LUKINOVICH LAGNIAPPE

October 2018 Volume XVII

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Suggested Reading:

The Way of Serenity
By Father Jonathan Morris

(A Road Map to Finding Peace)

A NEW WAY TO DEFER AND POSSIBLY FORGIVE CAPITAL GAINS TAX


Bonnie Wyllie

There is a new tax provision that provides planning opportunities for a taxpayer with capital gains. The taxpayer can defer the recognition of capital gains or, in certain circumstances, pay no capital gains tax. This new tax provision is part of the 2017 Tax Cuts and Jobs Act that was signed into law on December 22, 2017. It enacted Internal Revenue Code Section 1400Z-2, which provides for a deferral of capital gains tax for investments in opportunity zones. The purpose of this legislation is to spur investment in economically distressed communities; however, to receive the benefit of this tax incentive, a taxpayer makes an election after December 21, 2017 to defer tax on capital gains by making a particular type of investment that meets certain requirements. Some of these basic requirements are detailed below and provide a brief overview of the benefits of IRC Section 1400Z-2.

HOW CAPITAL GAINS ARE HANDLED

Treatment of Gains
(I.R.C. § 1400Z-2(a)(1))

In the case of gain from the sale to, or exchange with, an ***unrelated person*** of any property held by the taxpayer, at the election of the taxpayer:

- If the taxpayer invests a portion of the capital gains in a Qualified Opportunity Fund during the 180-day period beginning on the date of the sale or exchange, then these capital gains are excluded from gross income for the taxable year and deferred until the earlier of the time the investment is sold or exchanged or December 31, 2026. (I.R.C. § 1400Z-2(b))

- If some of the capital gain is not invested in a Qualified Opportunity Fund, then it is included in gross income for that taxable year; and

- If the taxpayer holds the investment for 10 years, the basis of the investment will equal its fair market value on the date of the sale or exchange. This is explained in more detail below under "Determination of Basis."

Required Time Period

In order to take advantage of the deferral of capital gains, the taxpayer must make an investment in a Qualified Opportunity Fund within 180 days of the taxpayer's sale or exchange. <u>After 180 days, this tax incentive is not available.</u> (I.R.C. § 1400Z-2(a)(1)(A))

In addition, if the sale or exchange occurs after December 31, 2026, this provision is no longer available. (I.R.C. § 1400Z-2(a)(2))

Amount of Gain Includible in Gross Income
(I.R.C. § 1400Z-2(b)(2))

The amount of gain included in gross income shall be the excess of:

- The lesser of the amount of gain deferred until the investment is sold or exchanged or

- the fair market value of the investment as of December 31, 2026, over the taxpayer's basis in the investment.

Determination of Basis
(I.R.C. § 1400Z-2(b)(2)(B))

Generally, the taxpayer's basis in the Qualified Opportunity Fund investment begins at zero and is then adjusted depending upon how many years the taxpayer holds the investment. The holding period is measured from the date the taxpayer sold the asset that created the capital gain.

- The basic rule for adjustments to basis:

    - ➢ The basis of the investment in the Qualified Opportunity Fund shall be increased by the amount of capital gain recognized. (I.R.C. § 1400Z-2(b)(2)(B)(ii))

        i. When the taxpayer makes the investment in the Qualified Opportunity Fund, the initial basis in the investment is zero.

        ii. If the taxpayer is still holding the investment on December 31, 2026, then he or she must pay tax on the deferred capital gain. Since the deferred capital gain has been taken into income, the basis gets stepped up by the amount of the deferred capital gain.

- There are three adjustments to basis that depend on how long the investment is held 5 years, 7 years, or 10 years.

  - ➢ If the taxpayer holds the investment for at least 5 years, the taxpayer's basis shall be increased by an amount equal to 10 percent of the amount of capital gain deferred.

    i. When the taxpayer makes the investment in the Qualified Opportunity Fund, the initial basis in the investment is zero.

    ii. If the taxpayer holds the investment for 5 years and sells it before December 31, 2026, the statute treats the taxpayer as having basis equal to 10% of the amount of capital gain deferred. The taxpayer is taxed on the amount of the deferred capital gain less the basis adjustment of 10% of the deferred capital gain.

    iii. If the taxpayer sells the investment after 5 years, which is after December 31, 2026, the taxpayer's basis is stepped up to the full amount of the capital gains deferred.

- If the taxpayer holds the investment for at least 7 years, there is an additional basis adjustment equal to 5 percent of the amount of capital gain deferred. The taxpayer gets the 10% adjustment for holding it for five years and the additional 5% for holding it 7 years, for a total basis adjustment of 15% of the deferred capital gain.

  - ➢ When the taxpayer makes the investment in the Qualified Opportunity Fund, the initial basis in the investment is zero.

  - ➢ If the taxpayer sells the investment after holding it 7 years but before December 31, 2026, the taxpayer is taxed on the amount of the deferred capital gain less the basis adjustment of 15% of the deferred capital gain.

  - ➢ If the taxpayer holds the investment for 7 years and sells it after December 31, 2026, the taxpayer's the basis is stepped up to the full amount of the capital gains deferred.

- If the taxpayer holds the investment for at least 10 years, the basis of the property shall be equal to the fair market value of the investment on the date that the investment is sold or exchanged.

  - When the taxpayer makes the investment in the Qualified Opportunity Fund, the basis in the investment is zero.

  - Since the 10-year holding period will include the December 31, 2026, the statute requires that the deferred gain will be subject to tax. This will cause the basis in the investment to be stepped up from zero to the amount of the deferred capital gain.

  - If the investment appreciates in value and is sold after the end of the 10-year period, there is another basis adjustment at the time of sale for the amount of the appreciation. This prevents the appreciation from being subject to capital gains tax.

  - The end result at the time of sale is the basis is equal to the fair market value of the investment on the date of sale.

QUALIFIED OPPORTUNITY FUND

There are complex rules outlining the types of investments that will qualify as a Qualified Opportunity Fund. A taxpayer can only take advantage of the benefits of IRC Section 1400Z-2 if the investment meets these rules. It is recommended that any taxpayer interested in making an investment in a Qualified Opportunity Fund consult his or her advisors. Of course, if you would like to discuss these matters with our firm, please call Bonnie Wyllie at 504-818-0401 or email her at bonnie@lukinovichlaw.com.

ADDITIONAL GUIDANCE

On October 19th the IRS issued additional guidance in Proposed Regulation-115420-18 and Revenue Ruling 2018-29, and these items are attached.

In addition, more information on the list of designated Qualified Opportunity Zones is located at: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

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