Deferring capital gain: Qualified Opportunity Zones

NATIONAL WEALTH PLANNING STRATEGIES, CHIEF INVESTMENT OFFICE

The tax legislation enacted in December of 2017 (often referred to as the "Tax Cuts and Jobs Act of 2017") included a new tax provision[1] that can allow capital gain recognized prior to December 31, 2026 to be deferred, and possibly reduced. The goal of the new provision is to provide tax deferral (and in some cases permanent exemption) in order to encourage investment in certain low-income communities, called "Qualified Opportunity Zones." The deferral is available only if the capital gain is timely reinvested into a "Qualified Opportunity Fund,"[2] which is an investment vehicle that invests in Qualified Opportunity Zones and meets strict tax law requirements.

This summary discusses the deferral provisions; we assume there is an available Qualified Opportunity Fund because the many requirements of having a Qualified Opportunity Fund are beyond the scope of this summary, although we touch on it briefly at the end.

New Section 1400Z-2

The new deferral provision can be summarized as follows: If before December 31, 2026 you sell to an unrelated person any property that generates capital gain and invest an amount equal to that capital gain into a Qualified Opportunity Fund within 180 days, then you might receive the following tax benefits:

- You can elect to defer that gain;
- Some of that deferred gain might be eliminated after 5 years;
- Some more of that deferred gain might be eliminated after 7 years; and
- Post-rollover appreciation is eliminated after 10 years.

There are several components involved here; we will briefly discuss them below, using the following recurring example.

> ***Recurring example:*** *You sell stock for $10,000,000, and your basis is $2,000,000, so your capital gain is $8,000,000. Within 180 days of the sale, you contribute $8,000,000 into a Qualified Opportunity Fund. You would not recognize the $8,000,000 of capital gain. Rather, it would be deferred under the rules discussed below.*[3]

Rules for selling any property for capital gain and investing in a qualified opportunity fund within 180 days

Capital gain: The statute allows deferral of any "gain." By its terms it is not limited to "capital" gain. Read literally, that could include gain recognized on the sale of property that is taxed as ordinary income, such as inventory. However, that seems unlikely. The title of the statute is "Special rules for *capital* gains..." It would seem more reasonable to assume this provision applies only to "capital" gain and does not apply to gain taxed as ordinary income.[4]

Nevertheless, this new deferral provision applies to *any* capital gain. The gain need not be capital gain from an investment. For example, assume you sell your principal residence for a capital gain of $1,200,000, and assume you exclude from income $500,000 of that capital gain pursuant to the special rule governing the sale of a principal residence. The remaining $700,000 of capital gain could be deferred under this provision, assuming the requirements are satisfied.

As another example of the breadth of this new deferral provision, there is no requirement that the capital gain be long-term. Short-term capital gain appears to be deferrable under this provision.

[1] This new provision is contained at new Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code.

[2] The term used in the statute is "Qualified Opportunity Fund," and so we use that term here.

[3] In our recurring example, the entire gain is deferred; this is not a requirement. If $5,000,000 was invested in a Qualified Opportunity Fund, then $5,000,000 of gain would be deferred and the remaining $3,000,000 of gain would be currently taxable.

[4] Treasury and the IRS are in the process of providing guidance regarding the 2017 tax legislation. The scope of "gains" to which new Section 1400Z-2 is available might be clarified through such guidance.

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Property: The gain being deferred must come from the sale or exchange of "property." This might rule out gain caused by the sale or exchange of a "contract" to the extent that contracts are not treated as property. Sometimes an asset is clearly property (e.g., stock). Other times it is not so clear, and the asset might be properly characterized as a "contract" that is not "property," in which case that gain on the sale of that contract could not be deferred under this provision.

Unrelated person: The sale/exchange causing the recognition of gain must be to an "unrelated person." Interestingly, that term is not defined in the statute. Instead, the statute defines "related persons." Presumably an "unrelated person" is someone who is not a "related person."

A "related person" is defined by cross reference to two other statutes. One is section 267(b) of the tax code, which disallows a loss on a sale to a related party, defined to include a family member, a controlled corporation, or a trust of which you are grantor or trustee or beneficiary. There are many other examples of a "related person" in this statute. The other is section 707(b)(1), which adds to this list partners and their 20%-owned partnerships and partnerships of which the same person owns more than 20%.

How much must be rolled over?: In our recurring example, property was sold for $10,000,000 and has a basis of $2,000,000, so capital gain is $8,000,000. To defer the $8,000,000 of capital gain, it is $8,000,000 that needs to be invested into a Qualified Opportunity Fund, not the entire proceeds of $10,000,000. If more than $8,000,000 is invested, that investment is divided into two parts:

- $8,000,000 subject to the deferral provisions of Section 1400Z-2 (with a basis of $0)
- The excess, which is not subject to the deferral or basis provisions of Section 1400Z-2

180 days: The investment in the Qualified Opportunity Fund must occur within the 180-day period beginning on the date of the sale that generated the capital gain. There is no requirement that the proceeds used for the investment somehow be traced to proceeds from the exchange that generated the capital gain. Rather, if you invest in a Qualified Opportunity Fund an amount that equals the capital gain, that will satisfy this requirement.

Election: You must elect to have this provision apply.[5] The process for making this election is not described; presumably Treasury and/or the IRS will issue guidance, and presumably the election would be made on one's tax return at the time of filing. In that case, the 180-day deadline might come after the filing deadline by which an election must be made. For example, if the sale occurs on December 1, the tax filing deadline for that tax year would be the following April 15 (absent an extension), but the 180-day deadline would be May 30. In that case, it's possible the capital gain has not yet been reinvested when the election deadline arrives. Presumably future guidance will address this, perhaps allowing this to be solved by allowing an extension for filing one's tax return to also be an extension of the time to make this election.

Some gain can be deferred; some gain can be eliminated

Assuming you have capital gain that has been deferred by reinvesting in a Qualified Opportunity Fund as described above, the deferral/elimination of that gain is accomplished in 4 steps.

Step 1: Deferral

Under the general rule of the statute, the capital gain is not recognized immediately if it is properly reinvested in a Qualified Opportunity Fund.

Step 2: 5-Year Rule

If the investment in the Qualified Opportunity Fund is held for 5 years, then your basis in the investment is increased by 10% of the deferred gain. This has the effect of permanently excluding from income that 10%.

> ***Recurring example:*** *You sell stock for $10,000,000, and your basis is $2,000,000, so your capital gain is $8,000,000. Within 180 days of the sale, you contributed $8,000,000 into a Qualified Opportunity Fund, deferring the entire gain. Because you have deferred the entire gain, your basis in that $8,000,000 investment is $0. If you hold that investment for 5 years, your basis in the investment would increase by $800,000. This has the effect of permanently excluding $800,000 of the deferred gain from income.*

Step 3: 7-Year Rule

If the investment is held for 7 years, then your basis in the investment is increased by another 5% of the deferred gain. This has the effect of permanently excluding from income that additional 5%. It also has the effect of lowering the effective capital gains tax rate on the original sale from 20% to 17% (or from 23.8% to 20.23% after considering the 3.8% net investment income tax).

> ***Recurring example:*** *Continuing with the example from above, assume you hold that investment for 2 more years, for a total of 7 years. Your basis in the investment would increase by another $400,000, becoming $1,200,000. This has the effect of permanently excluding an additional $400,000 of the deferred gain from income.*

[5] Only one election can be made for each sale/exchange. The statute states that an election cannot be made for a sale/exchange if there was a previous election. It is not entirely clear how a second election might otherwise occur.

If the investment is sold, then gain is recognized at that time, after adjusting for the 5- and 7-year basis increases described above, if applicable.

> ***Recurring example:*** *After holding the investment for 7 years (but before December 31, 2026), the investment has appreciated to $9,000,000, and you sell the investment for $9,000,000. Your gain would be $9,000,000 minus $1,200,000, or $7,800,000.*

Step 4: Deemed Recognition

If the investment is not sold, the initially deferred gain is nevertheless recognized on December 31, 2026, which will end the deferral. If the investment has appreciated or remained flat, this will cause all of the excess of the deferred gain over basis to then be recognized. If the investment has depreciated, the gain recognized on December 31, 2026 will be the excess of the fair market value over basis.

Note that this does not deem the entire investment to be sold, which would trigger all gain, including appreciation since the rollover. Rather, it is only the remaining originally deferred gain that is recognized on December 31, 2026. Post-rollover appreciation is not taxed yet.

> ***Recurring example:*** *After holding the investment for 7 years, the investment has appreciated to $9,000,000. You continue to hold the investment and do not sell. On December 31, 2026, you will be deemed to have recognized capital gain of $6,800,000 (the initially deferred gain of $8,000,000 less the $1,200,000 of basis adjustments). The post-rollover appreciation of $1,000,000 is not deemed to be recognized.*

Death before December 31, 2026. If you die before there's a deemed recognition event on December 31, 2026 and before selling your investment in the Qualified Opportunity Fund, there will be some initially deferred gain that has not yet been recognized. Just how much will depend on whether there have been basis adjustments for 5- and 7-year holding periods. The remaining initially deferred gain is "income in respect of a decedent" (known as "IRD") and does not receive a step-up in basis.

> ***Recurring example:*** *After holding the investment for 7 years, the investment has appreciated to $9,000,000. You continue to hold the investment and do not sell. You die on June 1, 2026. There will be a step-up for the $1,000,000 of post-rollover appreciation. At that time, there is $6,800,000 of initially deferred gain remaining ($8,000,000 less $1,200,000 of basis adjustment). There will not be a step-up in basis for that $6,800,000; it will be IRD. Overall, the basis of the inherited investment would be $2,200,000.*

> *Whoever inherits the investment would remain subject to the rule that on December 31, 2026, all remaining deferred gain would be recognized. It is possible that, like all IRD, the investment could be subject to both income tax after having already been subject to estate tax. In the case, to soften the double taxation, a special provision (section 691(c) of the tax code) allows an income tax deduction equal to the estate tax incurred on the amount of income (the deferred gain) that was exposed to estate tax.*

Gain on post-rollover appreciation eliminated after 10 years

If you hold the investment 10 years, you can elect to have your basis in the investment equal its fair market value when the investment is sold. This is in effect a step-up in basis.[6] Because the originally deferred gain will have already been taxed as of December 31, 2026 under the special rule noted above, with a corresponding adjustment in basis, this 10-year rule has the result of excluding from tax all post-rollover appreciation.

Deadlines inherent in the statute

In addition to the 180-day deadline discussed above, there are other important deadlines that are built into the statute.

- The 5-year basis adjustment will be of benefit only if it occurs before the December 31, 2026 deadline by which all remaining deferred gain must be recognized. This means that in order to receive the 5-year basis adjustment, you must invest in a Qualified Opportunity Fund before December 31, 2021.
- Similarly, the 7-year basis adjustment will be of benefit only if it occurs before the December 31, 2026 deadline by which all remaining deferred gain must be recognized. This means that in order to receive the 7-year basis adjustment, you must invest in a Qualified Opportunity Fund before December 31, 2019.

This doesn't mean that the deferral provision stops being useful after those dates. Assume you incur capital gain in 2023 and defer that capital gain under this provision. The following results would occur:

- You would not be eligible for the 5-year or 7-year basis adjustments;
- You would be deemed to recognize the deferred gain on December 31, 2026, so you will have benefitted from several years of deferral;
- If you died before December 31, 2026, the deferred gain would not receive a step-up in basis; and
- You would remain eligible for the 10-year rule that allows all post-rollover appreciation to be permanently excluded.

[6] Presumably this is elective because if the investment has depreciated, this would result in a "step down" in basis and you would not make the election.

What is a Qualified Opportunity Fund?

A key component of this new provision is that there be a Qualified Opportunity Fund. The new statute sets out a dizzying array of interlocking definitions, all leading to the general goal of having a "Qualified Opportunity Fund" into which capital gain can be rolled over to defer recognition. Those requirements are beyond the scope of this summary. However, we offer the following high-level introduction. Here are key new terms under this provision, and a diagram that shows how they interrelate.

Qualified Opportunity Zone. The goal of the statute is to encourage investment in low-income communities. The first step is to have a low-income community properly named a "Qualified Opportunity Zone" by being nominated by the governor of the State (or Mayor of Washington, DC or chief executive officer of a possession) and certified by the Secretary of the Treasury. Much of this step has been done already and the communities identified.

Qualified Opportunity Zone Business. If a trade or business meets certain requirements, including having substantially all of the tangible property used by the trade or business within a Qualified Opportunity Zone, that will be a Qualified Opportunity Zone Business ("QOZB").

Qualified Opportunity Zone Property. An investment could be made:

- In a QOZB by purchasing its stock in the case of a corporation (called "Qualified Opportunity Zone Stock")
- In a QOZB by purchasing a partnership interest in the case of a partnership or an LLC taxed as a partnership (called "Qualified Opportunity Zone Business Partnership Interest")
- By directly purchasing the tangible assets used in a QOZB (called "Qualified Opportunity Zone Business Property")

In all three cases, that investment is Qualified Opportunity Zone Property ("QOZP").

Qualified Opportunity Fund. A fund that is organized as a corporation or a partnership and invests 90% of its assets in QOZP is a Qualified Opportunity Fund.

Observations

Taxpayers such as family offices and those with considerable investment expertise may consider setting up their own Qualified Opportunity Fund to make investments in Qualified Opportunity Zone Property. Alternatively, taxpayers may consider investing in Qualified Opportunity Funds created by third parties. Those funds will need to have periodic investment windows within which you could timely reinvest capital gain. Those funds may also be set up as private investment vehicles and may be subject to fees, including an incentive fee for the fund's manager.

For elderly taxpayers, the benefits of investing in a Qualified Opportunity Fund should be compared with the benefits of holding property until death and getting a full step-up in basis. Deferred gain within a Qualified Opportunity Fund will never be fully eliminated, whereas gain from other property generally is eliminated at death due to the step-up in basis.

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