TAX IMPACT

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Qualified Opportunity Zones

A powerful tax incentive for investors

Investors willing to make long-term investments in distressed communities now have a powerful tax incentive for doing so: the Qualified Opportunity Zone (QOZ) program, created by the Tax Cuts and Jobs Act (TCJA). The program allows investors who recognize capital gains to reinvest those gains in Qualified Opportunity Funds (QOFs) that, in turn, invest in one of nearly 9,000 designated QOZs throughout the United States and certain U.S. territories.

Investor uncertainty

After the TCJA was passed, investors were hesitant to create QOFs because of uncertainty about certain aspects of the program. In October 2018, however, the IRS issued proposed regulations — on which you can rely until final regulations come out — that provide welcome guidance on the subject. For the most part, the proposed regulations are quite taxpayer friendly.

Investor benefits include:

- Deferral of tax on the capital gain until the end of 2026 (or, if earlier, the date the QOF investment is disposed of),
- A permanent, 10% reduction in the amount of capital gain, if the QOF investment is held for at least five years, plus an additional 5% reduction (for a total of 15%) if it's held for at least seven years, and
- No tax on capital gains attributable to appreciation of the QOF investment itself, provided it's held for at least 10 years.

A QOF defined

The benefits described above aren't available for direct investments in QOZs. Rather, you must invest through a QOF — a corporation or partnership (including an LLC taxed as a partnership) dedicated to investing in QOZs. To qualify, at least 90% of a fund's assets must consist of "QOZ property." Virtually anyone can create and manage a QOF, ranging from individuals who establish single-investor funds to defer capital gains to sponsors of multi-investor funds.

QOZ property includes QOZ business property — tangible property that's used by a trade or business within a QOZ and meets certain requirements. It also includes equity interests in corporations or partnerships that qualify as QOZ stock or QOZ partnership interests. To qualify, the entity must meet several requirements, including a requirement that "substantially all" of its tangible property (defined by the proposed regs to mean 70%) is QOZ business property.

Investment options

It's important to recognize that you can't simply invest cash in a QOF and enjoy the tax benefits provided by the QOZ program. Rather, you must first recognize capital gain by selling or exchanging property and then essentially "roll over" some or all of the gain by reinvesting cash in a QOF within 180 days. You can use a QOF to defer gains from virtually any capital asset — real estate, publicly traded stock, business interests, even artwork and other collectibles.

> ***It's important to recognize that you can't simply invest cash in a QOF and enjoy the tax benefits provided by the QOZ program.***

Maximize the benefits

To make the most of the QOZ program, you should invest in a QOF by the end of 2019. Why? Because the capital gain you roll over is deferred, at most, to the end of 2026 — but to enjoy a permanent, 15% reduction in the amount of gain, you need to meet a seven-year holding period.

As noted above, there's a separate incentive that allows you to exclude from income 100% of the capital gain attributable to the appreciation of your investment in the fund, provided you meet a 10-year holding period.

There was some confusion about this benefit, because all QOZ designations are scheduled to expire at the end of 2028, and it was unclear whether the exclusion would be available if the holding period extended beyond that date. Fortunately, the proposed regulations allow investors to exclude these gains so long as they're recognized before the end of 2047. This is a potentially significant benefit for long-term investors. (See "Tax-free investment returns?" at right.)

Tax-free investment returns?

This example illustrates the potential benefits of investing in a Qualified Opportunity Fund (QOF).

On June 1, 2019, Alice sells her interest in ABC Co., realizing a $1 million capital gain. On August 1, 2019, she invests $1 million in XYZ Property Fund, a QOF that develops residential properties in a Qualified Opportunity Zone. Because she reinvests the gain within the 180-day window, she may defer the tax until the end of 2026 or, if earlier, the date she sells the investment. Alice sells her investment on August 1, 2026, for $1.5 million. Because she satisfies the seven-year holding period, she owes capital gains taxes on 1) 85% of her original $1 million gain ($850,000), and 2) her $500,000 gain on the sale of her interest in XYZ.

Suppose, instead, that Alice holds the investment for 10 years, selling it on August 1, 2029, for $2 million. She'll still owe capital gains tax on the $850,000 at the end of 2026, but her $1 million gain on the sale of her interest in XYZ will be tax-free.

Be sure to work with advisors who are familiar with the QOZ program. The proposed regulations contain detailed, complex rules on structuring and operating QOFs, identifying eligible QOZ investments, and other elements of the program.

Getting in the zone

If you plan to sell property that will generate substantial capital gain, consider taking advantage of the QOZ program by reinvesting the gain in a QOF. If you're willing to hold the investment for seven years or more, the tax benefits can be worth your while. ■

Matters of interest

When are interest payments deductible?

The Tax Cuts and Jobs Act (TCJA) has made a significant impact — both directly and indirectly — on the deductibility of interest expense. Here's a quick review of where things now stand.

5 types of interest

Interest expense generally falls within one of five categories:

1. Business interest,
2. Qualified residence interest,
3. Investment interest,
4. Qualified student loan interest, and
5. Personal interest.

Let's focus on the four categories of nonbusiness interest. (The TCJA places new limits on business interest deductions for businesses with average gross receipts over $25 million.)

Qualified residence interest

The TCJA affects interest on residential loans in two ways. First, by nearly doubling the standard deduction and placing a $10,000 cap on deductions of state and local taxes, the act substantially reduces the number of taxpayers who itemize. This means that fewer taxpayers will benefit from mortgage and home equity interest deductions. Second, the act places new limits on the amount of qualified residence interest you can deduct, from 2018 through 2025.

Previously, taxpayers could deduct interest on up to $1 million in acquisition indebtedness ($500,000 for married taxpayers filing separately) and up to $100,000 in home equity indebtedness ($50,000 for married taxpayers filing separately).

Acquisition indebtedness is debt that's incurred to acquire, build or substantially improve a qualified residence, and is secured by that residence. Home equity indebtedness is debt that's incurred for any other purpose (such as buying a boat or paying off credit cards), and is secured by a qualified residence. A single mortgage could be treated as both acquisition and home equity indebtedness, allowing taxpayers to deduct interest on debt up to $1.1 million.

The TCJA reduced the deduction limit for acquisition indebtedness to interest on up to $750,000 in debt and eliminated the deduction for home equity indebtedness altogether, through 2025. The new limit on acquisition indebtedness doesn't apply to debt incurred on or before December 15, 2017, subject to an exception for mortgages that were incurred on or before April 1, 2018, in certain circumstances — specifically, for debt incurred pursuant to a written binding contract to purchase a qualified residence executed before December 15, 2017, and scheduled to close before January 1, 2018 (so long as the purchase, as it turned out, was actually completed before April 1, 2018). And it doesn't apply to existing mortgages that are refinanced after December 15, 2017, provided the resulting debt doesn't exceed the refinanced debt.

The elimination of interest deductions for home equity indebtedness, however, applies to existing debt. So, if you were previously deducting interest on up to $100,000 of home equity debt, that interest is no longer deductible. The same holds true for the $100,000 home equity portion of

$1.1 million in mortgage debt. Note, however, that interest on a home equity loan used to substantially improve a qualified residence is deductible as acquisition indebtedness (subject to applicable limits).

Investment interest

Investment interest refers to interest on money used to purchase *taxable* investments (margin loans, for example). Like qualified residence interest, investment interest is an itemized deduction, which is lost if you no longer itemize.

> ***The TCJA preserves the deduction for up to $2,500 in qualified student loan interest.***

Deductions of investment interest cannot exceed your net investment income, which generally includes interest income and ordinary dividend income, but not lower-taxed capital gains, qualified dividends or tax-free investment earnings. For many people, net investment income is now higher because the TCJA eliminated miscellaneous itemized deductions for such expenses.

Qualified student loan interest

Thankfully, the TCJA preserves the deduction for up to $2,500 in qualified student loan interest. This deduction is particularly valuable, because it's an "above-the-line" deduction (that is, it's deducted in calculating adjusted gross income) rather than an itemized deduction.

For 2019, the deduction is gradually phased out beginning at $70,000 in modified adjusted gross income (MAGI) ($140,000 for joint filers) and eliminated when MAGI reaches $85,000 ($170,000 for joint filers).

Personal interest

As it was pre-TCJA, personal interest — also known as "consumer" interest — isn't deductible. Generally, personal interest is any interest other than 1) the types described above, 2) passive activity interest (such as interest related to rental properties), and 3) interest on deferred estate tax payments. Examples include interest on car loans or credit card debt.

Review your interest expenses

In light of the TCJA's changes, it's a good idea to review your interest expense and make changes, if appropriate, such as paying off home equity loans whose interest is no longer deductible. Contact your advisor for more information. ■

Getting your affairs in order when you're terminally ill

If you receive the diagnosis of a terminal illness, likely the last thing on your mind is estate planning. But taking the time now to get your affairs in order can provide you and your family some peace of mind.

What to do first

Here are some (but by no means all) of the steps you should take if you or a loved one has a short life expectancy:

Gather documents. Review all estate planning documents, including your will, living trust and health care power of attorney. Make sure these documents are up to date and continue to meet your estate planning objectives. Modify them as appropriate.

Take inventory. Catalog all your assets and liabilities, estimate their value, and determine how assets are titled to ensure that they'll pass to their intended recipients. For example, do you own assets jointly with your ex-spouse? If so, title will pass to your ex-spouse on your death. There may be steps you can take to separate your interest in the property and dispose of it as you see fit.

Catalog all your assets and liabilities, estimate their value, and determine how assets are titled to ensure that they'll pass to their intended recipients.

Review beneficiary designations. Take another look at beneficiary designations in your IRAs, pension plans, 401(k) plans and other retirement accounts, insurance policies, annuities, deferred compensation plans and other assets. Make sure a beneficiary is named and that the designation continues to meet your wishes.

Review digital assets. Ensure that your family or representatives will have access to digital assets, such as email accounts and online bank and brokerage accounts. You can do this by creating a list of usernames and passwords or by making arrangements with the custodians of these assets to provide access to your authorized representatives.

The next steps

Your estate planning advisor can help you through this difficult time. Working together, you can gain peace of mind that your family will be taken care of per your wishes. ■

Tax Tips

Exporters, does an IC-DISC still make sense?

In recent years, the interest-charge domestic international sales corporation (IC-DISC) has been a popular tax-reduction tool for exporters. Without going into detail, one of the IC-DISC's most powerful tax-saving tools is its ability to convert ordinary income into qualified dividends taxed at preferential rates. However, by lowering corporate and individual tax rates, and creating a 20% deduction for qualifying pass-through entities, the Tax Cuts and Jobs Act narrowed the differential between ordinary tax rates and qualified dividend rates, thus reducing the tax benefits of an IC-DISC. If you have an IC-DISC, now may be a good time to evaluate whether its compliance and maintenance costs justify the benefits. ■

Handle related-party transactions with care

Owners of related businesses must structure and document transactions between those businesses carefully or risk unwelcome tax consequences. One taxpayer learned this lesson the hard way in a recent U.S. Tax Court case. In that case, the owner of three S corporations used one company's funds to pay its sister companies' debts. Rather than document these transfers, the owner "treated legally separate corporations as one big wallet."

Absent documentation or other evidence that the transfers were loans, the court concluded that they were capital contributions. What's more, because the contributions benefited the owner by satisfying two of his other companies' debts, they were constructive dividends and, therefore, taxable income to the owner. The court also found that the payments constituted wages for which the owner owed employment taxes.

These tax consequences likely would have been avoided if the owner had planned and documented the transfers more carefully. As the Tax Court observed, "Taking money from one corporation and routing it to another will almost always trigger bad tax consequences unless done thoughtfully." ■

Watch out for S corporation stock in your trust

To qualify for the tax benefits of S corporation status, a company must satisfy several requirements, such as having one class of stock and no more than 100 shareholders. In addition, certain persons or entities are ineligible to be S corporation shareholders, including certain trusts.

If your estate plan includes one or more trusts that hold S corporation stock, be sure that they qualify as S corporation shareholders or else you'll risk losing S status. Eligible trusts include grantor trusts, provided they have only one "deemed owner" who's a U.S. citizen and meets certain other requirements; qualified subchapter S trusts (QSSTs) or electing small business trusts (ESBTs) that meet certain requirements; and testamentary trusts, provided they distribute the stock to an eligible shareholder within two years after receiving it or become QSSTs or ESBTs. ■

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