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Potential Tax Benefits for Investments in Qualified Rural Opportunity Funds

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Among other benefits for multi-family investors, the Small Business Jobs Act provides enhanced capital gains tax savings for investments in qualified rural opportunity funds (QROF) by (i) a temporary deferral from the inclusion in gross income of capital gains reinvested in a QROF and (ii) the permanent exclusion of capital gains derived from the sale or exchange of an investment in a QROF. The Act, as currently drafted, allows qualifying investments to be made during the period beginning January 1, 2024 through December 31, 2032.

Qualified Rural Opportunity Fund

A QROF is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified rural opportunity zone property (QROZ Property) and holds at least 90 percent of its assets in QROZ Property. QROZ Property is rural property within a persistent poverty community population census tract that is designated as a “qualified rural opportunity zone.” The designation of a population census tract as a qualified rural 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 following such designation.

Deferral of Capital Gains

The Act provides for the temporary deferral of capital gains invested in a QROF (QROF Investment). To qualify, the QROF Investment must be made within 180 days of the date of the sale or exchange that generated the capital gains. The maximum amount of the deferred gain is equal to the QROF Investment. The

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deferred gain is recognized on the earlier of the date on which the QROF Investment is disposed of on December 31, 2032.

Exclusion of Capital Gains

Upon the sale or exchange of a QROF Investment, the investor is eligible for a permanent reduction of (i) ten percent (10%) if the QROF Investment was held for five (5) years or (ii) fifteen percent (15 %) if the QROF Investment was held for seven (7) years, in the amount of capital gain that must be recognized from such sale or exchange. The capital gains on a QROF Investment that is held for at least ten (10) years may be entirely excluded from gross income. In such event, upon the sale or exchange of the QROF Investment, the investor may make an election to modify the basis of the QROF Investment to be the fair market value of the QROF Investment at the date of such sale or exchange.

In the case of a QROF Investment, the exclusion provisions apply only to the investment of capital gains and does not apply to the investment of other amounts. Specifically, if an investor sells an asset (Prior Sale) and invests the proceeds from the Prior Sale in a QROF, the investor may only make an election for deferral or exclusion with respect to the capital gain portion of the proceeds of such Prior Sale. Therefore, upon the subsequent sale or exchange of a QROF Investment, the investor does not receive any special tax benefits with respect to capital gains on the portion of the QROF Investment that represented a return of basis from the Prior Sale.

Legislative Status of the Act

The Act was approved as HR 3937 during the 118th Congress (the Bill) by the United States House Committee on Ways and Means on June 13, 2023. The Bill is now eligible for consideration by the full House of Representatives and as of this writing, the status of the Bill remains unclear.

To become law, the Bill must be approved by the House, the Senate and signed into law by the President. Currently, govtrack.us estimates a 34% chance the Bill will become law.