PALLAS
CAPITAL ADVISORS

It's Not the Twilight Zone – It's Just Opportunity Knocking

March 2021

INTRODUCTION TO QUALIFIED OPPORTUNITY ZONES

Our recent Pallas Perspectives Podcast dealt with a still lesser-known part of 2017's major tax legislation, called the Qualified Opportunity Zone ("QOZ"). As we get closer to the April 15 tax filing date – many Americans are thinking about taxes – particularly, how to reduce them.

The QOZ can be an interesting opportunity (pun intended) for those individuals who are looking for ways to defer, and potentially reduce taxes related to capital gains from the sale of real estate, investments, a closely-held business, etc.

The *Tax Cuts and Jobs Act,* passed in December 2017, introduced the QOZ - an innovative way to stimulate private investment in low-income communities. The QOZ program rewards investors with significant tax savings in exchange for their commitment of long-term investment capital.

Generally speaking, low-income communities are characterized by:

1. The poverty rate in the community is at least 20%.
2. Or, if the community is located in a metropolitan area, the median household income does not exceed 80% of the metropolitan area's median household income.
3. Or, if not located in a metropolitan area, the median household income does not exceed 80% of the statewide median household income.

Nationwide, there are over 8,700 QOZs, that are home to more than 35 million Americans. Read on to learn more about how taxpayers may be able to do well by doing some good for communities that need help.

QUALIFIED OPPORTUNITY FUNDS

Those who want to make an investment in these low-income communities via the OZ program can do so through a Qualified Opportunity Fund (QOF). A QOF offers investors with capital gains the ability to reduce their tax burden while also providing investment capital to identified in-need communities. In general, the longer an investor holds a QOF, the larger the benefit, so those with longer time horizons should consider these investments.

An investor can sell an appreciated asset and then put his or her capital gains into a QOF **within 180 days of the sale**. As previously mentioned, gains can come from any source, such as the sale of real estate, a business, works of art, and stock or securities. There is no ceiling on the amount of gain that can be deferred. Short-term and long-term capital gains, as well as Section 1231 gains, are eligible for tax deferral in a QOF, but short-term gains will be taxed at ordinary income rates when ultimately realized.

(Deferral of the capital gain is not automatic. Investors must elect to defer the gain using Form 8949, and investors need to file this form along with the investor's annual tax return for the year the capital gains tax is due.)

TAX ADVANTAGES

Once invested in an Opportunity Fund, the taxpayer may realize the following three primary tax benefits:

1. **DEFERRAL OF GAINS:** Capital gains reinvested into a QOF are deferred until the fund is **sold or until 12/31/2026, whichever occurs first.**

2. **REDUCTION OF INITIAL TAXABLE GAINS:** Investors receive a periodic step-up in basis for the capital gains that are reinvested into a QOF.

   - If the investment is held for five years, the amount of the originally invested capital gains exposed to tax is reduced by 10%, and

   - if it is held for seven years, that reduction is increased by another 5%. *In order to achieve the maximum 15% exclusion, gains must have been reinvested in an Opportunity Fund before the end of 2019. So, that deadline has passed.*

3. **ELIMINATION OF CAPITAL GAINS TAX:** If the fund is held for longer than ten years, the gains earned by the QOF itself (***not** the gains that were originally deferred*) are exempt from capital gains tax.

EXAMPLE

In 2021, a hypothetical investor has a concentrated position in technology stocks, and she wants to diversify by selling some of her Amazon stock. This sale of Amazon stock results in the investor realizing $1 million of capital gain. The investor wants to invest in a QOF that places capital in distressed areas and delivers jobs, wealth opportunities, and better outcomes for the city's low-income communities.

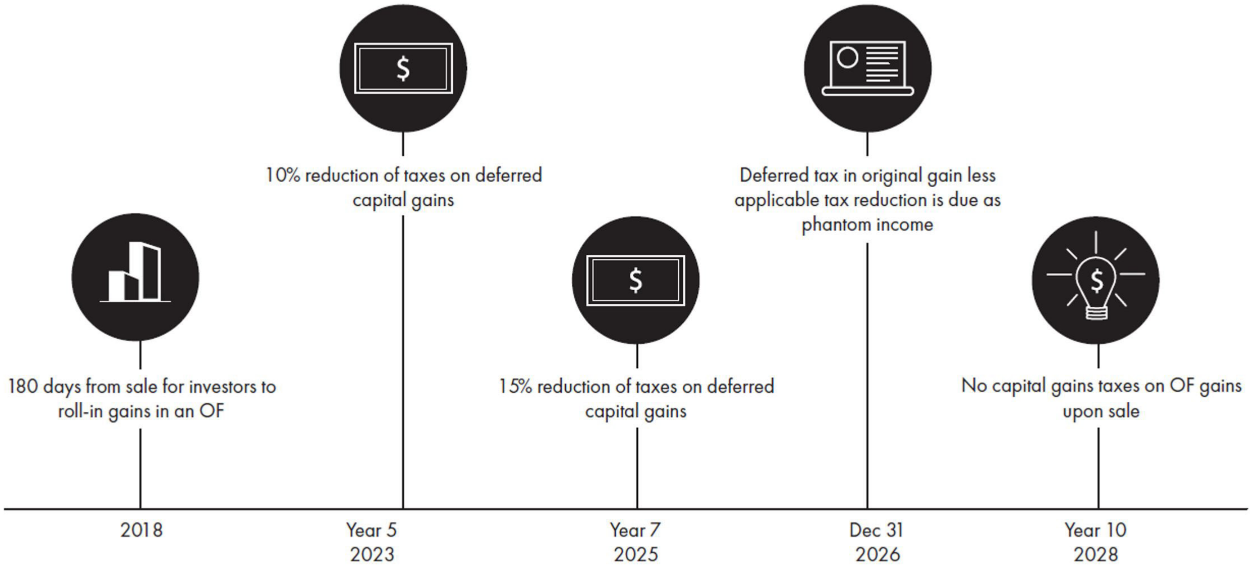
- By investing the $1 million capital gain only (not the entire stock sales proceeds) in a QOF (and receiving OZ shares in exchange), the investor can defer taxes on the capital gains until 2026.

- By holding the QOF shares for five years, the $1 million deferred gain is reduced by 10%, to $900,000.

- Importantly, if the investor holds the QOF for more than ten years, all of the appreciation in the value of the QOF shares can be excluded.

Result: The investor is required to pay long-term capital gains taxes on a smaller amount - $900,000 in 2026. Furthermore, if the investor sells the QOF shares after ten years for $1.5 million, the investor can exclude paying tax on the $500,000 capital gain attributable to the QOF shares.

Tax Deferral Timeline:



Source: Saxum Real Estate

Note: *15% reduction in capital gains is only available for amounts deferred into QOFs prior to 12/31/2019.*

ALERT – 180 DAY INVESTMENT DEADLINE UPDATE

In response to the ongoing COVID-19 pandemic, on January 19, 2021, the Internal Revenue Service released Notice 2021-10, offering a further extension to QOF investment deadlines. Thus, an investor may still engage in strategic tax planning for both the 2019 and 2020 tax years.

The notice states that if an investor's 180-day investment requirement falls on or after April 1, 2020, and before March 31, 2021, the last day of that 180-day period is postponed to March 31, 2021.

For most investors, therefore, the timeline for investing eligible capital gains into a QOF are as follows:

Capital Gains Recognized by Individuals

- Capital Gains Realized **Between October 4, 2019 and October 1, 2020:** — The deadline to reinvest those gains is now **March 31, 2021**.
- Capital Gains Realized **After October 1, 2020:** — The deadline to reinvest those gains is 180 days after the gain is realized.

Capital Gains Recognized and Distributed Through a Pass-Through Vehicle (e.g., partnership or limited liability company)

- Capital Gains Realized **At any time in 2019:** — The deadline to reinvest those gains is now **March 31, 2021**.
- Capital Gains Realized **At any time in 2020:** — The deadline to reinvest those gains is **September 11, 2021** (180 days following the entity tax return filing date of March 15, 2021).

Source: Griffin Capital

CAVEATS

While the tax benefits, like the ones highlighted above, are appealing, these investments should be viewed in light of the following considerations:

- Successful investments will provide tax benefits, while less successful enterprises may provide minimal or no advantages at all. As with any investment, there is no guarantee that the investment objective of any QOF will be achieved. Investments in real estate are subject to varying degrees of risk, including, among other things, local conditions such as an oversupply of space or reduced demand for properties an inability to collect rent, vacancies, inflation and other increases in operating costs, adverse changes in laws and regulations applicable to owners of real estate and changing market demographics.
- A QOF is not liquid. No public market currently exists, and one may never exist for the interests of any QOF.
- State tax benefits vary. Many (approximately 38) states have either fully or partially conformed with the federal tax breaks and offer state incentives as well, but a handful of states do not offer state tax breaks for QOF investments.
- Tax on deferred gains will be due after December 31, 2026. We do not know what capital gains rates will be at the end of 2026, but we have written before on the tax policy proposals of the new administration. Rates could certainly be higher in 2027 and beyond than they are now.

CAVEATS (CONT.)

- QOF investors should also be aware of the disadvantages to beneficiaries who inherit a QOF. Typically, assets originally purchased with non-retirement funds receive a "step-up" in basis upon the death of the owner, allowing the beneficiary to sell the asset with little to no tax consequence (although President Biden's proposed tax policies do consider eliminating this adjustment in cost basis at death.). Unfortunately, the gains that were originally reinvested into a QOF do not receive a step-up in basis, but instead, become income in respect to a decedent (IRD). Plus, given the forced inclusion of any still-deferred gain at the end of 2026 and the extremely illiquid nature of QOFs, a beneficiary with limited other financial resources could find the tax payment to be challenging.

ALTERNATIVES TO THE QOZ

For some investors, there may be better alternatives than a QOF, especially when considering the potential benefits, or lack thereof, for heirs. Some of these include, not selling the asset in the first place (and waiting instead to simply bequest an appreciated asset, which may eventually receive a step-up in basis), maintaining the eligibility for a step-up in basis by using a 1031 exchange (a tax-free exchange of like-kind non-residence real estate), or making use of a charitable trust.

CONCLUSION

When considering a traditional real estate investment vs. an investment into Opportunity Zone Funds, investors need to consider which approach they are going to adopt. The traditional choice may make the most sense - one that may provide a more secure return on a property near a thriving metropolitan area.

But the QOZ offers something else - a combination of tax savings, the potential for return on investment, and playing a part in the improvement in the quality of life in an economically challenged area. To help them consider the latter approach, current tax laws provide some interesting incentives.

Yes, for those that plan ahead, opportunity knocks....

Sincerely,

James Landry, ChFC
Chief Operating Officer, Director of Planning
Pallas Capital Advisors