SUMMIT FINANCIAL RESOURCES, INC.

Planning Alert

Qualified Opportunity Zones

The Tax Cuts and Job Act enacted into law on December 22, 2017 includes new Sections 1400Z-1 and 1400Z-2 which contain the rules surrounding investments in properties located in Qualified Opportunity Zones ("QOZ"). Such investments are made through an investment vehicle known as a Qualified Opportunity Fund ("QOF"), which is an economic development tool designed to provide tax benefits to investors in order to increase development and job creation in these distressed communities around the country.

A QOZ is a population census tract that is a low-income community designated as a QOZ by the Secretary of the U.S. Treasury. As stated above, the investment in the QOZ is made by utilizing a QOF which can be formed as either a Partnership or Corporation so long as its purpose is to invest in eligible property located in a QOZ, and 90% of the property held is QOZ property. New investments may provide tax benefits to the investors if certain conditions are met. Specifically, if a taxpayer enters into a transaction with an unrelated party to sell or exchange property (e.g., real estate, marketable securities, artwork, closely-held business interest) before 2027, and realizes gain from that sale or exchange, the taxpayer can elect to defer all or a portion of that gain by investing such gain in a QOF within 180 days after the date of such sale or exchange. The tax on these gains can be deferred until the earlier of the date when the new investment is sold or exchanged, or December 31, 2026.

Initially, the taxpayer's basis in the QOF investment is zero. However, the investment basis of the investment in the QOF would be increased by an amount equal to 10% of the deferred gain if the investment is held for at least five years and by another 5% of the deferred gain if held for at least seven years, for a total possible basis increase of 15% of the deferred gain. Also, the appreciation on that investment can be completely eliminated for investors who hold the investment in the QOF for at least ten years. By holding the investment for that period, the investors would be entitled to a basis increase to the fair market value of the investment when that specific investment is sold or exchanged, resulting in all appreciation in the investment above the deferred gain (which must be recognized by December 31, 2026) being excluded from tax.

The above rules can be illustrated by the following example: Victor sells a parcel of real estate with a tax basis of $1,000,000 to an unrelated party for $2.300,000, and realizes a capital gain of $1,300,000. Within 180 days after the closing of the sale, Victor invests the $1,300,000 gain into a QOF and a proper deferral election is made. Only the $1,300,000 gain needs to be invested in the QOF. Victor can take back his $1,000,000 basis and invest it elsewhere. He holds the QOF investment for ten years. The $1,300,000 gain will be recognized upon the earlier of the date that Victor sells the property, or December 31, 2026. Initially, Victor has no basis in the QOF investment. However, after year seven his basis is increased by $195,000 (15% of the deferred gain), and on December 31, 2026 he pays tax on $1,105,000, the remaining amount of the gain. By holding the QOF investment for ten years, Victor's basis becomes the fair market value of the investment when he ultimately sells it, and no tax would then be due on the sale.

An eligible taxpayer can become a QOF by following steps to self-certify as such. Thus, no approval or action is necessary by the IRS. To self-certify, a taxpayer merely completes a yet-to-be-released form and attaches that form to the taxpayer's federal income tax return for the taxable year. The return must be filed timely plus extensions. It should be pointed out that once a taxpayer elects to defer some or all of the gain from a sale or exchange, another election cannot be made with respect to the same sale or exchange resulting in such gain.

Investors should be cautious before investing in a QOF. There are certain restrictions on permissible QOZ investments such as a requirement that the property must be substantially improved, as well as other significant open issues regarding the manner in which the law will ultimately apply. Not-yet-published administrative guidance to address major aspects of the program is expected. Therefore, significant uncertainty remains regarding implementation of this new law as well as the tax consequences resulting from investments in QOFs.

Please contact us if you would like to discuss whether participating in the Qualified Opportunity Zone program is appropriate for you. We would be happy to discuss this strategy with you as well as other strategies that you might consider incorporating into your overall planning.