Deferring K-1 Capital Gains Through Investments in Opportunity Zones

This document is intended to provide information to help investors and their advisors understand aspects of the relevant regulations issued by the Treasury related to Opportunity Zone investing. Nothing contained in is this document should be considered legal or tax advice and investors should consult their legal and tax advisors before making any decision to defer capital gains or make an investment in Qualified Opportunity Zone Property or a Qualified Opportunity Zone Business.

Under the Tax Cuts and Jobs Act of 2017 (the "Act"), Congress provided a tax benefit for investors allowing them to defer capital gains through investments in Opportunity Zones. Most investors are aware of this benefit, including the exclusion of any gains realized on Opportunity Zone investments if held for 10 years.

With the deadline to make a deferral election with respect to capital gains passed through on K-1s quickly approaching, investors should understand the options and implications related to how the deferral of K-1 income works. The following discussion addresses some of these issues.

Deferral Deadline – June 28, 2019 – The law provides investors with 180-days to make the deferral election which is not equal to six-months. K-1 gain allocations are deemed to have been realized by an investor on December 31 so the 180-day period ends on June 28th. Many investors may be under the misconception that they have until June 30th which is not correct. The 180-days includes the date the gain was realized which, for K-1's, includes December 31, 2018. For investors to be fully protected, they should make the deferral election of K-1 gains no later than June 27th so that the proper paperwork can be filed within the 180-day timeframe.

No Linkage of Gains Funds to Investment – To fund the deferral of K-1 allocated gains, an investor does not need to use funds from the investment generating the gain. A deferral can be made for tax purposes with the funds capitalizing the Qualified Opportunity Fund ("QOF") coming from *any* source including funds that are borrowed on margin or under a loan agreement. This allows investors to maintain their investment in the fund generating the K-1 gains being deferred while simultaneously deferring the tax on those gains until 2026.

Investors can use Borrowed Funds – As noted above, an investor can borrow funds to create and capitalize a QOF. For certain investors, this capability can create additional tax benefits depending on the source of the borrowed funds. For General Partners of funds who receive allocated capital gains, the tax on these allocated gains can be deferred without the need for the General Partner executing a redemption from the fund. However, should the General Partner, or one of their underlying partners, members or employees who share in the GP's allocated income, look to collateralize a loan with their General Partner interest, a close review of the fund's operating agreements should be conducted to insure that hypothecation of the fund interest is allowed.

Specific identification of Gains Deferred – Investors can defer all or part of a realized gain or allocated gain appearing on a K-1. Should an investor generate long-term capital gains from the sale of portfolio securities, the corresponding tax on any portion of those long-term capital gains can be deferred. For investors receiving allocated gains on K-1s, the same holds true where all, or a portion of the tax attributable to allocated gains can be deferred.

The benefits of Opportunity Zone investing through the deferral of capital gains represents a significant tax planning opportunity for high net worth investors.

The following example reflects how the election to defer capital gains can reduce an investor's current tax liability. Assume, the investor generates $1.5 million in long-term capital gains from the sale of portfolio securities. The same investor receives three K-1s from partnership investments with allocated long-term capital gains and losses along with allocated short-term capital gains. In the following example, using the maximum marginal federal income tax rate, the investor would owe $740,000 in taxes for 2018. However, if the investor defers the $2 million of short-term capital gains and invests in Opportunity Zones, the investor would have no federal income tax liability in 2018, Instead, the investor's tax liability on the $2 million of short-term capital gains is deferred until December 31, 2026.

		No Deferral			**With Deferral**		
Stock Portfolio Sales		*Long-term*	*Short-term*		*Long-term*	*Short-term*	*Deferred Amount*
	Long-term capital gain	$ 1,500,000			$ 1,500,000		
Investment Partnership 1							
	Short-term capital gains	$ -	$ 750,000			$ -	$ 750,000
	Long-term capital gains	$(1,000,000)	$ -		$(1,000,000)		
Investment Partnership 2							
	Short-term capital gains	$ -	$ 500,000			$ -	$ 500,000
	Long-term capital gains	$ 500,000	$ -		$ 500,000		
Investment Partnership 3							
	Short-term capital gains	$ -	$ 750,000			$ -	$ 750,000
	Long-term capital gains	$(1,000,000)	$ -		$(1,000,000)	-	-
	Totals	$ -	$2,000,000		$ -	$ -	$2,000,000
	Federal tax	$ -	$ 740,000		$ -	$ -	$ -
		20%	*37%*		*20%*	*37%*	
	Total tax	**$ 740,000**			**$ -**		

For investors in high marginal tax rate states, electing to defer the tax liability attributable to allocated short-term capital gains while retaining allocated long-term capital losses to offset long-term gains could represent significant additional current tax savings.

Setting up a QOF – For investors who are interested in both reducing their current tax liability and investing in Opportunity Zones, setting up a QOF is relatively easy. JMP OppZone Services can establish a QOF for investors quickly using our unique approach. In addition, our QOF structure anticipates and manages for potential tax consequences over the long investment holding period required to exclude gains on Opportunity Zone investments upon liquidation of their QOF investment. Using a pre-designed structure reduces costs and decreases the time necessary to achieve the tax deferral of capital gains from the sale of an asset or allocated on a K-1.

Deferral versus non-Deferral – An investor making the decision to defer should consider their current tax position as well as their expected future resource requirements. Consideration of the potential tax benefits needs to be weighed against the investor's ability to lock up capital for more than 10 years in order to achieve the maximum tax benefits. For many investors, the commitment to a minimum 10-year hold will drive the decision and the amount, if any, of the deferral.

For investors who have already made an estimated tax payment for 2018 but have yet to file, creating a QOF before the deferral deadline extends the deferral through the October 15th filing deadline for taxpayers on extension with no interest or penalty. However, failing to make the deferral election in time eliminates any opportunity to defer the tax liability.

Options and Risks

The consequences of making a deferral election but ultimately failing to find suitable investments to deploy capital into Opportunity Zones would likely require the investor to pay the tax that would have been due if no deferral election was made plus late payment interest. At this point, it is difficult to anticipate how Treasury would view penalty assessments for investors who create a proper QOF and document their intention to deploy the capital in accordance with the law and corresponding regulations. It is incumbent on the investor to understand the risk of penalties so that they can assess the potential cost/benefit of making the deferral election only to dissolve the QOF should they be unable to find suitable Opportunity Zone investments.

As the implications of the statute and corresponding regulations related to investing in Opportunity Zones become clearer, investors are becoming more comfortable with pursuing these investments. Given the ability to assess and minimize the risk, if the investor believes investing in Opportunity Zones make sense, we advocate making the deferral election before the expiration of the 180-day deferral period. If, after further consideration, the investor decides not to pursue these investments, the QOF can be unwound with limited cost and consequence.

Summary – For investors with allocated K-1 gains who are considering gain deferral under the provisions of the Act and promulgated regulations, the decision to defer is rapidly approaching. However, there are opportunities to minimize the risk of making a deferral election that protects the investor's optionality while extending the timeline for an investor to consider the risks and identify appropriate Opportunity Zone investments.

At JMP, we offer solutions for investors who are looking to make deferral elections and invest in Opportunity Zones. Our primary goal is to create efficiency, transparency, and scalability for investors and sponsors looking to capitalize on the new law. Our unique shared services model provides a platform for investors to create multi-year investments, multi-asset portfolios and for sponsors to efficiently pool capital while simultaneously reducing operational and compliance risk. If you would like more information, please contact Sam Weiser at 312-375-8796 or send an e-mail with any questions to Info@jmpoppzoneserivices.com.

About JMP OppZone Services LLC – JMP OppZone Services ("JMP") assists investors interested in taking advantage of the tax deferral opportunities associated with Opportunity Zone investments. JMP also assists project sponsors in creating commingled vehicles to pool assets to fund investments in Opportunity Zone locations. JMP provides investors maximum flexibility to leverage the benefits of the law and corresponding regulations. We can assist with getting the clock started on the deferral and holding periods. Through our network of professionals, JMP assists with structuring and support services to form the QOF through an underlying investment in a Qualified Opportunity Zone Business ("QOZB") that provides the investor with time to evaluate, select and invest in appropriate Opportunity Zone investments.