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Mergers and Acquisitions of Closely-Held Corporations (PowerPoint)

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Chamberlain Hrdlicka
Attorneys at Law

MERGERS AND ACQUISITIONS OF CLOSELY-HELD CORPORATIONS

Jerald David August
Chair, Federal Tax Practice
Thursday, November 8, 2018
9:30 am. and 5:00 p.m.

Jerald D. August
Shareholder, Chair - Philadelphia Federal Tax Practice

Mr. August is a nationally recognized tax lawyer who advises clients on income tax matters, including foreign taxation of U.S. businesses and U.S. taxation of foreign businesses and investors. In many instances he works with corporate and real estate counsel on selecting the proper entity in which to engage in domestic or foreign business or investment operations. He has been involved in structuring as well as negotiating merger and acquisitions, both taxable and non-taxable, joint ventures, financings, workouts and recapitalizations. He also represents clients in tax controversy and litigation in challenging the positions maintained by the Internal Revenue Service and other taxing authorities. He has also worked with the National Office of the Internal Revenue Service in filing private letter rulings or pursuing the competent authority provisions of a particular bilateral tax treaty involving the United States and a foreign country.

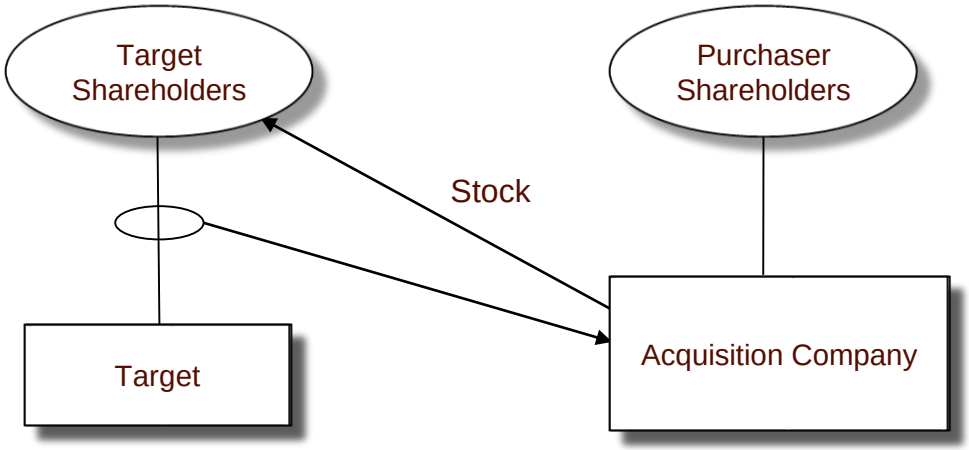
Corporate Acquisitions and Dispositions – Basic Structures and Tax Planning

- Tax Free Reorganizations
- Taxable Asset Acquisitions and Stock Purchases and Dispositions Treated as Asset Acquisitions - Section 338(h)(10) and Section 336(e)
- Private Equity Recapitalizations]
- Capital Gain Deferral – Rollover to Qualified Opportunity Funds

Corporate Acquisitions and Dispositions – Basic Structures

- Tax Free Reorganizations

Tax Free Reorganizations



- Seller treatment
- Nontaxable reorganization
- Structure as Type A, B, (a)(2)(D), (a)(2)(E), or C
- If QSub election made after acquisition, treated as C reorganization subject to "substantially all" requirement
- Buyer treatment
- Carryover of asset basis – no step up
- Carryover of tax attributes, but may be limited
- Buyer inherits old tax history – all of it – no amortizable goodwill

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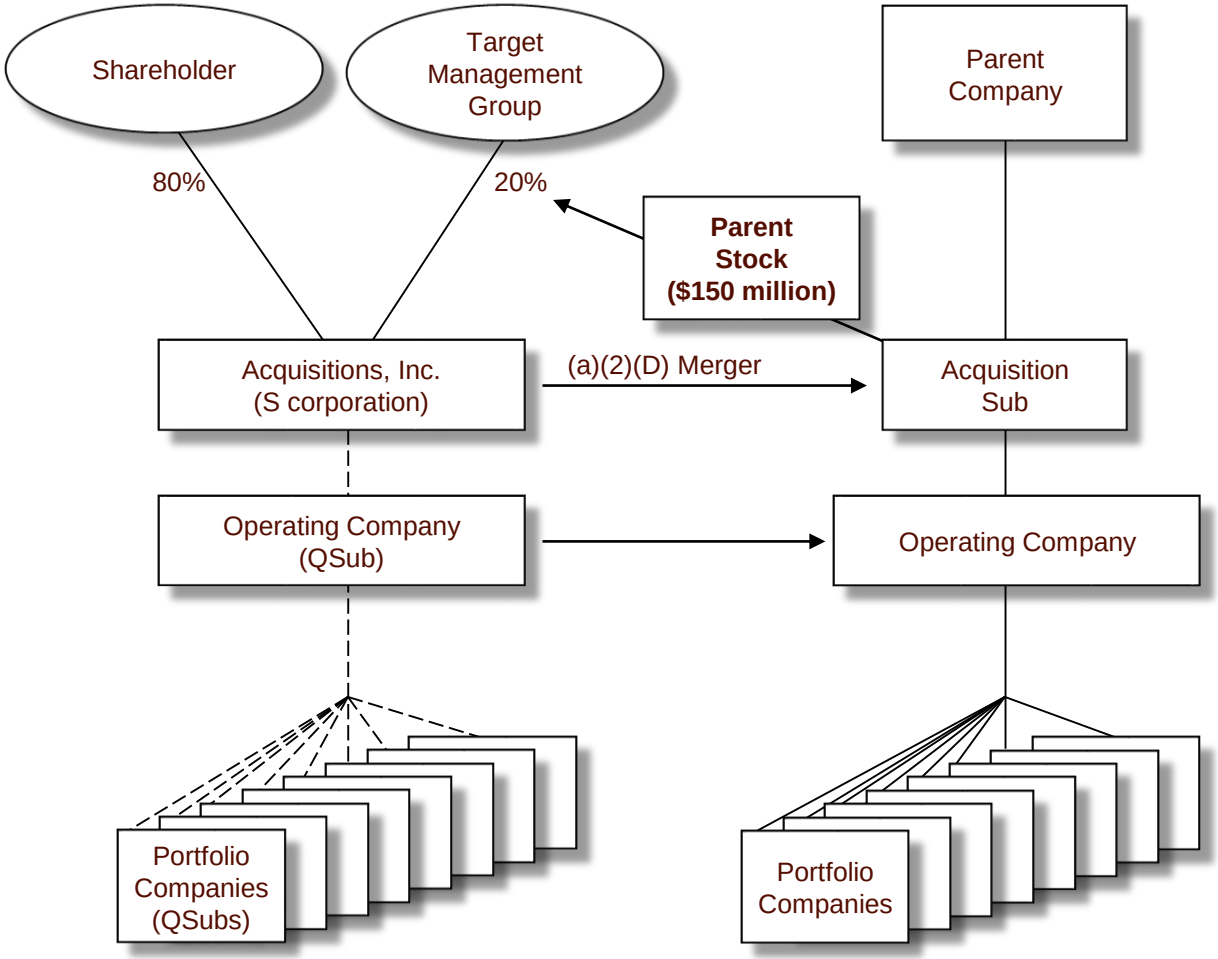
Attorneys at Law

Forward Triangular Merger Under Section 368(a)(2)(D) – Target Merges into Acquisition Sub and Target Shareholders Receive Stock in Parent Company



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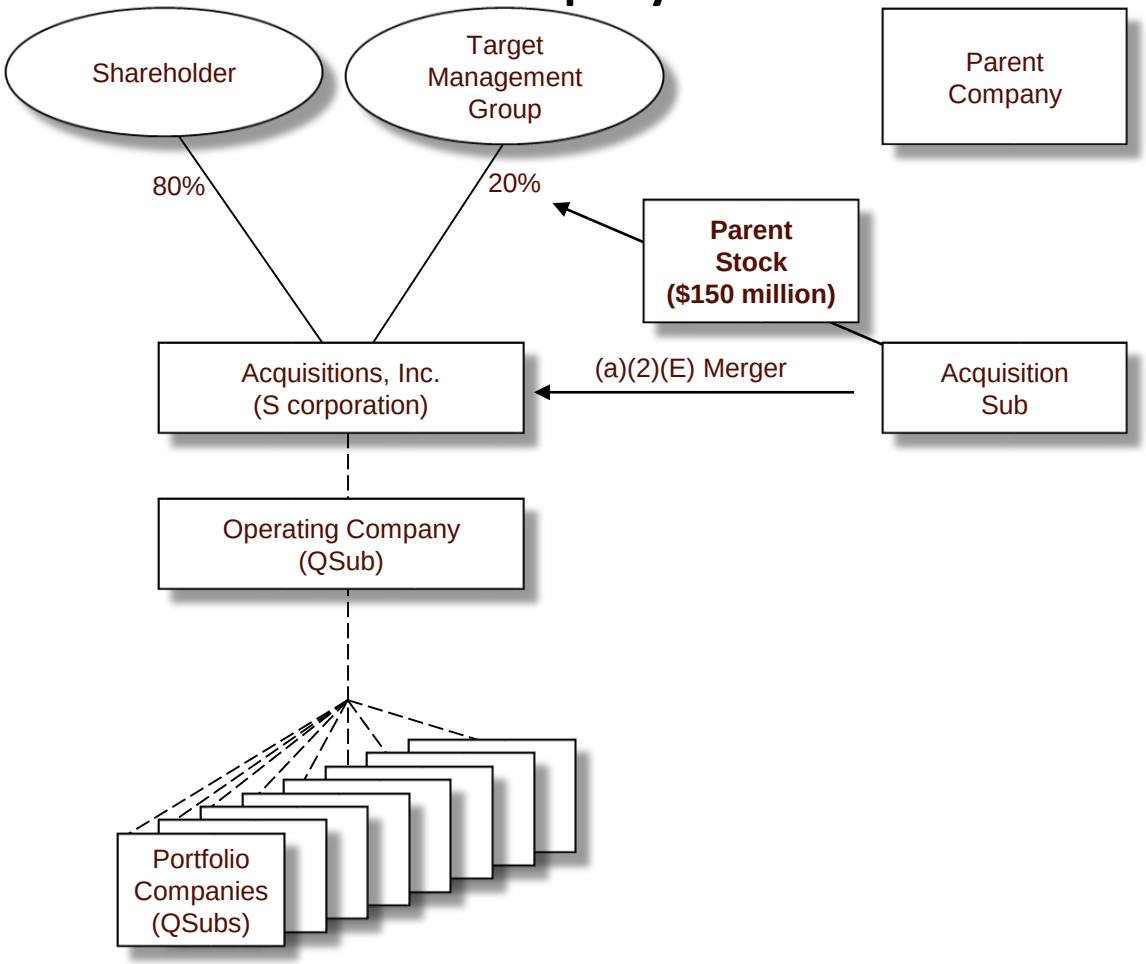
Reverse Triangular Merger Under Section 368(a)(2)(E) – Acquisition Sub Mergers into Target and Target Shareholders Receive Stock in Parent Company



Mergers Involving DREs – 2000 Proposed Regulations

2000 Proposed Regulations. On May 17, 2000, the Service issued a proposed rulemaking on mergers involving disregarded entities. Under the Proposed Regulations, the merger of a disregarded entity ("DRE") (including a QSub or qualified REIT subsidiary) into a tax corporation would not be a Type A reorganization because the merging entity is not a tax corporation.

In Rev. Rul. 2000-5, the Service held that a Type A merger must involve the transfer of the assets of a target corporation to a single transferee corporation ceasing to exist as a result of the "merger." Rev. Rul. 2000-5 implied that a merger of a DRE (single member) owned by a corporation (including a QSub), cannot be a Type A reorganization because it will be divisive and will not necessarily result in the termination or liquidation of the member.

Due to the additional requirements for a Type C ("substantially all of the transferor's assets," no more than 20% boot, including liability assumptions, and "solely for voting stock" requirements) and Type D ("substantially all"/liabilities in excess of basis) reorganization, many of the DRE mergers would constitute taxable transactions under the 2000 proposed regulations.

Mergers Involving DREs – 2003 Final Regulations

The final regulations, issued in 2003, retain the conceptual background and definitions of the proposed regulations, including the definition of a disregarded entity.

Defined terms included the following:

(i) Disregarded Entity; a business entity that is disregarded as an entity separate from its owner for Federal tax purposes;

(ii) Combining Entity; a business entity that is a corporation that is not a disregarded entity;

(iii) Combining Unit; is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such entity for Federal tax purposes;

(iv) Transferor Unit; and

(v) Transferee Unit.

Mergers Involving DREs – Example: Type A Merger

Under a Type A reorganization under the Final Regulations (i.e., a statutory merger or consolidation effected pursuant to the statute or statutes necessary to effect the merger or consolidation), the following events occur simultaneously at the effective time of the transaction:

(i) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and

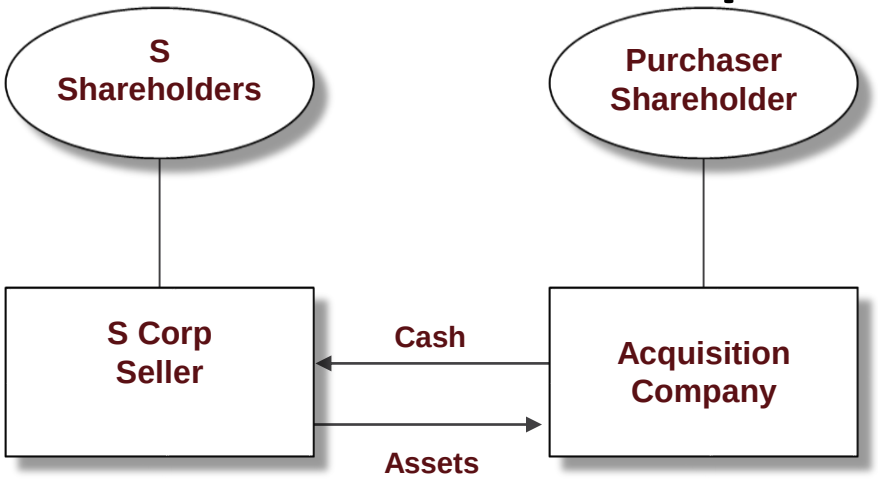
(ii) the combining entity of each transferor unit ceases its separate legal existence for all purposes.

Corporate Acquisitions and Dispositions – Basic Structures

- Taxable Asset Acquisitions and Stock Purchases and Dispositions Treated as Asset Acquisitions - Section 338(h)(10) and Section 336(e)

Chamberlain Hrdlicka
Attorneys at Law

Taxable Asset Sale – S Corp Seller



- Seller treatment
  - No double tax (except for BIG, entity level state taxes)
  - Potential for character differences
  - Installment sales treatment
- Buyer treatment
  - Step-up basis in assets (including amortizable goodwill) for Buyer
  - Buyer generally does not inherit exposure for pre-closing taxes
  - Exclude unwanted assets and excluded or undisclosed liabilities

Taxable Asset Sale – C Corp Seller Case Study I – C Corporation with Significant Goodwill

C corporation target with significant goodwill that can be attributed to shareholders without non-compete agreements. Types of businesses where this is likely to be found:

- Closely Held Businesses
  - Shareholder must be intimately involved in the business. Otherwise, any goodwill is due to the work of others.
  - Contrast with large publicly held corporation where owners (shareholders) relinquish control
- Technical, Specialized, or Professional Businesses
- Businesses with Customers or Suppliers

Taxable Asset Sale – C Corp Seller Case Study I – C Corporation with Significant Goodwill

- Personal goodwill is likely to be present when business relationships were developed and maintained by a single proprietor, when others do not develop business relationships, and the nature of relationships is personal to that individual. *See Martin Ice Cream Co. v. Commissioner*. 110 T.C. 189 (1998). *See also, Cullen v. Commissioner*, 14 T.C. 368 (1950); *MacDonald v. Commissioner*, 3 T.C. 720 (1944).
- Absence of a non-compete agreement between the individual and the target company is important to establish that value should be attributable to personal goodwill (otherwise, it is corporate goodwill) *Martin. See also*, T.A.M. 2002-44-009 (July 18, 2002).
- In *Howard v. United States*, 448 Fed.Appx. 752 (9th Cir. 2011), broad language of non-compete meant, in the court's view that there was no personal goodwill, even though the non-compete was entered into by a sole shareholder and his corporation.

Case Study II – Maximizing Expensing of Qualified Property under 2017 Tax Act

An Asset Purchase may be attractive to a Purchaser where value of tangible assets (FFE) is significant as compared to goodwill component.

Commencing in 2018, the 2017 Tax Act allows full expensing (100% deduction) of the cost of "qualified property," including depreciable tangible assets, such as machinery and equipment with a recovery period of 20 years or less. The 100% deduction is available for five years, then reduced by 20% per year and phased out as follows:

- For property placed in service in 2023, 80%.
- For property placed in service in 2024, 60%.
- For property placed in service in 2025, 40%.
- For property placed in service in 2026, 20%.
- Thereafter, normal depreciation rules apply.

Cost Recovery and Expensing of Business Assets

For property with longer production periods (over 20 years) placed in service after September 27, 2017, and before January 1, 2024, 100%:

- For property place in service in 2024, 80%.
- For property place in service in 2025, 60%.
- For property placed in service in 2026, 40%.
- For property placed in service in 2027, 20%
- Thereafter, normal depreciation rules apply.

Overview of New Section 168(k) & Proposed Regulations

- "Qualified property" is limited to:
  - Tangible property predominantly used in the U.S. that is subject to MACRS with an applicable recovery period ≤ 20 years;
  - Computer software not covered by §197;
  - Water utility property;
  - Qualified film or television production or qualified live theatrical production; and
  - Qualified improvement property (including leasehold, restaurant, and retail improvement property) placed in service after September 27, 2017 and before January 1, 2018 (Prop. Reg. §1.168(k)-2(b)(2)(A)).

Overview of New Section 168(k) & Proposed Regulations

Section 168(k) allows for 100% expensing for purchases of new and used qualified property from unrelated parties.

For used property to qualify, it must satisfy the used property acquisition requirements.

- Cannot be acquired from a related person (see §179(d)(2)(A), (B), (C), and (d)(3)).

The Proposed Regulations add special rules for property previously used by members of the same consolidated group and addressing certain property acquired in a series of related transactions

Taxpayers may elect out for a class of property placed in service in a given taxable year.

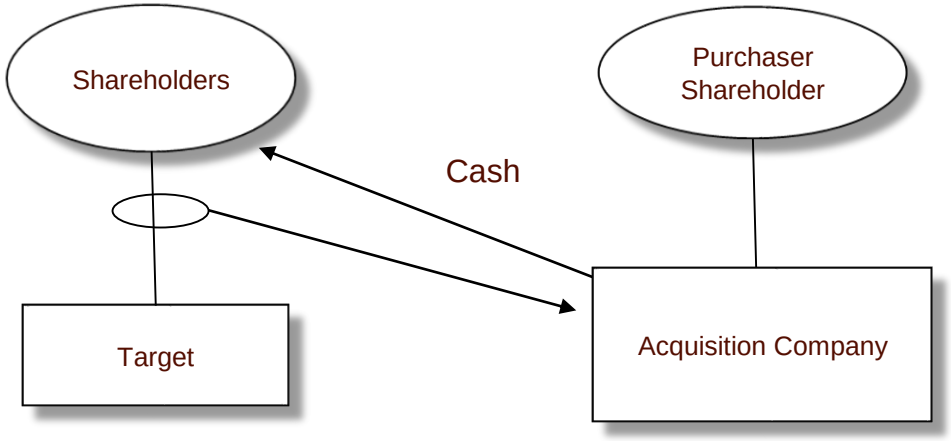
Taxpayers may not want to expense to extent would create an NOL.

Case Study II – Maximizing Expensing of Qualified Property under 2017 Tax Act

Asset Purchase may be attractive to Purchaser where value of tangible assets (FFE) is significant as compared to goodwill component. Additional considerations include the following:

- Potential for triggering recapture of depreciation and ordinary income to Seller.
- Buyer may expense portion of purchase price allocable to qualified property and amortize portion of purchase price allocable to goodwill.
- Other considerations and strategies?

Taxable Stock Acquisition – No 338(h)(10)



- **Seller treatment**
  - **Generally capital gain/loss**
  - **No double tax**
  - **Possible Installment sale treatment**
- **Buyer treatment**
  - **Carryover of asset basis – no step up**
  - **Carryover of tax attributes, but may be limited**
  - **Buyer inherits old tax history – all of it – no amortizable goodwill**
- **Same tax consequences (stock sale) if target is acquired in a cash-out reverse subsidiary merger of acquirer into target with no 338(h)(10) election**

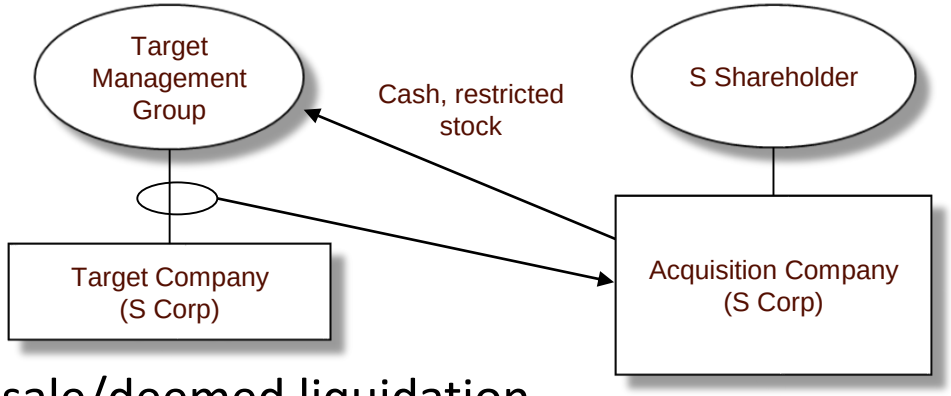
Qualified Stock Purchase Involving S. Corporations?

- Old Section 1371(a)(2): "S corporation treated as an individual in its capacity as a shareholder of another corporation"
- TAM 9245004: "Section 1371(a)(2) does not prevent an S corporation from being treated [in its capacity as a shareholder of T] as a corporation for purposes of applying Sections 338 and 332"
- SBJPA of 1996:
  - Repealed Section 1371(a)(2)
  - Permitted S corporation to hold 80% - 100% subsidiaries
  - QSub – DRE treatment of 100% subsidiary

Taxable Acquisition of Stock Treated as Purchase of Assets – Section 338(h)(10)

- Requirements:
  - Target is S corporation or member of affiliated group
  - Need a purchasing corporation (C or S)
  - QSP
    - 80% of vote and value within 12 months
    - Treas. Reg. §1.338(h)(10)-1(c)(2) - turn-off step transaction
  - Joint Election (Form 8023) to treat purchase of stock as purchase of assets for tax purposes

Taxable Acquisition of Stock of S Corp Target – Qualified Stock Purchase under 338(h)(10)



- Deemed asset sale/deemed liquidation
- Seller treatment
  - S Corp Target shareholders must consent to 338(h)(10) election
  - Sellers may qualify for installment sales treatment
  - Potential for timing and character mismatch
- Buyer treatment
  - Treated like an asset purchase
  - Assets basis adjusted to purchase price
  - Seller (or Buyer) may be exposed to BIG tax and any entity level state income taxes
  - Cash out reverse merger of acquirer into target- treated as stock sale (Rev. Rul. 73-247, Rev. Rul. 90-95)(eligible for 338(h)(10) election)
  - Cash-out forward merger of target into acquirer (corporate or LLC) - treated as asset sale and liquidation (Rev. Rul. 69-6: PLR 200628008)

Taxable Acquisition of S Corp Target – Section 338(h)(10)

- Tax Consequences To Seller
  - Deemed asset sale
  - Depreciation recapture at ordinary income rates
  - If T has Subchapter C history (10 year Section 1374 taint) BIG recognized at corporate level
  - T's taxable year closes on the acquisition date with respect to selling shareholders
  - State tax consequences
  - Deferral still available from installment reporting

Taxable Acquisition of S Corp Target – Section 338(h)(10) (cont'd)

- Tax Consequences To Buyer
  - Basis of Assets Stepped Up To Purchase Price of Stock
    - Excess value allocable to goodwill
    - Increased depreciation, amortization deductions
    - Reduced gain on subsequent sale of assets
  - T may qualify as QSub of S Corporation Acquirer
    - Election must be filed with 2-1/2 months
    - No Section 1374 taint on assets
  - T may merge upstream into S Corporation Acquirer

Taxable Acquisition of S Corp Target – Section 338(h)(10) – Post Closing Matters

- Purchase Agreement should require that Buyer, Sellers shall retain records relevant to any tax examination and cooperate with other party in the event of any tax examination during the applicable statute of limitations
- Section 338(h)(10) deemed asset sale – Form 8883 Asset Allocation Statement Under Section 338 to be prepared by Buyer or Seller subject to review and approval by other party prior to filing with tax returns for year that includes the closing date
- Asset sale, QSub or SMLLC sale - Form 8594 Asset Acquisition Statement Under Section 1060 to be prepared by Buyer or Seller subject to review and approval of other party prior to being filed with tax returns for tax year that includes the closing date

Section 338(h)(10) or Asset Sale vs. Traditional Stock Sale – Purchase Price Adjustments

- Purpose – make Sellers whole for extra tax costs of asset sale or deemed asset sale over stock sale
- Sources of differences
  - Character of gain – pass through ordinary income, LTCG, Section 1250 gain as compared with capital gain on sale of stock
  - Corporate level liabilities included in the calculation of the ADSP, including trade payables
  - Outside/inside basis disparities
  - State tax apportionment of gain vs. tax rate of shareholder's domicile
  - BIG tax, entity level state taxes
  - Reallocation of purchase price in the event of an audit
  - Installment sale gain recognition

QSP and Installment Sale-Sections 453(h) and 453B(h)

- Section 453B(h) - S gain not triggered on distribution of installment note to Seller shareholders
- Reg. §1.453-11 implementing section 453(h)
- Reg. §§1.338(h)(10)-1(d)(8) and -1(e), Ex.10
- Trigger of recapture income in year of sale
- Interest charge on deferred tax liability if Seller has ›$5 million face amount of obligations arising from installment sales during the tax year
- Seller must receive obligation that is not payable on demand or readily tradable – section 453(f)
- The one day note strategy – more favorable gross profit percentage calculation for Seller

Case Study III – QSP and Installment Sale-Sections 453(h) and 453B(h) – the One Day Note Strategy

- *Example 1*- Sale of assets for $1 million cash (distributed to Shareholder), $1 million debt assumption, and $3 million 5 year ISO, maintain existence of S for 5 years.
  - $750,000 gain in year of sale, $2,250,000 in year 5
- *Example 2*- Sale of assets on same terms as Example 1, followed by distribution of $2 million cash and $3 million ISO to Shareholder in liquidation of S.
  - $1,650,000 gain in year of sale, $1,650,000 in year 5
- *Example 3*- Distribution of $1 million cash to Shareholder, sale of assets for $4 million ISO ($1 million payable 1 day later and $4 million after 5 years), followed by distribution of ISO to Shareholder.
  - $750,000 gain in year of sale, $2,250,000 in year 5

Step Transaction Doctrine Inapplicable with QSP and Valid Section 338(h)(10) Election

- The Regulations provide that the step transaction doctrine will not apply if a corporation (i) engages in a qualified stock purchase ("QSP"), and (ii) makes a valid Section 338(h)(10) election.

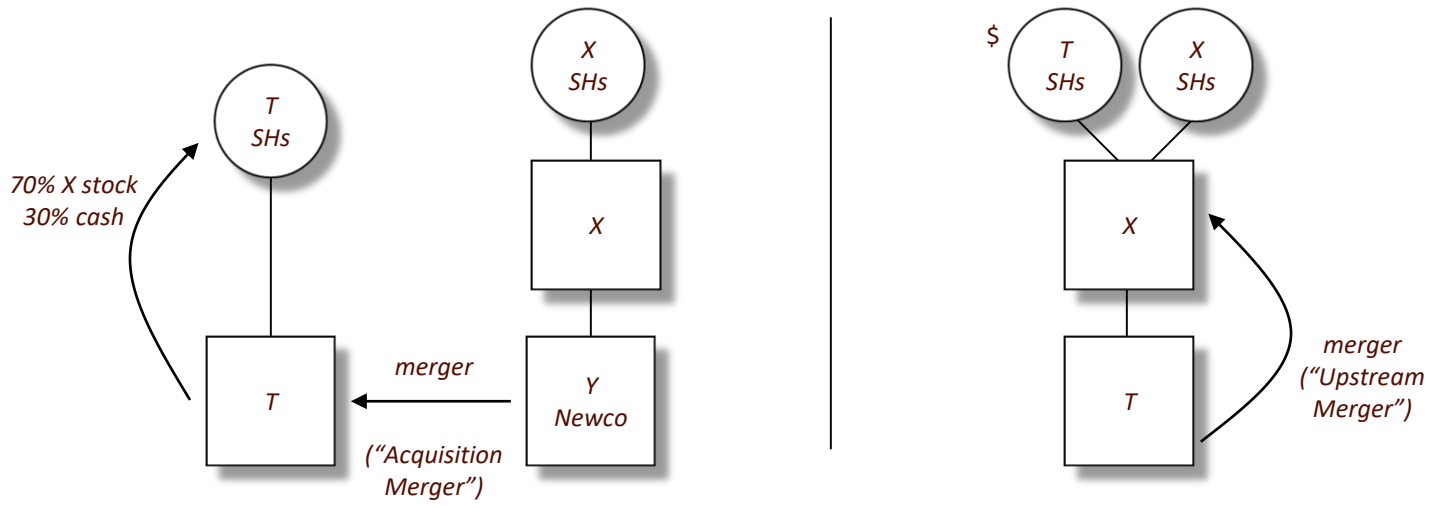
- The Regulations reflect the general principles of Rev. Rul. 2001-46, 2001-2 C.B. 321.

- Application to multi-step transactions: If a Section 338(h)(10) election is made in a case where the acquisition of T stock followed by a merger or liquidation of T into P qualifies as a reorganization described in Section 368(a), for all Federal tax purposes, P's acquisition of T stock is treated as a QSP and is not treated as part of a reorganization described in Section 368(a). Reg. § 1.338(h)(10)-1(c)(2).

Chamberlain Hrdlicka
Attorneys at Law

Rev. Rul. 2001-46 (Situation 1)

Stock Acquisition Followed By Merger



- The Regulations provide that the step transaction doctrine will not apply if a corporation (i) engages in a qualified stock purchase ("QSP"), and (ii) makes a valid Section 338(h)(10) election.

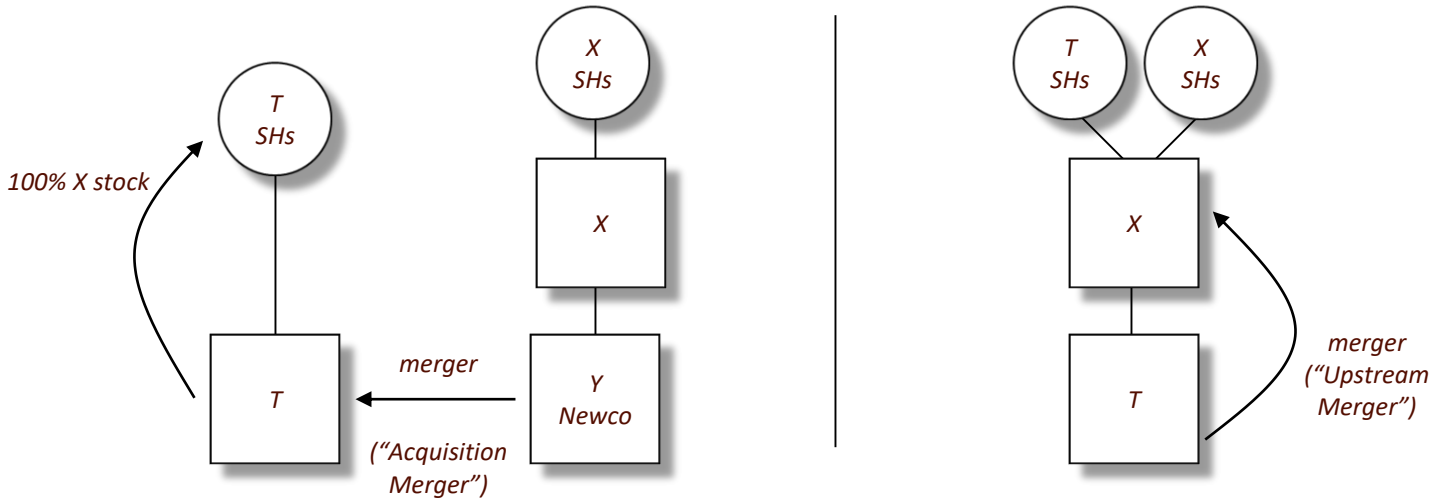
- The Regulations reflect the general principles of Rev. Rul. 2001-46, 2001-2 C.B. 321.

- Application to multi-step transactions: If a Section 338(h)(10) election is made in a case where the acquisition of T stock followed by a merger or liquidation of T into P qualifies as a reorganization described in Section 368(a), for all Federal tax purposes, P's acquisition of T stock is treated as a QSP and is not treated as part of a reorganization described in Section 368(a). Reg. § 1.338(h)(10)-1(c)(2).

Chamberlain Hrdlicka
Attorneys at Law

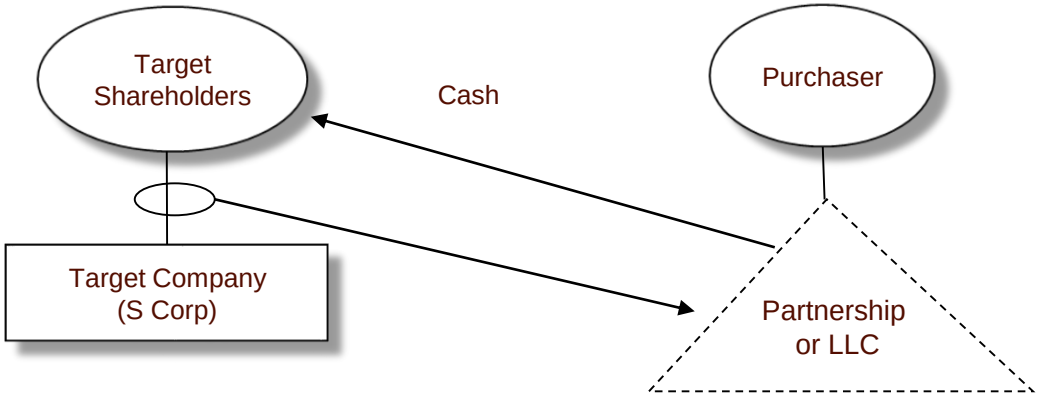
Rev. Rul. 2001-46 (Situation 2)

Stock Acquisition Followed By Merger



- The facts are the same as in Situation (1) except that in the Acquisition Merger the T shareholders receive solely X voting stock in exchange for their T stock, so that the Acquisition Merger, if viewed independently of the Upstream Merger, would qualify as a reorganization under 368(a)(1)(A) by reason of 368(a)(2)(E).
- Difference (all stock, no cash) does not change the result in Situation 1.

Taxable Acquisition of Stock of S Corp Target – Qualified Stock Disposition under 336(e)



- Deemed asset sale/deemed liquidation
- Seller treatment
  - S Corp Target shareholders must consent to 336(e) election
  - The purchaser in a qualified stock disposition is not required to be a corporation, as in the case of a qualified stock purchase under section 338(h)(10)
  - Potential for timing and character mismatch
- Buyer treatment
  - Treated like an asset purchase
  - Assets basis adjusted to purchase price
  - Seller (or Buyer) may be exposed to BIG tax and any entity level state income taxes
- Issues:
  - Step transaction doctrine should not apply to QSD for same reasons as it does not apply to QSP
  - Common ownership between Target and Purchaser may preclude qualification for QSD
  - Relaxation of the "related party" definition allows two partnerships with a common partner owning less than 5% in each to be treated as unrelated

Case Studies IV and V – Section 336(e) and Section 336(h)(10)

Case Study IV -Situation where section 336(e) works where section 338(h)(10) does not.

- Purchaser is a partnership or LLC, for example a private equity fund or a special purpose LLC.
- The purchaser in a qualified stock disposition is not required to be a corporation, as in the case of a qualified stock purchase under section 338(h)(10).
- S Corp Target shareholders must consent to 336(e) election

Case Study V -Situation where target corporation qualifies for section 338(h)(10) election but there are one or more subs of target which purchaser may choose not to make 338(h)(10) election for some reason, such as high inside basis of assets that exceeds the amount of consideration to be allocated to subsidiary

- Section 338(h)(10) election may be made selectively for target and subsidiaries of target

S Election Must be Valid for QSP or QSD to Apply to Target Corporation

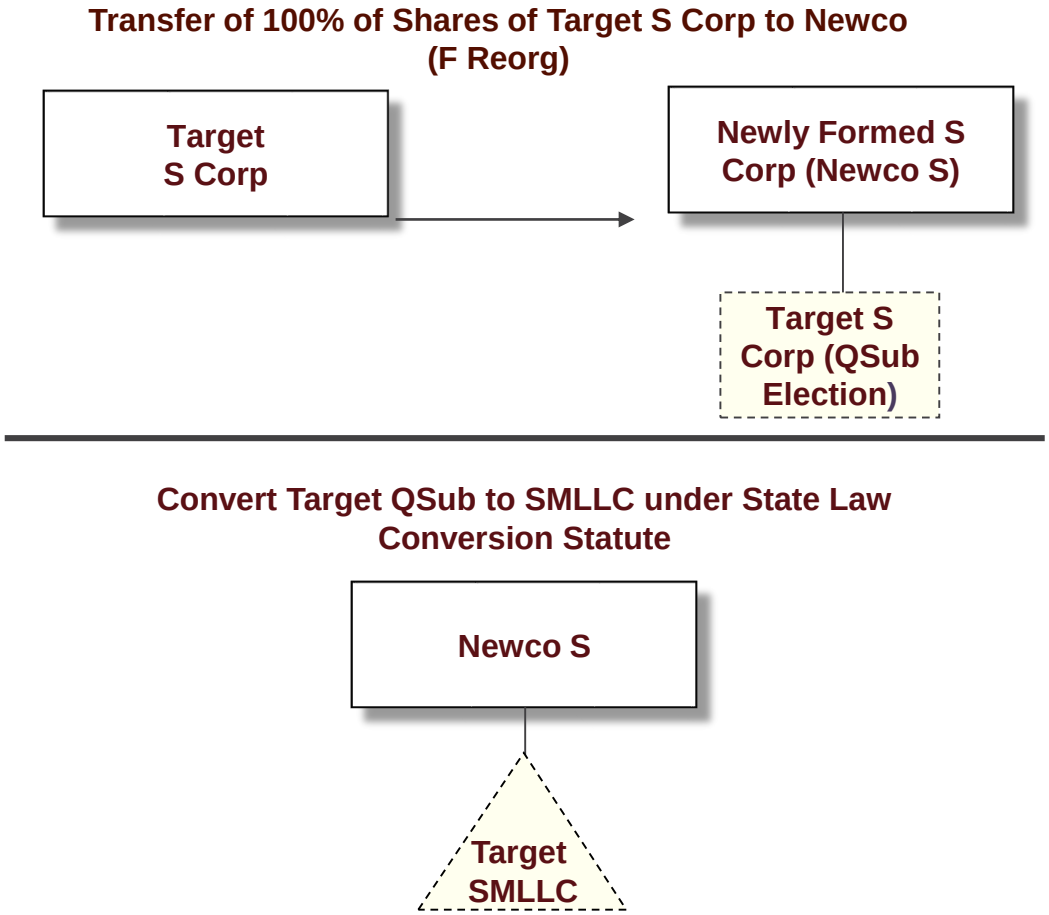
- Since the target must be either an S corporation or a member of an affiliated group to qualify as a QSP, due diligence will be conducted by the buyer to ensure that a target corporation owned by individual shareholders has a valid S election in effect.
- Corporate tax liability of transferee also a concern.
- Proof that the S election was filed and accepted by the IRS does not establish that the S election is valid if the eligibility requirements have not been satisfied at all times since the election was effective.
- Due Diligence inquiries may be exhaustive, leading to consideration of request for inadvertent termination relief from the IRS, or hold back of purchase price to back up shareholder representations and indemnities.

Case Study VI-S Corporation Target With Eligibility Issues Discovered Through Due Diligence

- S corporation target may have questionable eligibility for S election as a result of:
  - Single Class of Stock Requirement
  - QSST or ESBT Elections
  - Disproportionate Distributions to shareholders
  - Other eligibility issues identified through due diligence.
- Strategy:
  - F reorganization to convert old S to LLC owned 100% by new S
  - Purchaser acquired 100% of membership of LLC, treated as purchase and sale of assets
  - Risk of eligibility for S status remains with Seller
  - Transferee liability of Purchaser?

Chamberlain Hrdlicka
Attorneys at Law

Case Study VI – Transfer of S Corporation Shares of Target to New S Corporation (F Reorg) and Conversion of Target to LLC, Followed by Sale of Membership Interests in LLC (Treated as Sale of Assets)

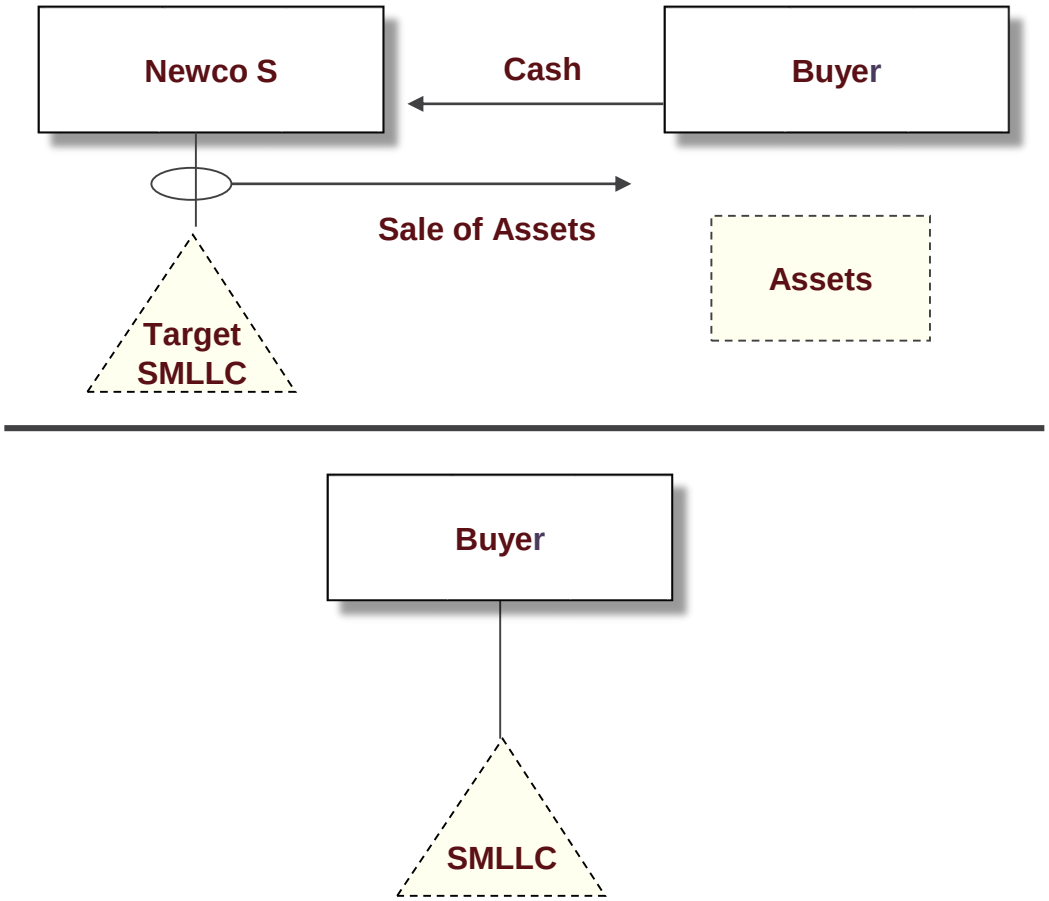


F Reorganization and Conversions From Corporation to Qsub or LLC Taxed as Disregarded Entity

Conversion of Corporation to Disregarded Entity. The conversion of a corporation to disregarded entity status constitutes a complete liquidation of the corporation pursuant to sections 331 and 336 and is taxable to the corporation and its shareholders. Exception from taxable treatment is provided where the liquidation meets of the requirements for the liquidation of a controlled subsidiary pursuant to sections 332 and 337. The conversion of an eligible entity to a disregarded entity can be accomplished by election. An election should be treated as a distribution of the assets in liquidation of a corporation. In general, the tax consequences of the conversion are deemed to occur at the end of the day preceding the election.

Chamberlain Hrdlicka
Attorneys at Law

Case Study VI – Transfer of S Corporation Shares of Target to New S Corporation and Conversion of Target to LLC, Followed by Sale of Membership Interests in LLC (Treated as Sale of Assets)



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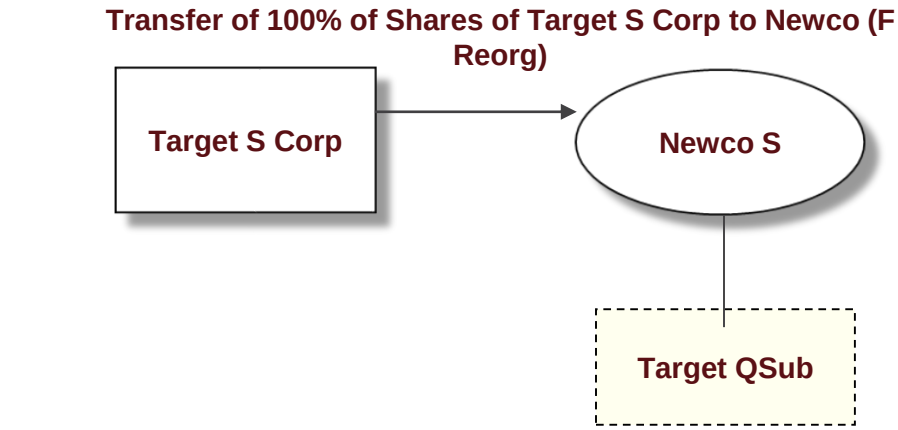
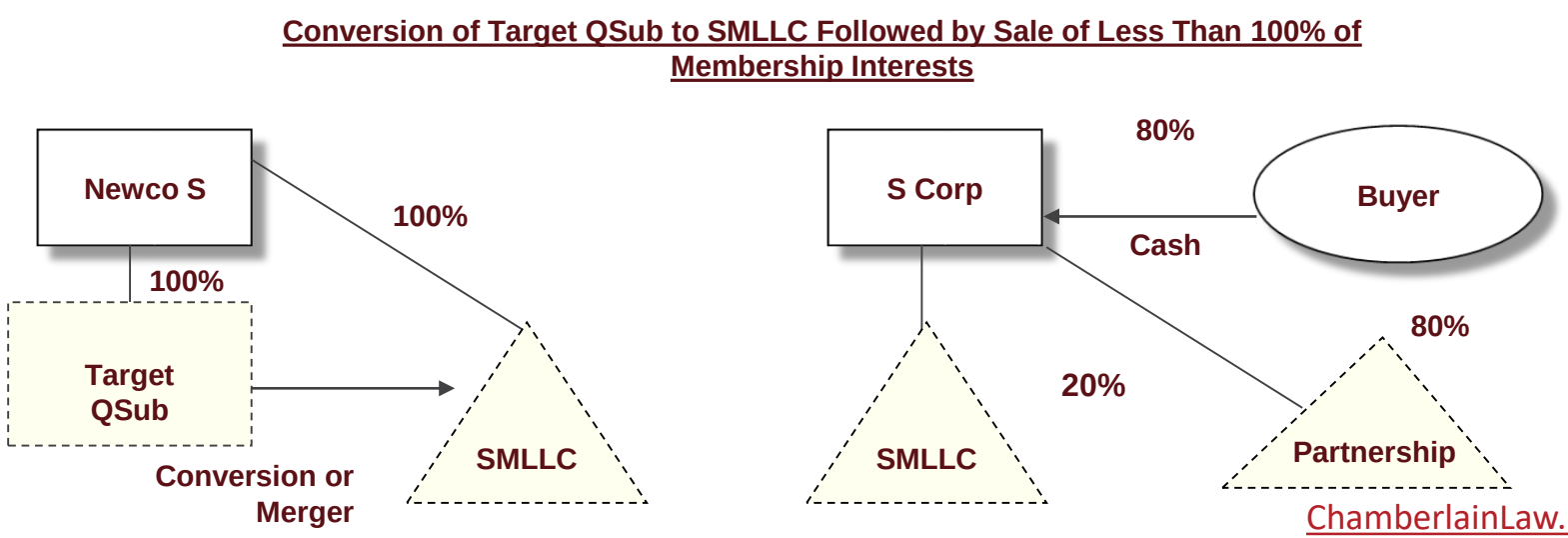
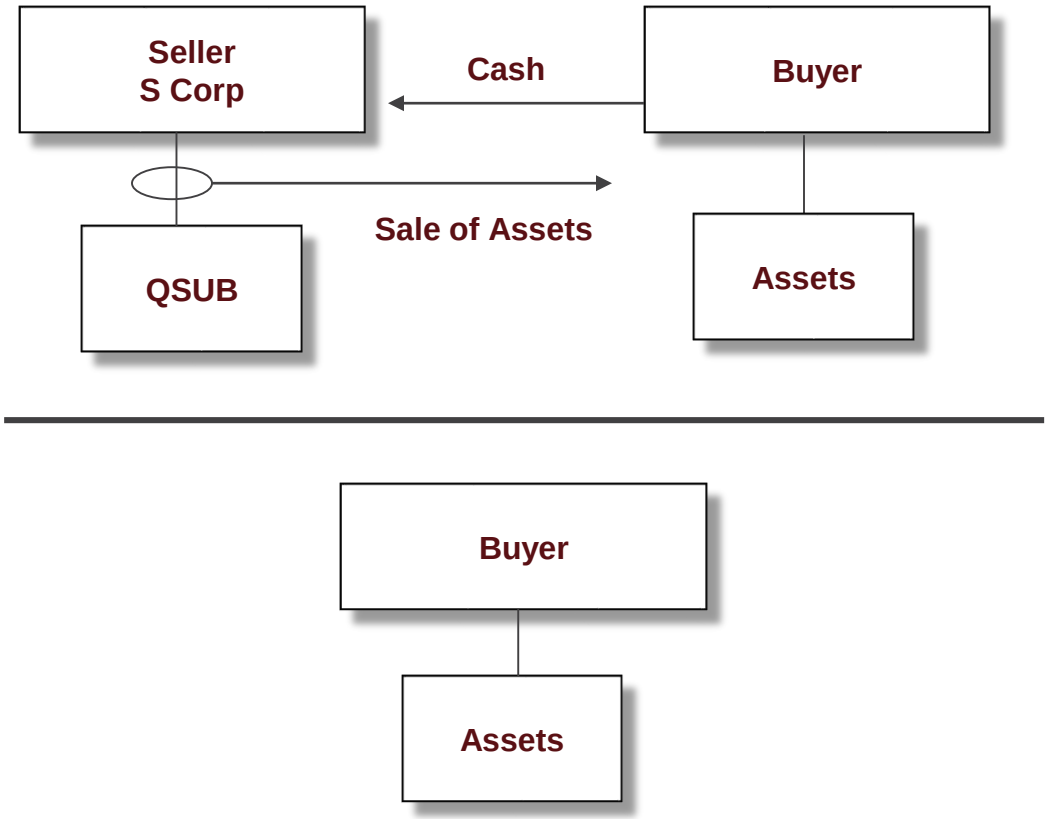
Case Study VII – Tax Free Rollover - Transfer of S Corporation Shares of Target to New S Corporation (F Reorg) and Conversion of Target to LLC, Followed by Sale of Less Than 100% of Membership Interests and Retention of Remaining Equity





Chamberlain Hrdlicka
Attorneys at Law

Sale of QSub Treated as Sale of Assets Followed by Transfer to New Corporation – Reg.§1.1361-5(b)(3), Example 9



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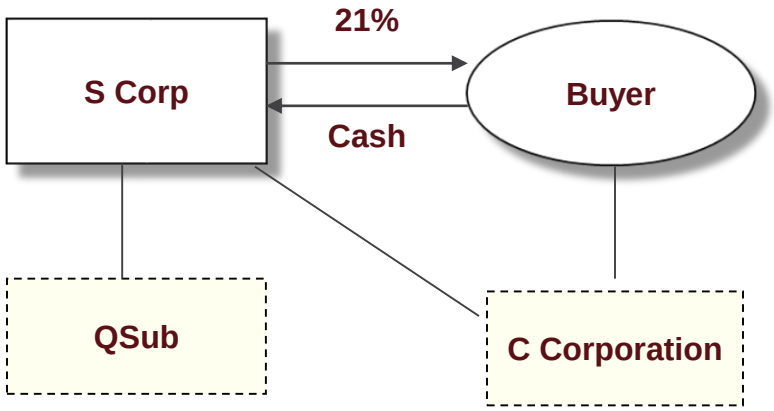
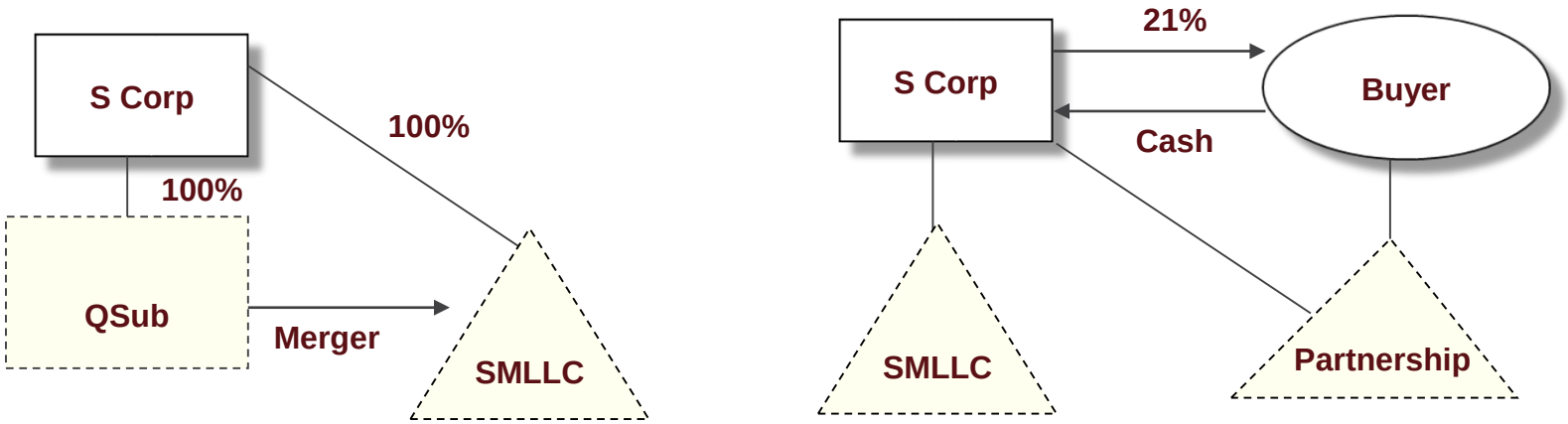
Attorneys at Law

Conversion of QSub to SMLLC to Maintain Pass – Through Treatment after Sale of Interest - Reg.§1.1361-5(b)(3), Example 2



Use of SMLLC in Lieu of QSub



Corporate Acquisitions and Dispositions – Basic Structures

- Private Equity Recapitalizations

Equity Recapitalization with Private Equity Investment in Operating Company

- Purpose: funding required by operating company to:
  - Fuel expansion
  - Provide equity to support borrowing
  - Buyout senior or minority shareholders
- Structure of investment by private equity investor
  - Subordinated debt
  - Warrants
  - Convertible preferred stock
  - Preferred interest in partnership or LLC

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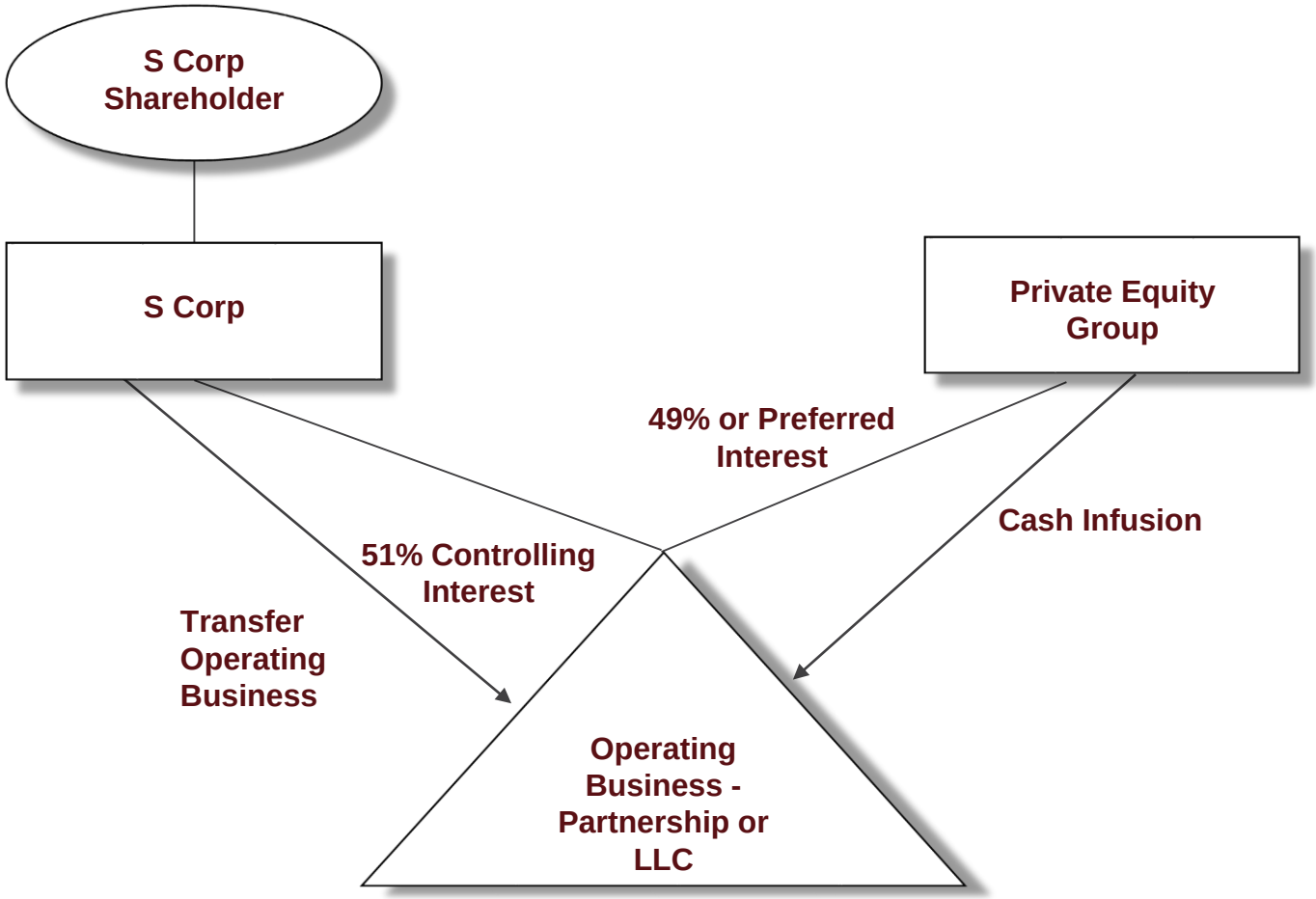
Attorneys at Law

Case Study VIII – Equity Recapitalization of S Corporation By Issuing Minority Interest in Operating Business to Private Equity Group under Rev. Rul. 94-43



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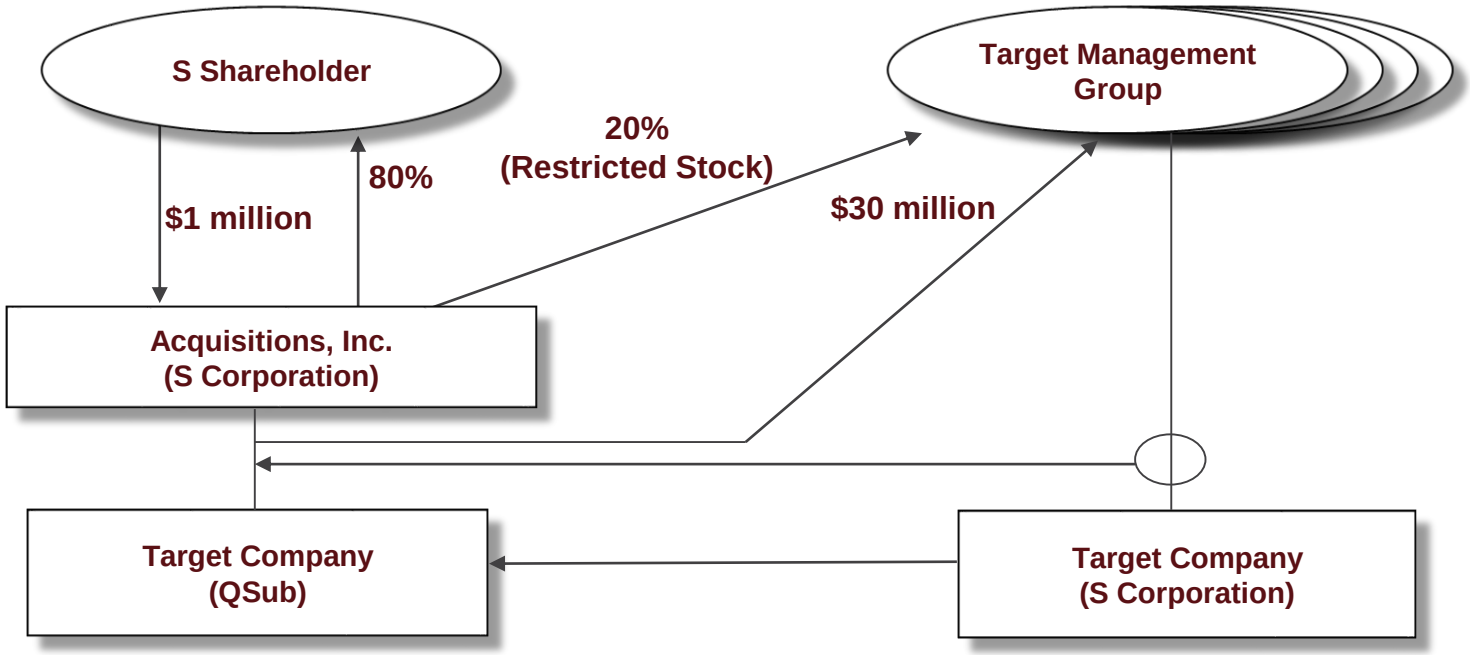
Attorneys at Law

Equity Recapitalization through Leveraged Purchase of 80 Percent of Operating Business



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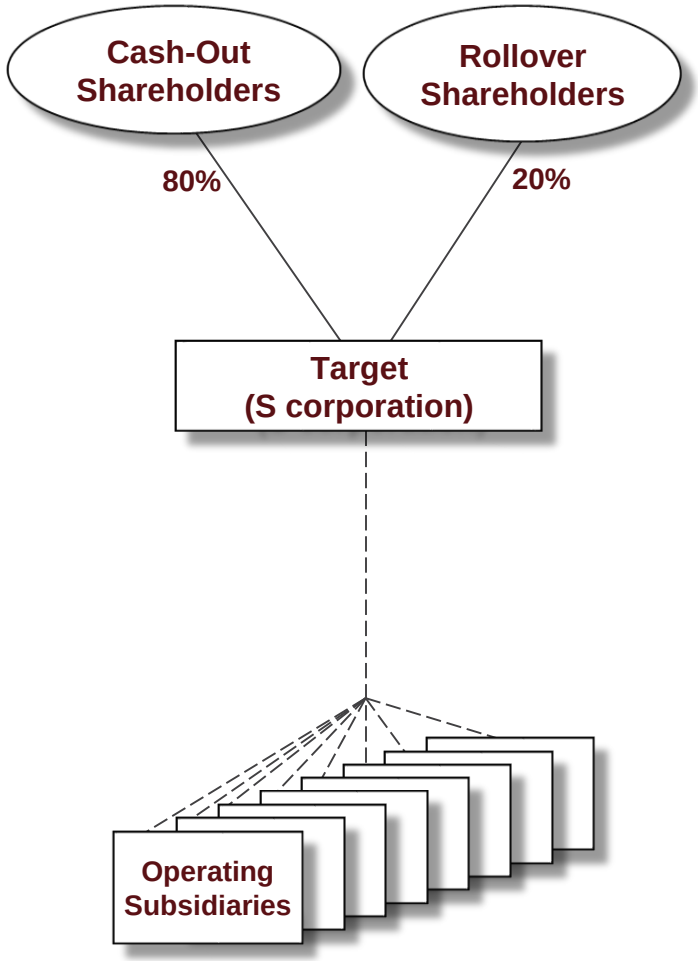
Attorneys at Law

Case Study IX – Use of Section 351 to Structure Rollover of Minority Shareholders into Acquiring Corporation – National Starch Structure



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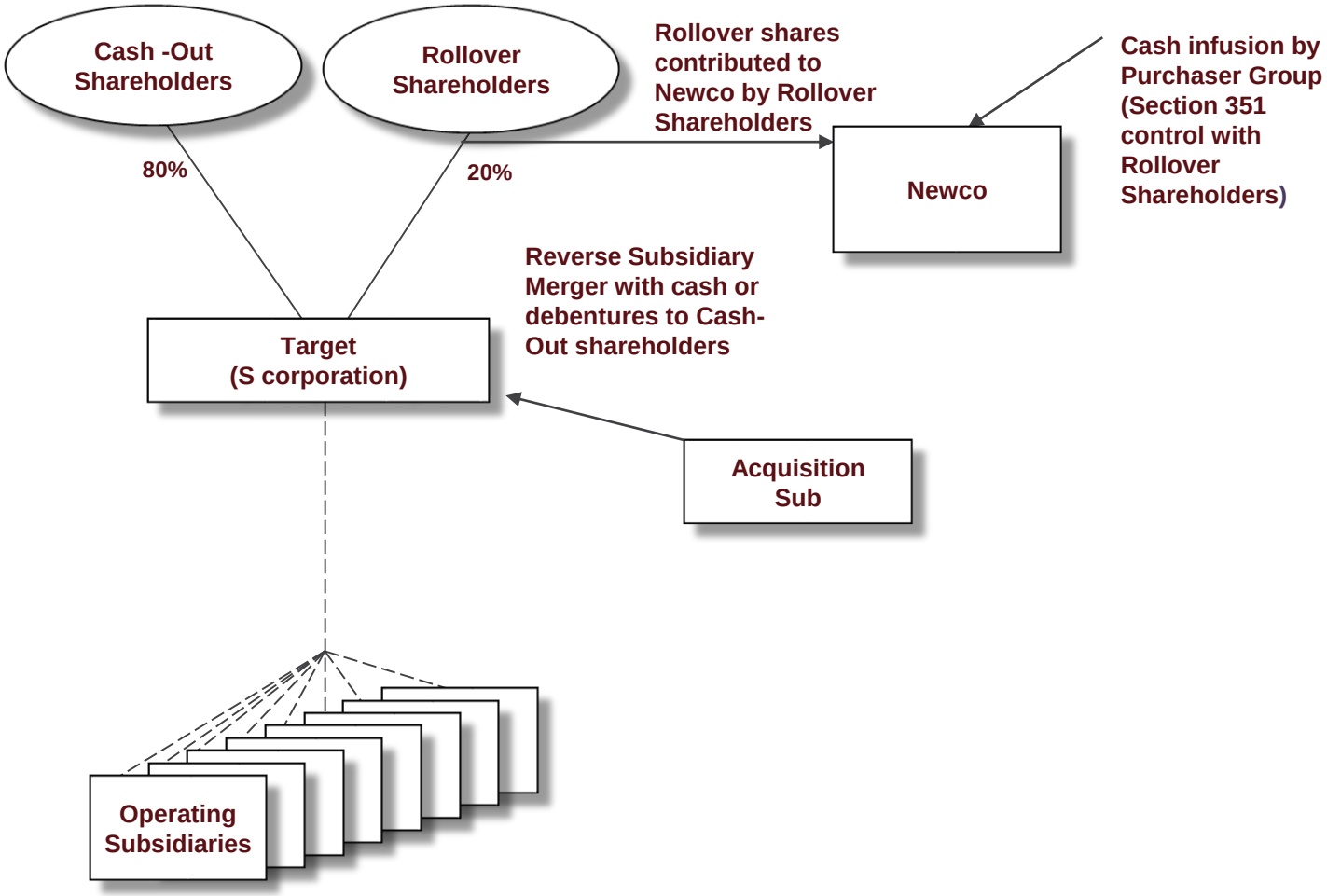
Attorneys at Law

Use of Section 351 to Structure Rollover into Acquiring Corporation – National Starch Structure



Capital Gain Deferral – Rollover to Qualified Opportunity Funds

The 2017 Tax Act allows for the temporary deferral of capital gains that are reinvested by a taxpayer in a qualified opportunity fund.

- A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property.
- Qualified opportunity zone property includes: any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property.
- The maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains.

Capital Gain Deferral – Rollover to Qualified Opportunity Funds

If the investment is held by the taxpayer for at least 5 years, the basis on the investment is increased by 10 percent of the deferred gain, for at least 7 years, the basis on the investment is increased by an additional 5 percent of the deferred gain. If the investment is held by the taxpayer until at least December 31, 2026, the basis in the investment increases by the remaining 85 percent of the deferred gain. In effect, Section 1400Z-1 excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years.

- Gains of all forms may qualify for reinvestment (short-term, long-term, ordinary, Section 1231).
- Property includes both physical (e.g. real estate) and financial property (e.g. stocks).
- Statute requires only the gain to be re-invested, not the total proceeds.
- Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

Capital Gain Deferral – Rollover to Qualified Opportunity Funds

The provision allows for the designation of certain low-income community population census tracts as qualified opportunity zones, where low-income communities are defined in Section 45D(e). The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation.

- Each population census tract in each U.S. possession that is a low-income community is deemed certified and designated as a qualified opportunity zone.
- There is no gain deferral available with respect to any sale or exchange made after December 31, 2026, and there is no exclusion available for investments in qualified opportunity zones made after December 31, 2026

Chamberlain Hrdlicka
Attorneys at Law

Jerald D. August

jaugust@chamberlainlaw.com

610.772.2330