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ClientAdvisor

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Special tax-incentives for long-term real estate investments

Substantial tax benefits are available to investors through Qualified Opportunity Zones (QOZ)

Qualified Opportunity Funds, which invest in special real estate projects, offer an opportunity for individual investors to defer paying tax on otherwise taxable gains for reinvestments[1] and, if the QOF is held long enough[2], the investor pays no tax on appreciation.

The Qualified Opportunity Zone (QOZ) Program was created by the federal government as part of the Tax Cuts and Jobs Act of 2017, and specific opportunities are known as Qualified Opportunity Funds. (QOFs).

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[1] Investors can avoid otherwise taxable gains for reinvestments that occur on or before December 31, 2026.

[2] Investors achieves a stepped-up cost basis on investments held 10 years or more.

QOFs are intended to encourage investment in lower-income communities across the U.S., principally by providing certain tax incentives in return for committing long-term capital to these communities.

Qualified Opportunity Funds (QOF) are corporations or partnerships that hold at least 90% of their assets in IRS designated qualified opportunity zones (QOZ) with the goal of rebuilding low-income communities.

Substantial potential tax breaks are available to investors who realize short-term or long-term capital gains from the sale of an investment and reinvest those gains into a Qualified Opportunity Fund within 180 days. Gains from stocks, bonds, real estate, companies, among other assets, are eligible.

There are two distinct benefits:

- Deferral: if a taxpayer invests the capital gain from the sale of any property into a QOF within 180 days of recognizing the gain, taxes on such proceeds may be deferred until the earlier of December 31, 2026 or the disposition of the QOF interest.

- Elimination: investors who hold their investment for at least ten years receive a step-up in basis which means they pay no tax on the appreciation of their QOF investment upon disposition, regardless of the size of the potential profit,[3] through 2047. In addition, the step-up in basis eliminates any depreciation recapture tax that would otherwise be owed upon sale.

To maximize the benefits of the QOZ Program, investors are incentivized to hold their investments over the long term. The QOZ Program provides maximum potential tax benefits to investors who hold their QOF Investment at least ten years, consistent with the investment's strategy and timeline.

[3] Assumes that the investor is a resident of a state that conforms with the QOZ Program.

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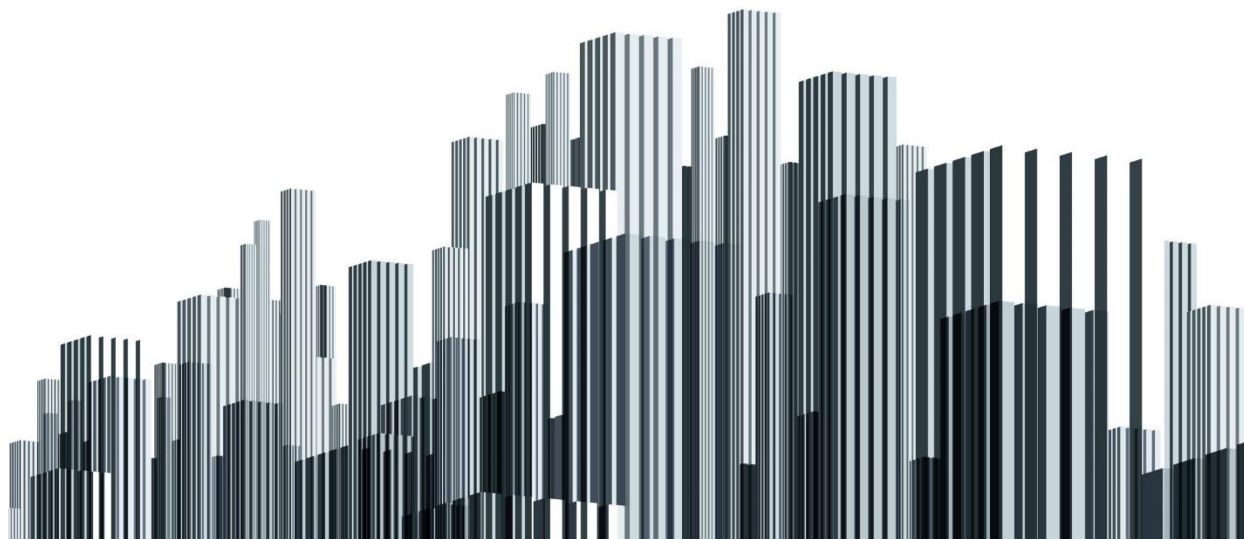
A hypothetical timeline is as follows:

- 2022: Invest capital gains from prior investment into a QOF.
- 2027: Pay taxes on original capital gain.
- 2032-2047: Pay no federal capital gains taxes on the gain from the QOF sale.



Scenario: Hypothetical After-Tax Value of Two Investments

Two investors each sell an asse that generates a $1,000,000 long-term gain. Investor A pays capital gains taxes and invests the remaining capital in a product that generates a 10% compounded annual return over ten years and then liquidates the investment. Investor B invests the gain in a Qualified Opportunity Fund, which generates the same return over the same time period. Both investors are residents of a state that conforms with the QOZ Program and are subject to the top marginal U.S. federal income tax rate of 20% on long-term capital gains for individuals, the neti nvestment income taxof 3.8% and a state tax of 6.2%, for a total tax liability of 30%.

	Non-Qualified Opportunity	**Qualified Opportunity Fund**
Original capital gain	$1,000,000	$1,000,000
Tax rate	30%	30%
Tax on original capital gain	($300,000)	Deferred
Investable amount	$700,000	$1,000,000
Hypothetical annual return	10%	10%
Appreciation	$1,115,620	$1,593,742
Tax on appreciation	($334,686)	Eliminated
Capital gains tax (2027)	$0	($300,000)
Final value	$1,480,934	**$2,293,742**

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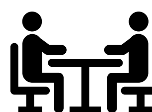

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Assumptions of the Hypothetical Illustration

The illustration assumes the investor is subject to the top marginal U.S. federal income tax rate of 20% on long-term capital gains for individuals, the net investment income tax of 3.8% and a state tax of 6.2% for a total tax liability of 30%. No brokerage or investment advisory fees are accounted for with respect to the non-QOF example above and no distributions made on the Class C common stock, no fees due to our Manager and its affiliates and no sales commissions, deal manager fees and non-accountable diligence and marketing allowances due to our Managing Broker-Dealer and its affiliates are accounted for with respect to the QOF example. This illustration assumes that the QOF investor is a resident of a state that conforms with the QOZ Program. It also assumes that the investor has no capital losses to reduce such capital gain and refers to the inclusion of the original, invested capital gains in such investor's taxable income on December 31, 2026.

How Qualified Opportunity Fund Tax Rules Work

Under Internal Revenue Code § 1400Z-2, the taxpayer may defer all or a portion of a capital gain a taxpayer realizes if the taxpayer reinvests the gain in QOFs within 180 days. The 180-day period begins on the realization date. For stock sales, the realization date is the trade date.

Special rules apply to pass-through gains. Pass-through gains are gains allocated to pass-through owners (i.e., partners, S corporation shareholders, etc.) from a pass-through entity (i.e., partnerships, S corporations, etc.). By default, these gains are realized on the last day of the pass-through entity's taxable year. Alternatively, pass-through owners may elect the realization date to occur on either the entity's trade date or its tax return due date (excluding extensions). For example, if a calendar year partnership sells stock on February 3, 2021, by default the realization date is December 31, 2021, or the partner may elect to use February 3, 2021, or March 15, 2022, as the realization date. Each pass-through owner of the same pass-through entity may choose different realization dates or not claim the deferral at all.

In general, taxpayers will benefit from a temporary tax deferral up until either the date the QOF is sold or the statutory date, December 31, 2026, whichever is earlier, except if certain inclusion events occur (such as gains triggered from distributions in excess of investor's QOF's basis). On December 31, 2026, the taxpayer will recognize a gain equal to the

lessor of the excess of the fair market value over basis or the deferred gain over basis. Investors who hold the QOF for at least 10 years and then sells the QOF investment may elect to adjust their basis to the fair market value at the time of sale and in effect reduce the taxable gain to zero.

For example, on January 31, 2022, a taxpayer sells stock for $1 million with a basis of $900,000 and realizes a capital gain of $100,000. On July 30, 2022, the taxpayer reinvests the $100,000 gain into a QOF fund, structured as a partnership for tax purposes. On December 31, 2026, the taxpayer continues to hold the QOF and its fair market value and basis is $110,000 and zero, respectively. The taxpayer pays tax on the $100,000 deferred gain (lessor of fair market value of $110,000 or the deferred gain of $100,000) even though the taxpayer has not sold the QOF. On August 1, 2033, the taxpayer sells the QOF for $140,000. If the QOF was not held for 10 years, then the investor would have recognized a gain for the sale of the QOF of $40,000 ($140,000 proceeds less $100,000 of deferred gain previously recognized). Since the QOF was held for a minimum of 10 years, the QOF's basis is adjusted to the fair market value of $140,000 lowering the taxable gain from $40,000 to zero.

Practical Tax Tips for Qualified Opportunity Funds

The 180-day statutory period begins with the realization event, not the date of the QOF investment. Investors cannot defer gains that are realized after the QOF investment is made. For instance, if pass-through owners elect to defer pass-through gains occurring in 2021, by default all the 2021 gains are considered realized on December 31, 2021, assuming a calendar tax year, for purposes of determining when the 180-day statutory period begins. Therefore, the taxpayer has until June 28, 2022, to reinvest the gains into a QOF fund. Since the reinvestment occurs during the 2022 tax year, investors may assume they can defer all gains realized in 2022 as well as 2021, but the QOF rules only permit taxpayers to defer gains generated prior to the reinvestment date. In this case, the taxpayer may defer gains realized during the 2021 tax year, but only the gains generated during the first half of 2022 (January 1, 2022 through June 28, 2022) may be deferred. Gains generated in the second half of the 2022 tax year (June 29, 2022 through December 31, 2022) may not be deferred because they occurred after the taxpayer invested in the QOF.

If the gains realized are less than the amount of the QOF investments, then the excess QOF investments may not be used to defer future gains. For example, on January 31, 2022, a taxpayer realizes $200,000 of capital gains and on June 1, 2022, invests $250,000 in QOFs. The excess $50,000 of QOF investments cannot be used to offset gains in 2023 or after.

Ideally, every dollar the taxpayer invests into a QOF would result in a capital gain deferral for tax purposes. That may be a challenge for taxpayers since typically, taxpayers invest in QOFs throughout the year and may not know the total realized capital gains until the end of the year. When estimating the amount of realized capital gains, it may be wise to underestimate for purposes of determining the QOF contribution amount to ensure QOF investments are fully utilized.

Taxpayers must reinvest in QOFs before December 31, 2026, to obtain the tax deferral. However, there is no statutory limit on the amount of realized gains that may be deferred through QOF reinvestments. Investors may want to schedule out the various QOF investments anticipated for the next four or five years to match with anticipated realized gains.

Gross Gains

Gains allocated to you through the partnership are typically reported on a net basis, where the sales transactions, whether a gain or a loss, are summed up into one overall gain or loss. The summary pages of investment accounts similarly report gains or losses on a net basis but provide the detail of each trade on subsequent pages. Taxpayers are permitted to defer capital gains without reducing the capital gains by other capital losses. Taxpayers may separate out the net gains into gross gains and gross losses to maximize the amount of the gains available to defer. Contact the partnership and your broker to obtain details if not already disclosed.

Choosing Gains to Defer

The characteristics (i.e., holding period) of the gain deferred stays intact when you recognize the gain in later years. Deferring short-term capital gains may create more valuable tax results than deferring long-term capital gains. Short-term capital gains can result in larger tax savings than long-term capital gains as short-term capital gains are taxed at a higher rate than long-term capital gains. The long-term capital gain tax rate may also increase in the future.

It's important to identify and document which deferred gains are associated with each QOF investment. Otherwise, the IRS will treat the first QOF investment as associated with the earliest eligible gains, followed by the next earliest gain and so forth. It is not necessary to report the relationship on the tax return, but the taxpayer should maintain records in the event of an audit.

Planning for Recognition Date

On December 31, 2026, taxpayers who have not yet disposed of their QOF fund will need to recognize the income on the deferred gain and may owe tax on that income on April 15, 2027. This may cause cash flow issues because the taxpayer

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is not receiving cash when the gain is recognized yet must pay tax on the gain. Consider harvesting losses during 2026 to reduce the tax impact and free up cash to pay the tax.

Check State Laws

The QOF tax laws are Federal tax provisions. Not all states conform to the Federal QOF deferral rules. Check to see if your resident state follows the Federal QOF rules. For instance, New Jersey conforms, but California and North Carolina do not currently conform. Beginning with tax year 2021, New York State and City no longer recognize the tax benefits afforded under the federal QOF rules. Some states might also have their own QOF programs that may be beneficial.

Investment in QOFs can create valuable tax benefits, but the rules can be complex. It's important to consult with tax advisors before making an investment so that a tax analysis is included during the due diligence process of investing.

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