I. Nonrecognition Provision: Section 1400Z-2: Deferral of Gain on Reinvestment in “Qualified Opportunity Fund”

Section 1400Z-2, added to the Internal Revenue Code by the Tax Cuts and Jobs Act of 2017, provides that gain on the sale of property may be deferred (and in some circumstances completely forgiven), at the election of the taxpayer, to the extent the amount of realized gain (i.e., not the amount of the proceeds) is invested within 180 days of the sale in a “qualified opportunity fund” (QOF)—i.e., a fund that invests in designated qualified opportunity zones, generally low-income communities. (The gain realized but deferred needn’t have any connection with a QOF.)

A. “Original Use” and “Substantial Improvement” of Land and Building

Among other requirements, to be “qualified opportunity zone business property,” one type of “qualified opportunity zone property,” property must be tangible property used in a trade or business, and “the original use of such property in the qualified opportunity zone [must] commence with the qualified opportunity fund or the qualified opportunity fund [must] substantially improve the property.” I.R.C. § 1400Z-2(d)(2)(D)(i)(II). One interpretive question that came up after enactment of section 1400Z-2 is what constitutes “original use” and “substantial improvement” of a property that consists of a building and the land on which the building sits.

“Substantial improvement” requires that, during any 30-month period beginning after a property is acquired, increases in the adjusted basis of the property in the QOF’s hands exceed what the basis of the property was to the fund at the time of acquisition. I.R.C. § 1400Z-2(d)(2)(D)(ii). For many tax purposes, such as computing depreciation allowances, it would be necessary to treat the land and the building as separate properties. Does that mean that a QOF would have to make substantial improvements to both the land and the building to be eligible for the deferral benefits of a QOF rollover? Land is permanent, and the original use of land may have been decades or even centuries ago. And what would constitute substantial improvement of land, other than improving the building that sits on the land?

In Revenue Ruling 2018-29, 2018-45 I.R.B. 765, the Service in effect said to look to the building, not to the land. If the building is substantially improved, the property as a whole can be “qualified opportunity zone property.” The critical comparison is between the adjusted basis of the building before improvements to the adjusted basis of the building after improvements. Proposed

B. The Rest of the Proposed Regulations

In addition to the land and building issue noted above, some of the other positions in the proposed regulations promulgated in October 2018 are:

- The gain that can be deferred under section 1400Z-2 must be capital gain. See Prop. Reg. § 1.1400Z-2(a)-1(b)(2)(i)(A). Statutory language doesn’t explicitly say that, but that result is probably consistent with congressional intentions.

- Any entity that is either a corporation or a partnership for federal income tax purposes and for which the other requirements to be a QOF are satisfied may self-certify as a QOF. Prop. Reg. § 1.1400Z-2(d)-1(a)(1). There should have been no serious doubt that a limited liability company could be a QOF, but the statutory language was muddled. Since an LLC would be either a corporation or a partnership for tax purposes, an LLC can obviously qualify.

- And a preexisting entity may be a QOF, so long as the qualified opportunity zone property is acquired after December 31, 2017. See Prop. Reg. § 1.1400Z-2(d)-1(a)(3).

- Self-certification as a QOF requires meeting requirements prescribed by the Commissioner in IRS forms or instructions or in rules or guidance published in the Internal Revenue Bulletin. See Prop. Reg. § 1.1400Z-2(d)-1(a)(1)(i). At this point, that means filing a Form 8996 with the IRS.

- For an entity to be a QOF, at least 90% of the entity’s assets must consist of investments in qualified opportunity zone property made after 2017, determined by averaging the applicable percentage at mid-year and at year-end. I.R.C. § 1400Z-2(d)(1). The proposed regulations describe two valuation methods: If the QOF is required to prepare an “applicable financial statement” (AFS) (either a financial statement filed with a government agency other than the IRS, or a certified audited financial statement for significant business use), the valuation figures in the AFS must be used for the relevant reporting period. Prop. Reg. § 1.1400Z-2(d)-1(b)(1) (citing Treas. Reg. § 1.475(a)-(4)(h)). In other cases, QOFs must use cost bases of the assets in the calculations. Prop. Reg. § 1.1400Z-2(d)-1(b)(2).

The deferral under section 1400Z-2 in general works as follows. Any deferred gain is generally recognized on the earlier of the date of disposition of the interest in the QOF or December 31, 2026. I.R.C. § 1400Z-2(b)(1). However, if the interest is held for at least five years, the basis of the interest is increased by 10%, thus altogether eliminating 10% of the deferred gain. I.R.C. § 1400Z-2(b)(2)(B)(iii). And if the interest is held for at least seven years, another 5% of the deferred gain is eliminated through a basis step-up. I.R.C. § 1400Z-2(b)(2)(B)(iv). If the interest is held for at least ten years, any realized gain attributable to appreciation in the value of the interest after its acquisition is forgiven (the “ten-year gain exclusion”). I.R.C. § 1400Z-2(c). (The ten-year gain exclusion doesn’t, however, affect any gain that was deferred under the rollover provision. Any such gain not
already eliminated by the basis step-ups after five and seven years will already have been recognized on December 31, 2026, before the ten-year period is completed.

The proposed regulations deal with some issues involving the ten-year gain exclusion, including the following:

- A question arose as to what happens on the sale of an interest in a QOF that has been held for more than ten years if the sale occurs after the qualified opportunity zone designation has expired. Given the purposes underlying section 1400Z-2, it would be peculiar to deny an eligible investor the exclusion of any gain attributable to post-acquisition appreciation in such a case, and the proposed regulations provide that the ten-year gain exclusion will apply so long as the disposal of the interest in the QOF (or what was a QOF) held for more than ten years is made before 2048. Prop. Reg. § 1.1400Z-2(c)-1(b).

- An interest that was acquired partly with funds for which the deferral election was made and partly with other funds (a “mixed-funds investment”) is treated under section 1400Z-2 as two separate investments. See I.R.C. § 1400Z-2(e)(1). For purposes of applying the ten-year gain exclusion, the proposed regulations not surprisingly treat only the portion of the interest in a QOF attributable to the rollover as eligible for the 10-year gain exclusion. See Prop. Reg. § 1.1400Z-2(c)-1(a).

Et cetera, et cetera.

Although the effective date will officially be the date on which the proposed regulations are finalized, a taxpayer may rely on the proposals for gains realized before that date, if the taxpayer “applies the rules in their entirety and in a consistent manner.” Prop. Reg. § 1.1400Z-2(a)-1(e).

II. Realization and Related Issues

A. Income

1. Estate of McKelvey reversed

At the September 2017 meeting, we noted *Estate of McKelvey v. Comm’r*, 148 T.C. 312 (2017), in which the court held that an extension of prepaid variable forward contracts (PPVFs) was not a sale or exchange of the contracts under section 1001. McKelvey, the founder of Monster Worldwide Inc., in September 2007 had entered into PPVFs with two financial institutions, with original maturity dates of September 2008, on 6.5 million shares of Monster stock. Prior to maturity, after Monster’s share price had declined, McKelvey “extended” the expiration dates to January and February 2010. The Commissioner contended that the extensions were taxable events under section 1001—that the extensions were in reality exchanges of the original PPVFs for new PPVFs. Although the Tax Court agreed that the original PPVFs had been terminated and new ones established, the Tax Court held that section 1001 was inapplicable: that section applies to gains from the disposition of property and, at the time of the modifications, the PPVFs were liabilities, not property. The Commissioner had also argued that the modifications created new PPVFs that resulted in a
constructive sale of the underlying shares under section 1259. However, that argument was moot given the ruling that the modifications were not taxable events to begin with.

The Tax Court’s decision attracted a lot of attention, much of it negative, and, shortly before the October 2018 meeting, the Second Circuit reversed the Tax Court. See Estate of McKelvey v. Comm’r, 906 F.3d 26 (2018). See also Mark Fichtenbaum & Robert Gordon, “Estate of McKelvey vs. Commissioner: The Trap Has Been Sprung,” 36(1) J. Tax’n Invs. (Winter 2019, forthcoming); Mark Fichtenbaum & Robert Gordon, “Estate of McKelvey v. Commissioner—Tax Planning Opportunity or a Trap for the Unwary?,” 34(4) J. Tax’n Invs. 25 (Summer 2017). The Second Circuit agreed with the Tax Court that while extension of the expiration dates may have extinguished the original contracts and created new ones, this wasn’t an exchange of property for purposes of section 1001. But the Second Circuit suggested that the requirements of section 1234A may have been satisfied. Section 1234A states that gain attributable to the cancellation or other termination of a right or obligation with respect to property that is a capital asset in the hands of the taxpayer is treated as gain from the sale of a capital asset. The Second Circuit remanded the case to the Tax Court for consideration of section 1234A, which the Tax Court hadn’t considered the first time around.

In addition, the Second Circuit concluded that section 1259 came into play with respect to the replacement PPVFs and the underlying shares. Under that section, when a taxpayer owns an appreciated financial asset and enters into a transaction that eliminates substantially all opportunity for gain and risk of loss from the asset, the taxpayer is deemed to have constructively sold the asset. For example, entering into a forward contract to sell a substantially fixed amount of property at a substantially fixed price would implicate section 1259. Given the terms of the original contracts and the price of Monster stock, no constructive sale of the underlying Monster shares would have occurred at that point. But when the old contracts were deemed to have been terminated and new contracts were deemed to have been established, the price of Monster was substantially lower than the floor in the PPVFs. That, concluded the Second Circuit, meant that there was a contract in place to sell a substantially fixed amount of property (i.e., all the shares) at a substantially fixed price; hence a constructive sale of the Monster shares had occurred. The Second Circuit directed the Tax Court on remand to consider the amount of long-term capital gain attributable to the constructive sale.


2. Market facilitation program payments to farmers harmed by tariffs in the mini-trade war

In a program manager technical assistance memorandum from John P. Moriarty (Deputy Associate Chief Counsel (Income Tax & Accounting)) to Carrie Y. Holland (Director, Tax Forms & Publications (Wage & Investment)) (PMTA 2018-021, Dec. 10, 2018), the Service advised that payments made by the Department of Agriculture to farmers harmed by tariffs imposed on targeted agricultural products by trading partners of the U.S. should be included in the farmers’ gross income. Payments to compensate for lost profits are generally gross income to a recipient, and that’s exactly what these market facilitation program payments are supposed to be. Congress could provide an ex-
clusion from gross income if it wished, of course, but it hasn’t done so and, one would think, is unlikely to do so. (In any event, these payments were the result of administrative action, not a congressional mandate. Congress hasn’t had to directly face this issue.)

B. Deductions

1. **Timing of deductions for worthlessness of property**

If you’re going to claim a deduction attributable to property’s becoming worthless in a particular taxable year, you of course have to be able to demonstrate worthlessness at that time. In *Ence v. Comm’r*, T.C. Memo. 2018-151, the Tax Court denied taxpayer’s claim that he was entitled, under section 165(a), to a capital loss deduction in 2010. He hadn’t demonstrated that his investment in a gym (made indirectly through a limited liability company) had become worthless in that year, and, as a result, no loss was sustained. (The relevant regulations require that for there to be a deduction, “a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year,” Treas. Reg. § 1.165-1(b), and no loss deduction may be taken in a particular taxable year if there’s a reasonable prospect of recovery of the loss at the end of that year. See Treas. Reg. § 1.165-1(d)(2)(i).) For several years after 2010, Ence pursued litigation trying to recover his investment, and this heavy lifting demonstrated that he didn’t believe the investment had become worthless. If his efforts at recovery are unsuccessful, and he can later demonstrate worthlessness, he should eventually be entitled to a deduction—just not for taxable year 2010.

*Ence* illustrates timing issues associated with loss deductions, and so too does *Raifman v. Comm’r*, T.C. Memo. 2018-101, in which taxpayers were denied a deduction in 2008 associated with a tax shelter gone bad. For one thing, the Raifmans had routinely been making recoveries of parts of the claimed losses after 2008, suggesting that they saw a reasonable prospect of recovery at that time. In addition, the claimed losses were associated with notes that were securities for purposes of the worthless security loss rules of section 165(g) (providing for a capital loss when such a security becomes worthless), but taxpayers hadn’t proven worthlessness at the end of 2008. A capital loss deduction may have been appropriate at some point, but not for taxable year 2008.

2. **No business deductions are available if there’s no business (duh-h)**

In 2004 Robert de Sylva purchased a boat that was unusable at that time, and, over a several-year period, he made no effort to get it into operating condition. In 2012, he finally incurred substantial repair costs and claimed those costs were ordinary and necessary business expenses attributable to a boat rental business. In *de Sylva v. Comm’r*, T.C. Memo. 2018-165, however, de Sylva was left with nothing but a sinking feeling. The Tax Court accepted the Commissioner’s argument that de Sylva was not yet engaged in a trade or business; the repair costs were at best start-up expenditures that might eventually be eligible for 15-year amortization under section 195, beginning in the year in which de Sylva actually commences a trade or business (if he does). See I.R.C. § 195(b)(1).
3. Charitable contributions of conservation easements

It’s common for cases to conclude that a contribution of a conservation easement to a charitable institution isn’t deductible because such an easement, if it’s not granted in perpetuity, isn’t a “qualified property.” See I.R.C. § 170(h)(2)(c). As reported at the October meeting, in \textit{PBBM-Rose Hill, Ltd. v. Comm’r}, 900 F.3d 193 (5th Cir. 2018), the Fifth Circuit affirmed the Tax Court’s conclusion that no charitable contribution deduction was available on an easement donation that didn’t satisfy the perpetuity requirement. Under the terms of the donation agreement, if the easement were extinguished at some point, the donee land trust would receive the larger of the fair market value of the easement at the time of donation or the proceeds of the sale reduced by any permissible improvements made by the taxpayer to the land. That latter alternative was held to be inconsistent with the perpetuity requirement. (In December, the Fifth Circuit refused to reconsider that decision \textit{en banc}.) It probably didn’t help the case for a deduction that the donated conservation easement was associated with a golf course. See also \textit{Champions Retreat Golf Founders, LLC v. Comm’r}, T.C. Memo. 2018-146 (denying deduction for easement that was both attributable to a golf course and associated with a syndicated tax shelter); \textit{Belair Woods, LLC v. Comm’r}, T.C. Memo. 2018-159 (denying deduction for easement associated with a syndicated tax shelter because of failure to demonstrate basis attributable to contributed easement).

In addition, for there to be a deduction, a contributed easement must obviously have value. The Tax Court refused to reconsider its earlier decision in \textit{Wendell Falls Development, LLC v. Comm’r}, T.C. Memo. 2018-45, that the easement contributed in that case had no value. See T.C. Memo. 2018-193 (denying a motion for reconsideration but providing a discussion that supplements the earlier opinion).

4. Deductibility of education expenses

In \textit{Valle v. Comm’r}, T.C. Summ. Op. 2018-51, a Tax Court special judge concluded that a Spanish lawyer, who characterized himself as an international attorney, was not able to deduct the cost of earning an LL.M. (not in taxation) at NYU. The judge concluded that the degree, although it improved Valle’s skills as an international attorney, also “qualified [the petitioner] to perform tasks and activities significantly different from those he could perform before obtaining it.” \textit{Valle}, slip op. at 9. As a result, the LL.M. qualified him for a new trade or business, which, under the relevant regulation, made the expenditures nondeductible. See Treas. Reg. § 1.162-5(b)(3). The judge thought it particularly important that the American LL.M. made it possible for Valle to take the New York bar examination and become an American lawyer, apparently a different trade or business than that of a Spanish lawyer.

The judge in \textit{Valle} noted that there might also have been an issue as to whether Valle was required to obtain the degree as a condition of securing his U.S. employment. If acquiring the degree was such a condition, that too would have made the expenditures nondeductible. See Treas. Reg. § 1.162-5(b)(2). Given the judge’s conclusion on the new trade or business point, however, it was unnecessary to rule on this other issue.

In \textit{Banini v. Comm’r}, Docket No. 6699-18S (Order of Dec. 13, 2018), a summary decision, a special trial judge granted partial summary judgment to the Commissioner, concluding that a patent
advisor at a law firm wasn’t entitled to deduct law school tuition expenses in that the education qualified him for a new trade or business. Slam dunk under Regulation section § 1.162-5(b)(3). (Whether the reg is right or not is another question.) Banini had argued that attending law school was a condition of keeping his employment at the law firm or that, in the alternative, he needed to go to law school to qualify for his position as a patent advisor. The judge concluded that the record didn’t support either claim. In any event, the conclusion that the law degree qualified Banini for a new trade or business effectively mooted those arguments.

5. Economic substance cases

Three recent cases have denied deductions associated with tax shelters that didn’t meet the requirements for economic substance: Sugarloaf Fund, LLC v. Comm’r, T.C. Memo. 2018-181, (partnership use of a distressed asset debt (DAD) tax shelter was a sham, not recognized for tax purposes) transactions); Curtis Investment Co., LLC v. Comm’r, 2018 U.S. App. LEXIS 34392 (11th Cir. 2018) (affirming Tax Court’s decision disallowing deductions from custom adjustable rate debt structure (CARDS) transactions); Baxter v. Comm’r, 2018 U.S. App. LEXIS 34497 (4th Cir. 2018) (also affirming Tax Court decision in a CARDS case).

6. Substance-over-form doesn’t apply when Congress wanted form to control

In Benenson v. Comm’r, 2018 U.S. App. LEXIS 35170 (2d Cir. 2018), yet another appellate court has weighed in on the Tax Court’s 2015 decision in Summa Holdings, Inc. v. Comm’r, T.C. Memo. 2015-119. Both the First and Sixth Circuits had already reversed the Tax Court in disputes involving the same factual situation. See Benenson v. Comm’r, 887 F.3d 511 (1st Cir. 2018); Summa Holdings, Inc. v. Comm’r, 848 F.3d 779 (6th Cir. 2017). The individual taxpayers had used a congressionally favored form of entity, a family-owned domestic international sales corporation (DISC), which Congress intended to provide incentives to export goods by deferring and lowering taxes on export income, to transfer funds to their sons’ tax-favored Roth IRAs in a way that had the arguable effect of circumventing contribution limits on such IRAs.

The several cases (involving parties to the same transaction, but whose appeals were to different circuit courts) have basically concluded that the substance-over-form doctrine invoked by the Commissioner should not be applied to invalidate transactions that had been blessed by Congress. Congress can provide that form controls if it wishes to do so, and it can provide for tax benefits that, by economic standards, may seem too good to be true. As the Second Circuit has now put it: “Congress has itself elevated form over substance insofar as DISC commissions are concerned by affording exporters ‘commission’ deductions for payments that lack the economic substance generally associated with commissions.”

III. Hobby Losses

Losses associated with activities not engaged in for profit are generally nondeductible, making the characterization of an activity critical. (Section 183(b)(2) does, in form, seem to permit a deduction for expenses up to the income from an activity not engaged in for profit, but the deduction would be a miscellaneous itemized deduction, subject to the 2% of AGI threshold of section 67. In
addition, as a result of the Tax Cuts and Jobs Act, for taxable years from 2018 through 2025, miscellaneous itemized deductions aren’t deductible at all.)

We earlier reported on the Tax Court’s 2018 decision in Ford v. Comm’r, T.C. Memo 2018-8, holding that a former recording artist’s operation of Bell Cove, a venue for the performance of country music, wasn’t an activity for profit even though, for the years in issue, she spent most of her time on that activity. This wasn’t an easy case in that several business characteristics were in evidence: Bell Cove charged admissions fees, sold refreshments, and engaged well-known performers. In addition, Ford had purchased Bell Cove with her late husband, a music producer and record company owner. The court nevertheless concluded that Bell Cove was intended to generate losses that could be used to offset Ford’s income from other sources. Not surprisingly, given that the determination as to whether an activity is for profit is a factual one, the Sixth Circuit has now affirmed that decision. 2018 U.S. App. LEXIS 31221 (6th Cir. 2018). What is surprising, however, is the detail Judge Karen Nelson Moore, writing for the Sixth Circuit panel, went into in examining, one by one, the relevant factors set out in the regulations, see Treas. Reg. § 1.183-2(b), rather than summarily accepting the Tax Court’s factual determinations. Judge Moore once taught taxation (and civil procedure) at a prominent Cleveland law school, and her care with the facts demonstrates that this was a much more difficult case than the typical hobby loss dispute.

In Hylton v. Comm’r, T.C. Memo. 2016-334, the Tax Court had concluded that substantial claimed deductions associated with a horse breeding activity were limited by section 183. The court concluded that horses were the well-to-do taxpayer’s passion and that, even though she spent significant time on, and had special expertise in, the activity, the elements of personal pleasure dominated. In addition, she wasn’t dependent on the horse activity for income—a good thing in that the activity created large net losses over a multi-year period. In May 2018, the Fourth Circuit summarily affirmed the Tax Court in a one-paragraph per curiam opinion. See 2018 U.S. App. LEXIS 35001 (4th Cir. 2018). Hylton has now petitioned the Supreme Court for cert, claiming that the lower courts’ decisions rejected forty years of precedent and that she was denied due process by the Fourth Circuit because the court decided the case without oral argument. See Abraham Gross, “Horse Owner Asks Justices to Review Biz Profit Motive Case,” 2018 Law360 354-121 (Dec. 20, 2018). I hope Ms. Hylton isn’t betting on a favorable outcome. She has a better chance of winning the Kentucky Derby ten years in a row.

IV. Passive Activity Losses: More Failed Real Estate Professional Cases

To be a real estate professional in a particular year, and thus to avoid the limitations of section 469, a taxpayer must spend more than half her personal services time in trades or businesses that are real property trades or businesses in which she materially participates; and she must have spent more than 750 hours during the year in such real property trades or businesses. I.R.C. § 469(c)(7)(B). Although taxpayers occasionally prevail in real-estate-professional cases, it’s far more common to find defeats—as in the following two cases.

In Antonyshyn v. Comm’r, T.C. Memo. 2018-169, a couple claimed losses associated with rental activities and argued that the passive activity loss limitations shouldn’t apply because Mrs. Antonyshyn was a real estate professional under section 469(c)(7) during the relevant years. She
claimed to be the property manager for rental properties in several different states (North Carolina, Missouri, Texas, Georgia, and Pennsylvania). She obviously couldn’t handle the day-to-day management of such widely dispersed activities, however, and the couple therefore hired management companies to oversee several of the properties. Under the circumstances the Tax Court accepted the government’s argument that much of the time Mrs. Antonyshyn had logged as having been associated with real estate management was in fact associated with the couple’s holding the properties as investments. Such time doesn’t count as participation in a real estate activity for purposes of determining whether Mrs. Antonyshyn met the 750-hour requirement for being a real estate professional. In addition, she had counted hours attending seminars toward meeting the 750-hour requirement, with no evidence to show a connection between the seminars and the rental properties. If all of that weren’t enough to be fatal, the logs included several discrepancies, and they weren’t supported by other documentation. Under the circumstances, the court reasonably concluded that the logs weren’t reliable, Mrs. Antonyshyn was not a real estate professional, and the limitations of section 469 therefore applied to the claimed losses.

And, in Ballard v. Comm’r, T.C. Summ. Op. 2018-53, a special Tax Court judge concluded that a couple had not demonstrated that they were real estate professionals, for several reasons. For one of the years at issue, the couple hadn’t prepared contemporaneous logs; what was prepared was done several years after the fact based on “recollection.” For two other years the documents presented didn’t establish how many hours the couple had spent on what they claimed was a residential real property trade or business holding properties in both California and Georgia (the judge accepted that characterization for the sake of argument), and the documents that were produced showed that the couple had hired an agent to manage the Georgia properties and they hired workers to maintain all of the properties. The court found the husband’s testimony to be “incredible, uncorroborated, and self-serving.”

V. Capitalization

In Wasco Real Properties I, LLC v. Comm’r, 2018 U.S. App. LEXIS 34267 (9th Cir. 2018), an unpublished per curiam opinion, the Ninth Circuit affirmed a Tax Court decision that, under section 263A, taxpayer was required to capitalize property taxes and interest on acquisition indebtedness attributable to the portion of a property on which almond trees were grown.