

Qualified Opportunity Zones: Opportunity to Defer and Potentially Eliminate Tax on Gains



The Tax Cuts and Jobs Act (the TCJA) provides a new tax benefit starting on December 22, 2017 that is aimed at attracting investments in low-income communities and some surrounding census tracts certified by the Community Development Financial Institutions Fund (CDFI Fund) within the Treasury Department (Treasury) as Qualified Opportunity Zones (QOZs).

A taxpayer who invests gain from a sale into a Qualified Opportunity Fund (QOF) can defer tax on the gain until 2026. A QOF is any corporation or partnership organized for the purpose of investing at least 90% of its assets in QOZ *property* (a defined term).

The potential tax benefits associated with the new rules include:

- Deferral of tax on all gains invested in a QOF until 2026,
- Elimination of tax on up to 15% of the gains invested in a QOF, and
- Elimination of tax on all gains earned above the amount invested in a QOF.

Deferral of Tax

A taxpayer may elect to exclude gains from gross income to the extent the gains are invested in a QOF. To qualify for deferral, gains must be invested within 180 days from the date of sale. All or part of the deferred gain is includible in taxable income when the taxpayer sells the investment in the QOF or on December 31, 2026, whichever occurs first.

If the taxpayer has not sold the QOF investment by December 31, 2026, the inclusion of the deferred gain may result in phantom income.

Permanent Reduction in Deferred Gain

Under the law, a taxpayer's initial basis in the deferred gain amount (DGA) that is invested in the QOF is zero. Depending on how long the taxpayer holds the QOF investment, the taxpayer may eliminate up to 15% of the DGA that must be included in income.

- After five years, the taxpayer's basis is increased by 10% of the DGA
- After seven years, the taxpayer's basis is increased by an additional 5% of the DGA

Since the DGA is triggered no later than December 31, 2026, a taxpayer must rollover gains into a QOF no later than 2021 to realize the 10% benefit and no later than 2019 to take advantage of the full 15% benefit.

Recognition of Deferred Gain

The DGA includible in a taxpayer's taxable income is calculated by subtracting the taxpayer's basis in the QOF investment, including the 10% and 5% increases, if applicable, from the lesser of (1) the DGA or (2) the fair market value (FMV) of the investment on the recognition date. If the value of the investment declines after acquisition, the amount of the taxpayer's DGA is also reduced.

Election to Exclude QOF Gains

After the DGA is recognized, the taxpayer's basis in the QOF investment will be equal to the DGA included in taxable income, plus any of the holding period basis increases.

If the taxpayer holds the QOF investment for at least 10 years, the taxpayer can permanently exclude any gain on the QOF investment by making an additional election. This second election treats the basis in the QOF investment as equal to its FMV on the date of sale.

Taxpayers are allowed to recognize losses on the disposition of a QOF as with any other investment asset.

Example:

On April 10, 2018, Taxpayer sells XYZ shares with a basis of \$1 for \$1,001, realizing \$1,000 of gain. On June 30, 2018 (within 180 days of the sale date), Taxpayer invests \$900 of the XYZ capital gain in a QOF and elects to defer the gain. The remaining \$100 of gain is retained by Taxpayer. On August 1, 2028, Taxpayer sells the QOF investment for \$2,000.

- For 2018, Taxpayer will only include \$100 of the \$1,000 gain in taxable income. The \$900 gain invested in a QOF on June 30, 2018 is deferred. At the end of 2018, Taxpayer's basis in the QOF investment is \$0.
- On June 30, 2023 (five years after investment), Taxpayer's basis in the QOF investment is increased to \$90 (10% of the \$900 deferred gain) with no resulting impact on taxable income for 2023.
- On June 30, 2025 (seven years after investment), Taxpayer's basis in the investment is increased by \$45, from \$90 to \$135 (5% of the \$900 deferred gain). Similar to tax year 2023, there is no impact on taxable income.
- On December 31, 2026, Taxpayer is required to include the deferred gain in taxable income. The amount included is equal to the lesser of deferred gain of \$900 or the FMV of the investment, less the Taxpayer's \$135 basis in the investment.
- Assume the FMV of the investment on December 31, 2026 is \$1,500. The amount of the deferred gain included in Taxpayer's 2026 taxable income is \$765 (\$900 deferred gain less \$135 of basis). This capital gain is included in 2026 taxable income even though the QOF investment has not been sold (phantom income).
- For 2028 (10 years after investment), Taxpayer sells the QOF investment and makes the election to treat its basis in the QOF shares, otherwise \$900, as equal to FMV or \$2,000 on the date of sale. Although Taxpayer has realized an additional \$1,100 of gain, this amount will not be included in Taxpayer's taxable income under the new QOF rules provided in the TCJA.

The Takeaway

The TCJA created a significant tax incentive that may interest investors seeking to defer or abate taxes on gains while providing benefits for rehabilitating distressed communities. States must nominate QOZs, with those designations subject to certification by the CDFI Fund within Treasury. More guidance related to the certification and investment mechanics of QOFs is also anticipated.

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