Act 39.6% top individual marginal rate. This can be seen as real relief for owners of pass-through businesses including real estate owners and investors that earn rental income. As discussed below, the rate reduction on QBI to 29.6% is not automatic, but instead depends on the relative amounts of the underlying business' QBI, wages and tangible property investment, with exception for ordinary income from real estate investment trusts ("REITs") and publicly-traded partnerships ("PTPs")[2]. As discussed in more detail below, the potential 29.6% rate arises from the new deduction against taxable income generally equal to 20% of the sum of QBI from each qualified trade or business and certain income of REITs and PTPs (effective through 2025).[3] However, note that the potential 20% deduction on a taxpayer's QBI expires after the taxable year ending December 31, 2025.[4]

For taxpayers above certain income thresholds (discussed below), the qualified trade or business must have sufficient amounts of W-2 wages paid or a combined sufficient amount of wages plus the unadjusted basis of certain property (including buildings, but not land).[5] The IRC

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[1] We note that an investor taking part in an IRC Section 1031 exchange should consult with his or her own tax advisor regarding the possible application of Section 199A to his or her own particular circumstances. This memorandum is for informational purposes only and should not be construed as giving tax advice.

[2] Although outside the topical discussion herein, we note that dividends of ordinary income from REITs, as well as PTPs taxed as pass-throughs, are not subject to the QBI wage and property limitation (i.e., REIT and PTP ordinary income automatically receives the full 20% deduction and is taxed at the QBI pass-through rate of 29.6%). The JOBS Act does not change the 20% tax on REIT distributions of capital gain. PTP distributions, to the extent of qualified income and ordinary income realized by PTP holders from disposition of the PTP interest (allocable to non-capital gain assets), will receive the full 20% QBI pass-through deduction https://www.akerman.com/en/perspectives/tax-reform-the-impact-on-real-estate.html.

[3] "Qualified trade or business" includes all trades and businesses except the trade or business of performing services as an employee and "specified service" trades or businesses (those involving the performance of services in law, accounting, financial services, and several other enumerated fields, or where the business's principal asset is the reputation or skill of one or more owners or employees).

[4] https://www.law.cornell.edu/uscode/text/26/199A.

[5] The W-2 wage limitation does not apply to taxpayers with taxable income of less than $157,500 for the year ($315,000 for married filing jointly) and is phased in for taxpayers with taxable income above those thresholds. Income from specified service businesses is not excluded from qualified business income for taxpayers with taxable income

Section 199A deduction gives unincorporated businesses, S corporations, and real estate investors a special "bonus" deduction equal to the lesser of 20% of business income or 20% of their taxable ordinary income. For example, if an individual makes $100,000 a year in an incorporated business, with the new IRC standard deduction, his or her taxable income would equal $76,000. If we were to assume all of the individual's taxable income is ordinary income (i.e. no capital gains), his or her IRC Section 199A deduction would equal the lesser of 20% of $100,000 ($20,000) or 20% of $76,000 ($15,200).[6]

The IRC Section 199A deduction, however, is subject to "phase-out" calculations. The phase-out calculations do not apply to single taxpayers with taxable income less than $157,500 and married taxpayers with taxable income less than $315,000, as in the example above. Nevertheless, the phase-out calculations do apply to those single taxpayers with taxable income between $157,500 and $207,500 and for married taxpayers with taxable income between $315,000 and $415,000. For these taxpayers, as taxable income increases closer to the threshold amounts stated above, the percentage of the IRC Section 199A deduction slides closer to 0%.[7]

Single taxpayers making more than $207,500 and married taxpayers making more than $415,000 (a "High-Income Taxpayer") do not utilize the phase-out calculations. Instead, High-Income Taxpayers apply a couple of simple rules. First, as stated above, if the High-Income Taxpayer earns business income in a specified service business (white-collar professionals, athletes, performers or one-person celebrity businesses), the High-Income Taxpayer does not get the IRC Section 199A deduction. Second, if the taxable income of the High-Income Taxpayer that holds the real estate investment exceeds the annual threshold levels, the value of the QBI deduction is limited to the greater of (i) 50% of W-2 wage income or (ii) the sum of 25% of the W-2 wages of the business plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property ("UBIA").[8] The resulting IRC Section 199A deduction is then subject to a second limitation equal to 20% of the excess of (a) the High-Income Taxpayer's taxable income for the year, over (b) the sum of the High-Income Taxpayer's "net capital gain".[9] The purpose of this second limitation is to ensure that the 20% deduction is not taken against income that is taxed at preferential rates.[10] <u>Please note that an accredited investor placing capital within syndicated IRC Section 1031-structured real estate offerings is likely going to either be subject to the aforementioned IRC Section 199A phase-out calculations, or in the event the investor is a High-Income Taxpayer, the above rules may limit the investor's IRC Section 199A deduction to 2.5% of the investor's UBIA given the probability that he or she is not paying W-2 wages</u>.

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under the same threshold amounts https://www.thetaxadviser.com/issues/2018/apr/understanding-sec-199A-business-income-deduction.html.

[6] https://evergreensmallbusiness.com/sec-199a-deduction-phase-calculations.

[7] See https://evergreensmallbusiness.com/sec-199a-deduction-phase-calculations for an example of the phase-out calculations.

[8] https://www.thinkadvisor.com/2018/11/07/tax-reform-hits-1031-exchanges-with-hidden-penalty.

[9] "Net capital gain" means the taxpayer's net capital gain increased by qualified dividend income. https://www.law.cornell.edu/uscode/text/26/1#h_11_A,

[10] Example: In 2018, "A", a married taxpayer, has $100,000 of qualified business income, $100,000 of long-term capital gain, and $30,000 of deductions, resulting in taxable income of $170,000. A's Section 199A deduction is limited to the lesser of $20,000 (20% of $100,000) or $14,000 (20% of $70,000, the excess of taxable income of $170,000 over net capital gain of $100,000) https://www.forbes.com/sites/anthonynitti/2018/08/09/irs-provides-guidance-on-20-pass-through-deduction-but-questions-remain/#36b42972ff84.

As a result of the JOBS Act rules, for a High-Income Taxpayer or business that exceeds the annual threshold levels discussed above, calculation of UBIA becomes important. In the case of IRC Section 1031 exchanges, it is necessary to determine which acquisition date is relevant for determining basis. The regulations provide guidance on how UBIA should be calculated in the case of an IRC Section 1031 exchange, and follow the IRC Section 168 regulations in providing that property acquired in an IRC Section 1031 be treated as Modified Accelerated Cost Recovery System ("MACRS") property, and therefore, the depreciation period is determined using the date the relinquished property was first placed into service unless an exception applies.[11] Consequently, for calculating UBIA, the relevant date is the date the taxpayer places the new property into service, although for calculating its depreciable period, the relevant date is still the date the taxpayer placed the relinquished property into service.[12]

Therefore, for some IRC Section 1031 exchanges, the relevant figure for determining basis is the purchase price of the original property less any depreciation that the owner was able to take over time. This would substantially reduce the value of the QBI deduction for (i) retail investors placing capital within syndicated IRC Section 1031-structured real estate offerings, and (ii) business owners who make IRC Section 1031 exchanges, especially where the business owner has significant property holdings, but few employees with W-2 wages, as is often the case with partnerships that are formed to hold real estate investments.[13]

*Example: Determining UBIA*[14]

Assume a High-Income Taxpayer, subject to the wages and depreciable property limitation, that receives no W-2 wages. Further, assume this High-Income Taxpayer purchased a $1,200,000 home, broken down into $200,000 of land (which he or she cannot depreciate) and $1,000,000 of building (which he or she is depreciating). Further assume that the High-Income Taxpayer has depreciated half of the building, and therefore, to date, has deducted $500,000 of depreciation.

In this example, the depreciable basis value for the IRC Section 199A calculation equals $1,000,000, as depreciation is ignored, as noted earlier. Now assume that the building has appreciated in value to $2,000,000 and that the High-Income Taxpayer wants to trade his or her property for a new property that also has a value of $2,000,000.[15] In this circumstance, the depreciable property value for the new $2,000,000 replacement property equals $500,000. In other words, the old depreciation the High-Income Taxpayer had ignored for purposes of the IRC Section 199A calculation must now be recognized. The High-Income Taxpayer also ignores the appreciation on which he or she is deferring tax via the IRC Section 1031 exchange. The real

[11] https://www.law.cornell.edu/cfr/text/26/1.168%28i%29-6.

[12] Please note that a taxpayer, under certain circumstances may "reset" the depreciation schedule so it starts at the like-kind exchange date by making an election under IRC §1.168(i)-6(i)(1).

[13]https://www.forbes.com/sites/anthonynitti/2018/08/09/irs-provides-guidance-on-20-pass-through-deduction-but-questions-remain/#702772a2ff84.

[14] https://evergreensmallbusiness.com/the-sec-199a-sec-1031-conundrum.

[15] See Id. Please note that if the exchanging High-Income Taxpayer does not complete a straight trade of equal valued real estate, but instead "trades up" by injecting additional cash or by borrowing additional funds, or by recognizing a gain during the nonrecognition transaction, "extra basis" is created. The real estate investor/owner can treat the extra basis as a separate asset with its own depreciable basis and its own depreciation schedule.

impact of this loss is that the High-Income Taxpayer potentially loses an annual 2.5% deduction on the "lost" $500,000 of basis ($12,500 annually).

In summary, if the High-Income Taxpayer completes an IRC Section 1031 exchange and trades his or her fully depreciated business for another building with equal value, he or she defers the capital gains tax on $500,000. However, the High-Income Taxpayer reduces the size of the IRC Section 199A deduction and possibly shortens the number of years he or she can take the IRC Section 199A deduction. On the other hand, if the High-Income Taxpayer does not complete the IRC Section 1031 exchange, he or she would pay immediate capital gains tax (a tax he or she may still pay in the future) but will enjoy years of larger IRC Section 199A deductions (currently only through 2025).

*Under the JOBS Act, the 10% threshold for "substantial understatement" is reduced to 5% for taxpayers claiming the deduction for QBI under IRC Section 199A.*

The American Jobs Creation Act of 2004 consolidated all penalties relating to the accuracy of tax returns into a single accuracy-related penalty equal to 20% of the portion of the underpayment to which the penalty applies. The penalty applies to any portion of any underpayment that is attributable to: (i) negligence or disregard of rules or regulations; [16] (ii) any substantial understatement of income tax; or (iii) any substantial valuation misstatement. The penalty is increased to 40% in the case of an underpayment which is attributable to one or more "nondisclosed noneconomic substance" transactions or a misstatement in the value of any property (or its adjusted basis) of 200% or more (a "Gross Valuation Misstatement"). In addition to these provisions, the American Jobs Creation Act of 2004 imposes a 20% accuracy related penalty for: (a) listed transactions;[17] or (b) reportable transactions[18] having a significant tax avoidance purpose. This penalty is increased to 30% if the transaction is not properly disclosed on the taxpayer's federal income tax return. Failure to disclose such a transaction can also prevent the applicable statute of limitations from tolling in certain circumstances and can subject the taxpayer to additional disclosure penalties ranging from $10,000 to $200,000, depending on the facts of the transaction. Similarly, any interest attributable to unpaid taxes associated with a non-disclosed reportable transaction may not be deductible for federal income tax purposes.

A substantial understatement of income tax generally occurs if the amount of the understatement for the taxable year exceeds the greater of: (1) 10% of the tax required to be shown on the return for the taxable year; or (2) $5,000. For a C corporation, a substantial understatement generally occurs if the amount of the understatement exceeds the lesser of: (i) 10% of the tax required to be shown on the return for that tax year (or $10,000, if that is greater); or (ii) $10,000,000. Under the JOBS Act, the 10% threshold is reduced to 5% for taxpayers claiming the deduction for QBI under IRC Section 199A.

[16] Negligence is generally any failure to make a reasonable attempt to comply with the provisions of the IRC and the term "disregard" includes careless, reckless, or intentional disregard.
[17] The term "listed transaction" means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the IRS as a tax avoidance transaction for purposes of IRC Section 6011.
[18] The term "reportable transaction" means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under IRC Section 6011, such transaction is of a type which the IRS determines as having a potential for tax avoidance or evasion.

A substantial valuation misstatement occurs if the value of any property (or the adjusted basis) is 150% or more of the amount determined to be the correct valuation or adjusted basis. The penalty doubles if the property's valuation is misstated by 200% or more. No penalty will be imposed unless the underpayment attributable to the substantial valuation misstatement exceeds $5,000 ($10,000 in the case of a C corporation).

*Pursuant to the JOBS Act, tangible personal property and intangible property are no longer eligible for IRC Section 1031 exchange.*

The JOBS Act, which effects taxable years beginning on or after January 1, 2018, made many significant changes to the U.S. federal income tax laws pertaining to IRC Section 1031. To date, the IRS has issued limited guidance with respect to certain of the new provisions, and there are numerous interpretive issues that will require additional guidance. It is highly likely that legislation will be needed to clarify certain aspects of the new law and give proper effect to Congressional intent. In any event, an investment in solely real property was not impacted by the JOBS Act. Specifically, subject to certain transition rules, for transfers effective after December 31, 2017, IRC Section 1031 exchanges are only allowed with respect to real property that is not held primarily for sale. Further, tangible personal property and intangible property are no longer eligible for IRC Section 1031 exchanges. Thus, investors will be able to utilize an IRC Section 1031 exchange to achieve tax deferral on gain in connection with the disposition of real property, but not with respect to tangible or intangible personal property. This is important to note as certain asset classes, such as student housing and hotel properties, wherein there may be significant personal property involved in the transaction, may be subject to a higher risk of IRS audit in the event one decides to include the value of the related personal property in an IRC Section 1031 exchange.

Based on IRC Section 1031, an exchanger must acquire one or more like-kind replacement properties that are equal to or greater in net purchase value than the net sales value of the exchanger's relinquished property (or properties). Further, the exchanger must also reinvest all of the net cash proceeds from the sale of his or her relinquished property. However, pursuant to the JOBS Act and as stated above, tangible personal property and intangible property are no longer eligible for IRC Section 1031 exchanges. Therefore, the value of the tangible personal property and intangible property involved in the IRC Section 1031 exchange would be considered "boot" and, assuming a gain was realized in the IRC 1031 exchange, subject to taxation.[19]

Please note that although tax can no longer be deferred through an IRC Section 1031 exchange for tangible or intangible personal property, the full expensing deduction can be used to offset any capital gain or depreciation recapture recognized in that same year or future years. However, full expensing is temporary, as it will expire in 2022, and will be reduced to 80% for assets placed in service in 2023, 60% for 2024, 40% for 2025, and 20% for 2026. This deduction applies to both new and used personal property acquired by the taxpayer.[20]

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[19] Boot is first applied to any depreciation recapture income tax liabilities and then to any capital gain income tax liabilities.

[20] https://www.ipx1031.com/updates-and-impacts-for-2018.