



# A Capital Gains Tax Break

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Clients who have realized capital gains have an opportunity to invest in a Qualified Opportunity Fund (QOF) investment, and defer capital gains tax on the capital gain portion of the sales proceeds until 2026, as well as to possibly avoid paying tax on the depreciation recapture and capital gains on the sale of the QOF investment in the future. Qualified Zones (QZ) and Qualified Opportunity Funds (QOF) were created by the Tax Cuts and Jobs Act of 2017 and are designed to stimulate new investment in qualifying communities. Individuals and entities with substantial capital gains can receive Federal tax benefits by investing those gains or a portion thereof in a QOF, which in turn are invested in real estate or operating businesses within more than 8,700 OZs located across all 50 states.

A QOF investment offers three potential tax benefits:

1. A **deferral** of the tax on the original capital gain until the earlier of December 31, 2026, or in the year the investor sells or exchanges their investment in the QOF.
2. A **10% reduction** of tax on the original gain if the QOF investment is held for five years by December 31, 2026.
3. **No taxable gain** on the QOF investment if held for 10 or more years.

Let's look at a hypothetical example of an individual or entity with a past realized gain of \$1,000,000 who finds an attractive real estate development that qualifies for OZ benefits. Fractional interests are being offered by a reputable national real estate sponsor and an experienced developer. The client wants to defer recognizing the realized gain until 2026 by investing in this QOF investment. Let's assume the following:

1. 20% Federal Capital Gains Tax, 6% State Income Tax, and 3.8% Net Investment Income Tax.
2. 9% Average Annual Appreciation on QOF investment.
3. QOF investment is held for 10 years.

Let's also compare that QOF investment outcome to a similar investment made outside a Qualified Zone, which would not receive any of the tax benefits afforded QOF investments. The calculation chart on the next page reflects the comparison and end results.

As you can see, paying only one tax on two different investment gains (original and QOF) makes a substantial difference in the after-tax cash amount (\$2,099,164) compared to after-cash amount (\$1,493,436) realized after paying taxes on each of the two realized gains. The investor received 40% more after-tax cash (\$605,728) compared to the Non-OZ investment. **Note: Using a smaller amount for an example would have shown the same 40% difference in the after-tax result.**

## "What If" Scenario

What average annual rate of return would that Non-OZ investment have to realize to equal the QOF investment return using the same assumptions as the example on the next page?

It is very important to note that this Non-OZ investment has to achieve a much greater average annual return (14.39%), presumably taking on a greater risk, to achieve the same return as the QOF investment.

## Deadlines for Making a Qualified Opportunity Fund Investment

**Capital gain not reported on a K-1** – 180 days from the date of the transaction.

**Capital gain reported on a K-1:**

1. 180 days from the date of the transaction; or
2. 180 days after the final day of the reporting entity's tax year (typically December 31 for flow-through entities); or
3. 180 days from the original tax return due date of the reporting entity (March 15 for entities with a December 31 year-end)

Note: IRS Notice 2021-10 extended the 180-day investment period for some late 2019 and early 2020 for capital gains until March 31, 2021.

## 10-Year Hold Period and Financing Strategy

As illustrated in the above comparison, the most significant and advantageous tax benefit of a QOF investment is the 100% step-up in basis by holding the QOF investment for 10 years. However, if a Sponsor and developer utilizes all equity to provide total project cash funding, free and clear of financing, they may be able to later obtain permanent financing upon occupancy stabilization of the property. **These financing proceeds could possibly be used to return a significant portion of the investors' initial capital contribution at that time.**

## Real Estate Sector Consideration for a QOF Investment

QOF investments are being offered by large real estate sponsors and developers. They offer experienced development and ongoing professional management of the income producing, real estate offered in a Qualified Zone(s). In some cases, they are a single property development, or preferably a multiple property development that is geographically diversified across the U.S. The real estate development could possibly be office, retail, apartments, hotel, industrial, or self-storage.

In light of the COVID-19 pandemic, it is the author's opinion that office and retail real estate are less attractive real estate sectors for investment. Self-storage appears to be a real estate sector that may continue to be an attractive investment. The demand for self-storage remains consistent even amid uncertain times, with consumers viewing storage as a solution to both personal and business needs. While the past cannot accurately predict future results, the self-storage sector has generated the second-highest net operating income growth of various real estate sectors over the past 15 years. Fractional interests in these nationally syndicated Qualified Opportunity Fund investments may be purchased by individual and entities that qualify as accredited investors.



## Calculation Comparison

	After-Tax Non-OZ Investment	Qualified Opportunity Fund Investment
<b>Capital Gain</b>	<b>\$1,000,000</b>	<b>\$1,000,000</b>
Initial Capital Gain Tax	\$(298,000)	—
Initial Investment	\$762,000	\$1,000,000
<b>Average Annual Appreciation In Value</b>	<b>9.00%</b>	<b>9.00%</b>
Gross Proceeds at Liquidation in 10 Years	\$1,803,931	\$2,367,364
Total Investment Gains	\$1,041,931	\$1,367,364
Payment of Deferred Capital Gains in 2026	—	\$(268,200)
Second Capital Gains Tax on Liquidation in 10 Years	\$(310,495)	
<b>Net Cash After Taxes</b>	<b>\$1,493,436</b>	<b>\$2,099,164</b>
	<u>Current Rate</u>	<u>Future Rate Assumption</u>
Federal Long-Term Capital Gain	20.00%	20.00%
Net Investment Income Tax (if applicable)	3.80%	3.80%
State Capital Gain (if applicable)	6.00%	6.00%
<b>Total Tax Rate</b>	<b>29.80%</b>	<b>29.80%</b>
Additional Cash Resulting From Qualified Opportunity Fund Investment		\$605,728
Percentage Increase in Cash From Qualified Opportunity Fund Investment		40.56%

## “What If” Scenario

	After-Tax Non-OZ Investment	Qualified Opportunity Fund Investment
<b>Net Cash After Taxes</b>	<b>\$2,099,164</b>	<b>\$2,099,164</b>
<b>Average Annual Appreciation</b>	<b>14.39%</b>	<b>9.00%</b>

## Questions and Answers

**Q.** Does a client have to invest the entire amount of the gain in the Qualified Opportunity Fund (QOF) investment?

**A.** No, they can invest a portion of the realized capital gain in a QOF investment. However, the remaining portion of the gain would be taxable.

**Q.** What capital gains qualify for tax deferral?

**A.** Gains from the sale of stocks, business interests, timber, real estate, mineral interests, collectibles, etc., can be deferred utilizing a QOF investment.

**Q.** Can both short and long-term capital gains be deferred?

**A.** Yes, and individuals and entities can carve out a specific gain or partial gain to be deferred. However, the character of the gain when recognized in 2026 will remain the same.

**Q.** What if President Biden’s tax platform increases the capital gains tax rate to 39.6% in the future?

**A.** Assuming a hypothetical \$1,000,000 investment amount, the after-tax cash amount realized from the QOF investment would be \$1,922,764 as compared to \$1,289,217 for the Non-OZ investment. The client would have received 49% more after-tax cash compared to the Non-OZ investment.



**T. Craig Lewis III, CPA, CFP®**, provides investment opportunities in Qualified Opportunity Fund (QOF) Investments and 1031 Replacement Properties. He does not provide individual tax advice or tax preparation services. Securities are offered through DAL Securities, L.L.C. Craig resides in Shreveport, LA. He can be reached at 318.797.0447.