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Treasury Should Ensure the Acquisition Cost of 1031 Acquired Property is Included When Calculating the 199A Capital Limitation

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The Treasury Department is in the process of writing guidelines for a number of new tax provisions that were created by the Tax Cuts and Jobs Act of 2017 (TCJA).

One of the rules being developed by Treasury relates to the application of guardrails around the 20 percent deduction for businesses organized as pass-through entities, which exists under Section 199A of the tax code.

For instance, the TCJA required the Treasury Secretary to "prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions."

Treasury should interpret the unadjusted basis immediately after acquisition under 199A for all assets as the acquisition or purchase cost of the qualified property – regardless of whether the asset was purchased or acquired through a Section 1031 like-kind exchange.

Ensuring that the unadjusted basis for 1031 acquired assets is calculated in the same manner for all assets will ensure that all business investment is treated equally when the Sec. 199A deduction is calculated.

What is the Section 199A Deduction?

The TCJA implemented a tax cut for pass-through businesses (partnerships, S-Corporations, LLCs) in the form of a 20 percent deduction for qualified business income. This deduction, under Section 199A of the tax code, is limited in order to prevent taxpayers from improperly allocating wage income, which is paid by the individual, as business income.

One of the main limitations within Sec. 199A is a wage limitation combined with a capital limitation. The wage limitation applies to taxpayers with greater than $315,000 in income for joint filers or $157,500 for single filers and is phased in over the next $100,000 or $50,000 respectively.

Past this threshold, the 199A deduction is limited to the greater of 50 percent of a business's W-2 wages or 25 percent of W-2 wages plus a capital limitation of 2.5 percent of the "unadjusted basis" immediately after acquisition of all qualified property.

Generally, unadjusted basis equals all tangible property subject to depreciation. However, the TCJA did not explicitly define how like-kind exchange acquired property is treated. Instead, this will be decided through Treasury's regulatory authority.

What are Section 1031 Like-Kind Exchanges?

Like-kind exchanges are allowed under Section 1031 of the tax code and permit taxpayers to defer paying taxes when purchasing an asset when they use the equity and profits to invest in another, similar asset.

Because investors don't have to pay tax until they cash out, Section 1031 eliminates a potential barrier to investment, which in turn promotes the more efficient allocation of capital resources.

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Section 1031 has existed in the tax code for 100 years and in prior years has been used on real estate, machinery for farming and mining, and equipment such as trucks and cars. The TCJA restricted like-kind exchanges to real estate, effective January 1, 2018.

While Congress made many changes to the tax code through the TCJA, they affirmed that Section 1031 is an important provision in the code that incentivizes capital formation and business investment. Congress did limit the scope of 1031s for some assets, however as part of a tradeoff that involved moving from a system of multi-year depreciation of personal property assets to immediate expensing.

1031 Acquired Property Should Be Included in the Calculation of the Unadjusted Basis in Section 199A

"Unadjusted basis immediately after acquisition" should be defined as the cost or purchase price of qualified property without regard to how that property was acquired. This means that the acquisition cost of 1031 acquired property would be the cost or purchase price of the replacement property, or when the 1031 exchange occurred.

This matches the legislative intent of Congress and will ensure past business investment is properly recognized under the new code. On the other hand, failing to recognize 1031 acquired property when calculating the capital limitation will arbitrarily punish businesses that utilized like-kind exchanges prior to passage of the TCJA.

Utilizing a different calculation of unadjusted basis for 1031s, such as the value of the asset sold under the like-kind exchange, would create an unfair disadvantage for businesses that take advantage of 1031s by giving them a lower 199A deduction. It would also create a lock in effect for real estate, which retained a 39 year depreciation life under the TCJA.

The Sec. 199A capital limitation was written with the goal of providing a benefit to businesses with significant capital expenditures. Functionally, a 1031 purchased asset is no different from any other acquired property. Therefore, there is no reason to discriminate otherwise economically similar activities based solely on how the asset was purchased.

The fact that Congress limited 1031s should also not be justification for excluding this type of investment from 199A calculations. Where lawmakers chose to restrict their use, they replaced 1031s with immediate expensing, an alternative provision expected to promote investment and growth.

Sections 1031 and 199A serve distinct policy goals – 1031 is designed to stimulate business investment and expansion, while 199A is designed to provide rate reduction for businesses. These two valuable tax tools should not be interpreted in a way that disadvantages one section over the other.

In addition to creating economic harm, failure to treat 1031 acquired property equitably with other property would create a disincentive for pass-through entities to use 1031s. In effect, this would mean 1031s could be used by corporations but would be restricted for pass-throughs.