December 2018

# Tax Talk

*A quarterly publication of Bridges & Dunn-Rankin, LLP*

**Inside this issue:**



Dear Clients and Friends,

In December of last year, Congress passed the most significant tax legislation in at least 31 years; *The Tax Cuts and Jobs Act*. Initially, much of the focus was on the reduction in the corporate tax rate, the reduction in individual rates, the new 20% qualified business income deduction, the severe new limitations on personal deductibility of state and local taxes, and the incredibly complex international provisions. In recent months, however, the questions we have received have increasingly pertained to what was initially a somewhat obscure provision in the tax legislation, new IRC Section 1400Z-2 "Special Rules for Capital Gains Invested in Opportunity Zones" (aka the "Qualified Opportunity Fund" or "QOF" rules). The interest in this new tax deferral/ tax exclusion opportunity has particularly increased since U.S. Treasury issued the first set of proposed regulations in this area in mid-October.

Given the interest in the new QOF rules, and the potentially incredible tax savings opportunity they represent, we will focus this issue of our newsletter on these rules.

We hope that you will enjoy this issue and gain from it some useful information.

Kent Bridges, Managing Partner

Sincerely,

*Kent Bridges*

## The Qualified Opportunity Fund Tax Savings Opportunity

Included in *The Tax Cuts and Jobs Act* legislation enacted in late 2017 was new Internal Revenue Code Section 1400Z-2, "Special Rules for Capital Gains Invested in Opportunity Zones". These new rules, often referred to as the "Qualified Opportunity Fund", "QOF", "Opportunity Zone", or "OZ" rules provide taxpayers who have recognized a capital gain the opportunity to defer tax on the gain for up to 8 years, the opportunity to have up to 15% of that gain permanently escape tax, and the opportunity to permanently avoid any tax on the appreciation in the value of the reinvested gain; provided the gain is invested in a "qualified opportunity zone" and you meet the other requirements of the statute. The purpose of this new tax incentive is to encourage investment in economically depressed areas.

***What are the basics?*** In general, if, within 180 days after realizing a capital gain, you reinvest the amount of the gain in a QOF, then: (1) you can elect to defer tax on the gain until the earlier of the date you dispose of your ownership in the QOF or 2026; (2) if you hold your ownership in the QOF for at least 5 years you can permanently exclude 10% of the deferred gain or if you hold for at least 7 years 15% of the gain; and (3) if you hold your ownership for at least 10 years, then you can exclude from tax 100% of the appreciation in value of your investment in the QOF. So, the tax benefits are the ability to defer tax on the original gain realized until 2026, avoid tax completely on up to 15% of that gain, and then avoid tax on all of the appreciation in the QOF investment itself. These are, obviously, potentially substantial tax benefits.

***What is a QOF?*** A "qualified opportunity fund" is any corporation or partnership (including an LLC with two or more members) which is formed for the purpose of investing in qualified opportunity zone (QOZ) property and that holds at least 90% of its assets in such property. As a practical matter, most QOFs will likely be LLCs taxed as partnerships.

***What is QOZ property?*** Qualified opportunity zone property means QOZ stock, QOZ partnership interest, or QOZ business property. QOZ stock basically means stock in a corporation which is operating an opportunity zone business, and QOZ partnership interest essentially means the same with respect to a partnership (or LLC) conducting such a business. QOZ business property means tangible property used in a business in an opportunity zone. In each case, the stock, partnership interest or business property must have been acquired after 2017, and the original use of the property (other than land) must commence with the QOF or the QOF must substantially improve the property.

***What is a QOZ?*** A qualified opportunity zone is a population census tract nominated by the governor of the state based on its low-income status. The governors of each state were permitted to designate up to 25% of the low-income communities within their state for this special status. An interactive map of QOZs can be found at https://www.cdfifund.gov. Because some of the QOZs are relatively small, in some cases you have to drill down deeply into the map to see them. There are over 8,700 designated QOZs in the U.S., Puerto Rico and the U.S. Virgin Islands. Because the QOZ designations are based on census data that is almost 10 years old, many real estate professionals are finding that there is some very good property in QOZs.

***Can the QOF acquire an existing building in an OZ?*** Yes, but only if the QOF substantially improves the building. The purpose of the legislation is to encourage economic development in opportunity zones, not just the changing of ownership of existing assets. Accordingly, if you buy an existing building (as opposed to new construction of a building), you must spend at least as much on improving the building as the amount you spent to acquire the building. In a very taxpayer-friendly ruling, the IRS

*(Continued on page 2)*

## Member in the Spotlight—Gabe Rivers

The newest member of Bridges & Dunn-Rankin is Gabe Rivers, a CPA with a BBA in Accounting and a Masters of Accountancy (with emphasis in tax) from The University of Tennessee in Knoxville. Prior to joining BDR, Gabe spent three years with a large regional CPA firm (focusing on business taxation) and then four years with an Atlanta-based CPA firm (focusing on the taxation of high net worth families).

Gabe is a member of the AICPA and the GSCPA, and is actively involved in Leadership Ministries (an organization that equips men to be leaders in their families, marriages, businesses, and communities), Brookhaven Presbyterian Church, and Capital City Club. He enjoys spending time with wife Charley and daughter Anna Charles and playing golf.

Bridges & Dunn-Rankin is proud to have Gabe Rivers as a member of our firm.


Gabe J. Rivers, CPA

## The Qualified Opportunity Fund Tax Savings Opportunity — continued

*(Continued from page 1)*

has said you can exclude from this test the portion of the purchase price allocated to land.

***Can the holding of raw land as an investment qualify?*** The intent of the legislation is to encourage economic development in OZs, not to reward speculative investment in land. However, a favorable ruling from the IRS says that, in order to meet the substantial improvement test, you look only to the amount of the purchase price allocated to the existing building, not the amount of the purchase price allocated to the land. So, could you buy a strategically located piece of property with a dilapidated building on it for $10,000,000, demolish the building, and put a hot dog stand on the land while holding it for 10 years in order to qualify for the gain exclusion? We do not appear to have clear guidance at this time.

***Is this solely a real estate play?*** No. A QOF can invest in a non-real estate operating business. However, most of the early interest in QOFs appears to be with respect to real estate investment. More guidance will likely be needed from the IRS before investors are comfortable with most non-real estate based QOZ business investments. Also, with respect to operating business investments, it may be possible to attain the holy grail of the QOF rules (permanent exclusion from taxable income of the appreciation in value) through the existing IRC 1202 exclusion, which applies to investments in certain C-corp stock held for at least 5 years, whether the business operates in a QOZ or not.

***What is a QOZ business?*** A QOZ business is one in which substantially all (70% or more) of the tangible property owned or leased by the entity is in a QOZ, at least 50% of the gross income of the entity is derived from the active conduct of the business, and less than 5% of the assets are nonqualified financial assets (with a working capital exception). The business can<u>not</u> be a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

***How do you become a QOF?*** Becoming a QOF is relatively simple. Your organization documents need to include some language specifying your intent to be a QOF, and then you self-certify by filing a Form 8996 with the entity's income tax return.

***What are the ongoing compliance requirements for the QOF?*** The QOF will need to file a Form 8996 with its income tax return each year to certify that it continues to meet the 90% asset test, and to compute and pay a penalty if it does not meet the 90% test.

***What is the penalty for failure to meet the 90% test?*** If the QOF does not meet the 90% test for the year (based on an average percentage computed at the mid-point of the year and the end of the year), the QOF must pay a penalty computed based on the amount of the shortfall for each month multiplied by the IRS annual interest rate on underpayments (6% as of Q1 2019) divided by 12. E.g. if a QOF with $1,000,000 in assets has only $800,000 of its assets invested in QOZ property for the entire year, then the QOF would owe a penalty for the year of $6,000 (6% x the $100,000 shortfall).

***Are there any exceptions to the 90% test?*** Yes. There is a "working capital exception" whereby a QOF subsidiary can have up to 31 months to invest its cash, so long as the funds are held in "cash, cash equivalents, or debt instruments with a term of 18 months or less" and the QOF subsidiary has a written plan for deploying the cash into QOZ property. Note that, under the rules as currently written and interpreted by many commentators, you may need a subsidiary corporation or partnership under the QOF entity in order to avail yourself of this exception.

***Are there potential advantages or disadvantages to a two-entity structure?*** As noted above, under the rules as currently written and being interpreted by many professionals (due to a distinction in the statute between QOZ business property and a QOZ business), you may get different results by having your QOF entity own a subsidiary entity (corporation or partnership, but not single member LLC unless electing corporate status for it) from owning QOZ property directly. First, the required threshold for investment in QOZ property may potentially be as low as 63% (90% test multiplied by 70% test) if you use a two-entity structure. Secondly, you may need this structure in order to take advantage of the working capital exception for holding funds in cash. On the flip side, it is possible that a QOF might have direct ownership in a business type (e.g. golf course) which is prohibited in the two-entity structure. These are nonsensical differences which may be eliminated by future guidance or statutory changes.

***Can a QOF make multiple investments?*** Yes. Nothing prohibits a QOF from investing in more than one QOZ property or business. However, because the exclusion from taxable income of appreciation in the QOF investment is based on selling your ownership in QOF units (and not a sale by the entity of the underlying asset itself), as a practical matter you will probably want to have a separate QOF entity for each different investment

*(Continued on page 3)*

## The Qualified Opportunity Fund Tax Savings Opportunity — continued

(Continued from page 2)

opportunity.

***Can you have a fund of funds QOF?*** No. A QOF must either invest directly in QOZ property or invest in an entity which is conducting a QOZ business. A QOF cannot invest in another QOF.

***What kinds of gain are eligible for deferral into a QOF?*** In order to be eligible for the deferral, a gain must be a "capital" gain from a sale to an unrelated party. The gain can be short-term or long-term, and it can be IRC 1231 gain (e.g. gain from sale of an apartment complex, office building, or business assets), so long as it would be treated for income tax purposes as a capital gain, and not as ordinary income.

***Can you convert a short-term gain into long-term gain by deferring it into a QOF?*** No. The character of the gain does not change. So, if it were a short-term gain when you realized it, it will be taxed as short-term capital gain in 2026 (or when you dispose of your ownership in the QOF, if sooner).

***What tax rates will apply to the deferred gain when you have to recognize it in 2026?*** Whatever tax rates are in effect at that time. Accordingly, if capital gains rates increase, your tax rate could potentially be higher by virtue of the deferral election; or if capital gains rates are cut, your tax rate could be lower.

***How does a taxpayer with a gain elect to defer it into a QOF investment?*** In order to enjoy the tax benefits of the QOF investment, you first have to invest the amount of gain you wish to defer in the QOF within 180 days of realizing the gain, and then you simply make the election on a Form 8949 attached to your income tax return for the year of the gain.

***Do you have to invest all of your gain in the QOF?*** No. You can invest any amount you wish up to the amount of your realized capital gain. There is no minimum amount you have to invest.

***Do you have to invest all of the proceeds from the sale that gave rise to the gain?*** No. Unlike the IRC 1031 like-kind exchange rules (which require reinvestment of the full amount of proceeds in order to enjoy full gain deferral), with the QOF rules you only invest the gain portion of the sale proceeds.

***Will a loan to a QOF qualify?*** No. Your investment must be for equity in the QOF; although preferred equity will qualify.

***Can you borrow against your QOF ownership in order to create liquidity?*** Yes.

***Can you invest in a QOF a capital gain realized inside a partnership?*** Yes. Either the partnership itself can reinvest the gain into a QOF, or an individual partner can reinvest his or her K-1 share of the gain. In the latter case, you have up until 180 days after the end of the tax year for which the gain was realized to invest in a QOF.

***Can you invest in a QOF amounts above and beyond your gain?*** Yes. Non-gain amounts can be invested in the QOF. However, the non-gain amount is treated as a separate investment and does not enjoy any of the tax benefits associated with QOFs (including the permanent gain exclusion for investments held at least 10 years).

***How long do I need to stay in the QOF to really enjoy the tax benefits?*** As noted previously, you get an immediate tax deferral just by reinvesting the gain into a QOF, and 10% of that gain goes away after 5 years and 15% after 7 years. However, the most significant potential tax benefit of a QOF investment (permanent exclusion from tax of all appreciation in the QOF investment) comes only once you have been in the QOF for at least 10 years.

***What happens after 10 years in the QOF?*** In 2026, you have to pay the tax on at least 85% of the gain you originally deferred. Beyond that, there is no triggering event until you sell your ownership in the QOF or the QOF sells the underlying assets (although you will need to dispose of your QOF ownership by the end of 2047 in order to enjoy the gain exclusion). You may have taxable K-1 income from the operation of the property or business, but the appreciation in the QOF can permanently avoid tax.

***What is the deadline for investing in a QOF?*** You can invest in a QOF gains realized through 2026. However, the tax benefits will gradually begin to diminish after 2019 (e.g. for investments made after 2019, it will not be possible to get the 7-year holding period required for the 15% exclusion of the original gain).

***Can depreciation recapture enjoy the QOF benefits?*** With respect to the property you are selling at a gain before investing in the QOF, depreciation recapture (other than certain real estate depreciation) is typically ordinary income, and thus not eligible for QOF deferral. With respect to the property acquired by the QOF, the answer is less clear. On the surface, the basis step-up you are permitted after a holding period of at least 10 years would appear to enable you to avoid depreciation recapture. However, the actual mechanics of how the gain exclusion operates may make this less likely (e.g. the benefit of the depreciation expense may have been suspended by the lack of basis in the QOF).

***What are the state tax considerations?*** Most states use Federal adjusted gross income or taxable income as a starting point in computing state taxable income. Accordingly, assuming a state adopts Federal rules and has not specifically opted out of the QOF rules, then you should enjoy the same benefits for state tax purposes. Some states (e.g. Georgia and South Carolina) are following the Federal QOF rule, while others (e.g. Alabama and North Carolina) are not. Accordingly, you will need to check the rules of your own state before concluding that the QOF deferral and exclusion will apply in computing your state income tax.

***How do the QOF rules compare to the 1031 like-kind exchange rules?*** IRC 1031 has always been somewhat limited in its applicability in that stock and partnership interests were not eligible; and, after changes made by the 2017 legislation, now only real estate qualifies for IRC 1031. The QOF deferral, on the other hand, can apply to any type of capital gain, including gain from the sale of publicly-traded stock or the sale of a business. Accordingly, the QOF rules are potentially applicable to a much broader range of gains. However, in order to enjoy the QOF benefits, your reinvestment must be into a QOZ; whereas a 1031 reinvestment could be into property located anywhere. Also, a QOZ investment in real estate will have to be new construction or substantial rehabilitation; whereas a 1031 exchange could be into an existing building with no rehabilitation. The QOF rules require only that you reinvest gain; whereas 1031 requires

(Continued on page 4)

## The Qualified Opportunity Fund Tax Savings Opportunity — continued

(Continued from page 3)
reinvestment of the full proceeds. Investment in a QOF can result in up to 15% of the original gain being permanently excluded, and 100% of the post reinvestment appreciation avoiding tax; but at least 85% of the original gain will be subject to tax in 2026 or sooner. On the other hand, a 1031 exchange can result in indefinite deferral; and potentially permanent deferral if the property (or other replacement property acquired in successive 1031 exchanges) is held to death. In the case of a sale of real estate, it may make sense to involve a 1031 qualified intermediary, give yourself the up to 45 days allowed to identify potential replacement properties and up to 180 days to acquire a replacement property, and then if you decide against going the 1031 route you can still potentially go the QOF route. In short, if you are selling something other than real estate, then 1031 is not a consideration; but if you are selling real estate, then you should carefully consider whether 1031 or QOF will work best for you.

***What happens in 2026*?** If you have not disposed of your QOF ownership by 2026, then you will have to report the deferred gain on your 2026 return (minus up to 15% of the gain, depending on when you made the investment). Accordingly, it is very important that you ensure that you will have some source of liquidity in 2026 to pay the deferred tax.

***What if you die owning QOF units?*** Unlike with IRC 1031 like-kind exchange property, there is no basis step-up at death for QOF units.

***Who are the likely winners and losers*?** Likely winners include those who already owned or had under contract desirable property in a QOZ (the property likely just became more valuable), and those who were going to realize a taxable capital gain anyway and were going to invest the gain into a QOZ property absent this new tax benefit (in this latter case, structuring the investment to take advantage of these new rules is almost a no-brainer). Winners could also include the residents of the opportunity zones, if the program results in quality development and jobs in their communities. Likely losers include those QOF investors who have a deferred tax liability come due in 2026 with no cash to pay the tax, and those who become so enamored with the potential tax benefits that they invest in a deal with poor economics.

***The devil is in the details.*** Conceptually, the QOF rules are very simple. If within 180 days of realizing a capital gain you reinvest the gain into a QOF, then you get to defer the tax on the gain until 2026, up to 15% of the original gain can be permanently excluded from tax, and, so long as you hold the investment at least 10 years, any post investment appreciation forever escapes tax. The devil, however, is in the details. The statute is mind-numbingly confusing, and the first set of regulations issued by the IRS, while very taxpayer friendly, only partially answers the questions raised by a reading of the statute. More guidance will be forthcoming, but, in the meantime, if you have a significant realized capital gain and an interest in possibly investing in an opportunity zone, this is too good of an opportunity to not at least investigate. And, if you are starting a new business, consideration should be given to locating it in an opportunity zone.

### Quick Notes

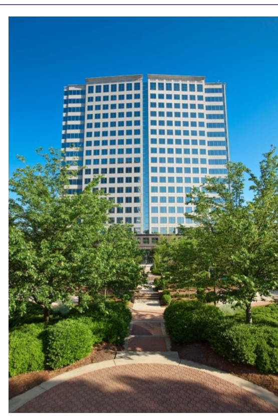
Although the broad-based US stock market is fairly flat year-to-date, it is anticipated that many actively managed mutual funds will report 2018 taxable capital gain distributions in excess of 10% of the value of the fund.

For 2019, the Social Security wage base increases to $132,900, the maximum wage base for computing retirement plan contributions increases to $280,000, the maximum amount which can be contributed to a defined benefit plan increases to $225,000, the maximum amount which may be contributed to a defined contribution plan increases to $56,000, and the maximum permissible elective 401(k) deferral increases to $19,000 ($25,000 for those age 50 and older). The maximum permissible contribution to an IRA increases to $6,000 ($7,000 for those age 50 and older).

The annual gift tax exclusion remains at $15,000 for 2019, and the lifetime estate and gift tax exclusion amount will increase to $11,400,000.

Bridges & Dunn-Rankin, LLP
CERTIFIED PUBLIC ACCOUNTANTS

400 Galleria Parkway, Suite 1050
Atlanta, GA 30339
Phone: 770-563-8888
Fax: 770-563-8885
www.bridgesdunnrankin.com



Bridges & Dunn-Rankin, LLP is an Atlanta-based full-service accounting firm serving clients in the technology, real estate, services, manufacturing, distribution, construction and healthcare industries, as well as high net worth families.