PUBLICATION

Tax Act Presents New Opportunity for Gain Deferral

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The legislation commonly referred to as the Tax Cuts and Jobs Act (the "Act") that was signed into law in late 2017, ushered in significant changes to the Internal Revenue Code (the "Code"). Some of these changes are beneficial to taxpayers, while others are not.

One unwelcome change is the elimination of like-kind exchanges for personal property. Individuals and entities alike had regularly taken advantage of the ability to defer gain from the sale of personal property used in a trade or business or held for investment. To qualify for this deferral, the proceeds from a qualifying sale were required to be reinvested in property that is of like-kind, and certain technical requirements must have been followed. As a result of the Act, however, this specific type of deferral is no longer available.

It is possible, however, that a new deferral mechanism found under new Code sections 1400Z-1 and 1400Z-2 can provide similar (or even better) benefits to taxpayers under the right circumstances. These new Code sections permit a taxpayer to elect to defer gain from a sale or exchange with an unrelated person, provided the taxpayer reinvests the proceeds from the sale or exchange in a qualified opportunity fund within 180 days. The gain is deferred by this election until the earlier of: (i) the tax year in which the taxpayer sells or exchanges his interest in the qualified opportunity fund, or (ii) December 31, 2026 (as applicable, the "Recognition Date").

The amount of deferred gain that the taxpayer must recognize on the Recognition Date is equal to the excess of (A) *the lesser of*, (i) the amount of gain originally excluded **or** (ii) the fair market value of the taxpayer's interest in the fund as of the Recognition Date, over (B) the taxpayer's basis in his or her interest in the fund, which depends upon how long he or she has held his or her interest in the fund as of the Recognition Date. A taxpayer's basis for purposes of calculating gain is initially zero. If an investment is held for at least five years, the basis is increased by ten percent of the gain originally deferred, and if the investment is held for at least seven years, the taxpayer's basis is increased by an additional five percent, or 15 percent total. In addition, the new Code sections provide that if a taxpayer holds an investment in the fund for at least ten years, he or she is only required to pay tax on the gain calculated as of the Recognition Date; that is, they avoid tax on any gain accruing after the Recognition Date.

Example 1 illustrates the gain deferral for a taxpayer that holds his investment in a fund for at least five years.

Example 1: On January 1, 2018, Acme sells property with a zero basis to an unrelated party resulting in a $5 million gain, which Acme elects to defer for federal tax purposes under Section 1400Z. Acme reinvests the proceeds from such sale in Fund A, a qualified opportunity fund, within 180 days. If Acme later sells its investment in Fund A on December 31, 2023 for $6 million, Acme's basis in its investment in Fund A is $500,000 (increased from $0 to $500,000 because it has been held more than five years, but less than seven), resulting in a gain of $5.5 million for federal tax purposes ($4.5 million of previously deferred gain and $1 million of new gain).

Example 2 illustrates the gain deferral for a taxpayer that holds his investment in a fund for at least ten years.

Example 2: Apply the facts of Example 1, except that Acme did not sell its investment until December 31, 2029 at a price of $6 million. Acme would have been required to recognize a gain of $4.25 million on December 31, 2026. Because Acme will have held the investment in Fund A for at least seven years by December 31, 2026, it will benefit from the full 15 percent basis increase and will therefore only be required to recognize 85 percent of the originally deferred gain. On January 1, 2027, Acme's basis in its investment in Fund A will be $5 million ($750,000 basis increase + $4.25 million gain). When the interest in Fund A is finally sold on December 31, 2029 for $6 million, Acme will not have to recognize any additional gain for federal income tax purposes because it will have held the investment for more than ten years.

For purposes of obtaining this gain deferral, the following definitions apply:

- "Qualified opportunity fund" is defined as a corporation or partnership organized for the purpose of investing in and holding assets, at least ninety percent (90%) of which, constitute 'qualified opportunity zone property'. To be designated as a qualified opportunity fund, an entity must be certified by the Community Development Financial Institutions Fund (CDFI Fund), which certification is similar to that granted to Community Development Entities under the Federal New Markets Tax Credit Program.

- "Qualified opportunity zone property" is either: (i) qualified opportunity zone stock, (ii) qualified opportunity zone partnership interests, or (iii) "qualified opportunity zone business property." Each of (i) and (ii) are generally equity interests in a trade or business in which substantially all of the tangible property owned or leased is "qualified opportunity zone business property."

- "Qualified opportunity zone business property" is tangible property used in a trade or business of the qualified opportunity fund (or by entities described in items (i) or (ii) above), if: (A) purchased by the qualified opportunity fund after December 31, 2017; (B) originally used or substantially improved by the qualified opportunity fund; and (C) *used in a qualified opportunity zone* during substantially all of the qualified opportunity fund's holding period.

- "Qualified opportunity zone" is defined as "[A] population census tract that is a low-income community that is designated as a qualified opportunity zone." Impoverished areas are designated as qualified opportunity zones only after a recommendation by the 'chief executive officer' of a state (governor, or mayor in the case of the District of Columbia) is made to the Secretary of the Treasury, and after consideration, the Secretary designates the recommended area as a qualified opportunity zone. The Act imposes limits on the number of qualified opportunity zones that can be designated in any one state.

As of the publication of this alert, numerous areas through the southeastern states, including Mississippi, Alabama, and Georgia, have been designated as qualified opportunity zones. For additional information pertaining to the application of these deferral rules or the Act in general, please contact one of the authors, C. Tyler Ball, David P. Webb, or any member of Baker Donelson's Tax Group.