GRIFFIN CAPITAL
guardians of wealth

The Power of Deferring Capital Gain Recognition

Ushered into the U.S. Internal Revenue Code, as part of the Tax Cuts and Jobs Act in 2017 with the creation of subchapters 1400z-1 and 1400z-2, the Qualified Opportunity Zone ("QOZ") legislation provides a host of meaningful tax benefits for investors with capital gains that allow for the thoughtful combination of tax, financial planning, and investment strategies. One of the central benefits is deferral of the recognition of any capital gain tax liability on any capital gain invested in a Qualified Opportunity Zone Fund ("QOF") until December 31, 2026. It is important to note that there is an Extension Act in Congress that, if passed, would extend the deferral period to December 31, 2028. While the most significant of the QOZ benefits is the ability to grow capital free of taxation as long as the QOF interest is held for at least 10 years, the deferral presents a host of interesting opportunities to potentially minimize tax liability with respect to the original capital gain through the implementation of thoughtful planning over the several tax periods that remain prior the end of the deferral period.

Tax Loss Harvesting to Reduce Deferred Gains in Tax Year 2026

Deferred gains will need to be recognized by QOZ investors in the 2026 tax year,[1] and the associated federal taxes for these capital gains will be due by April 15, 2027. Additionally, state tax liabilities may apply for investors residing in QOZ-conforming states, where such gains were previously deferred for state tax purposes.

Fortunately, the thoughtful recognition, accumulation, and utilization of capital losses can potentially offset some or all of the deferred gains recognized in the 2026 tax year, thereby reducing the need to pay all or part of the potential tax liability.

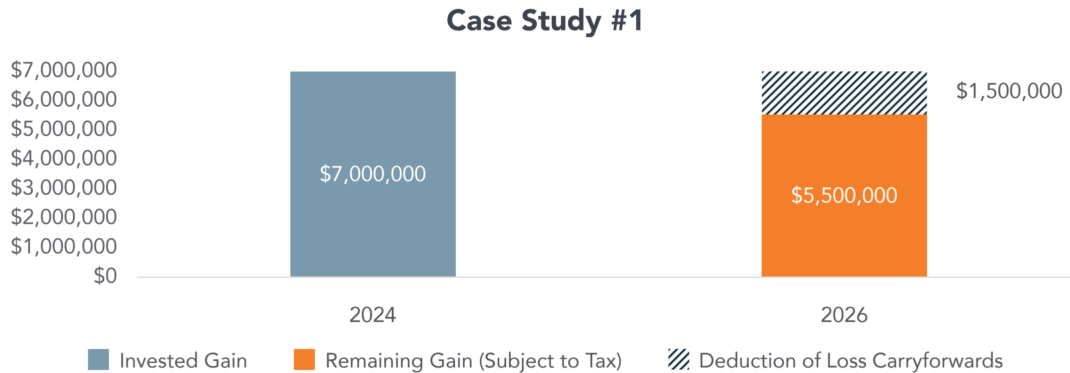
For individual taxpayers, capital losses are used in the following order:

1. Capital losses and capital loss carryforwards from prior years are first used to offset any capital gains incurred in the current tax year. Note that when determining eligible gain to invest in a QOF, losses do not need to be netted.
2. If the capital losses and capital loss carryforwards exceed capital gains, up to $3,000 of the excess capital losses can be used to offset any ordinary or portfolio income in the current year (e.g., interest income, dividend income, and wages).
3. If there are excess capital losses remaining, the unused capital losses can be carried forward to offset future capital gains. **Unused capital losses can be carried forward indefinitely until they are fully utilized.**

> ### Case Study #1
>
> John sells his Operating Business in 2024 for $10 million, triggering a $7 million long-term capital gain. John also has realized $500,000 in long-term capital losses from the direct indexing strategy he is utilizing in his liquid

1. There are exceptions for missed elections or an earlier inclusion event.

portfolio in 2024. John elects to invest all $7 million in a QOF. John has no other gains in his portfolio and carries his $500,000 loss forward. In 2025 and 2026, John is able to harvest an additional $1 million of losses from his core portfolio but does not have any realized capital gains in either tax period. In 2026, John must recognize the $7 million of capital gain he elected to defer by investing in the QOF. Because John has accumulated $1.5 million of loss carryforward, he can now use the entire $1.5 million to reduce the $7 million gain to $5.5 million.

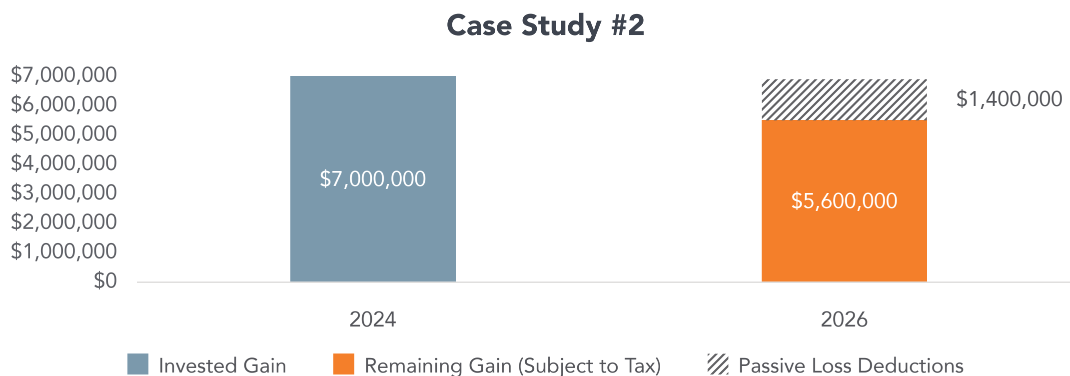


Using Passive Losses to Offset a Passive Gain

If a QOF is structured as a partnership for tax purposes, investors will be allocated their pro rata share of the fund's income and losses, including Section 1231 ("Passive") income and losses, which are attributable to real estate. For real estate development strategies, meaningful Passive losses are typically generated for much of the Fund's life due to depreciation deductions, which have no impact on the Fund's actual cash flows since they are non-cash deductions. Under the Tax Code, Passive losses can only be used to offset Passive income or gain. If Passive losses are not used to offset Passive income/gain in the year it was recognized, then those losses can be carried forward indefinitely until they are utilized. This means that an investor in a QOF that invested Passive gain can use Passive losses from his QOF investment to reduce his deferred gain when it becomes taxable on December 31, 2026.

Case Study #2

John is invested in a partnership and is allocated a Passive gain of $7 million. He invested the $7 million in a QOF in 2024. As of December 31, 2026, John has been allocated $1.4 million of Passive losses from the QOF. As a result, the amount of gain subject to tax at such time is only $5.6 million or 80% of his deferred gain.

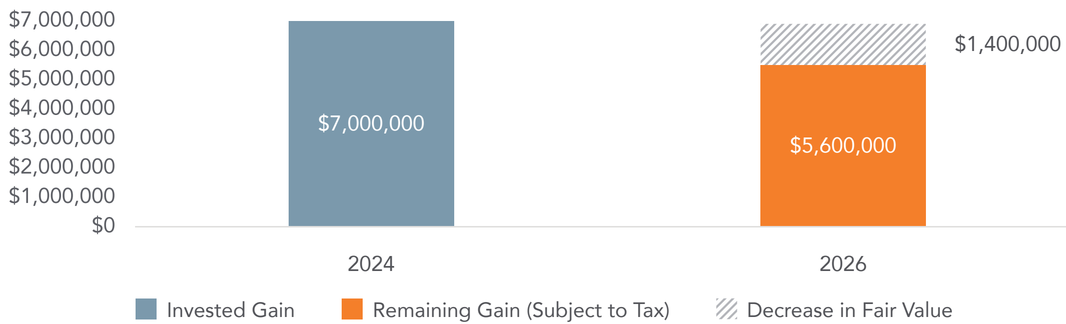


Impact of Changes in the Fair Value of the QOF on the Amount of Deferred Gain Subject to Tax in 2026

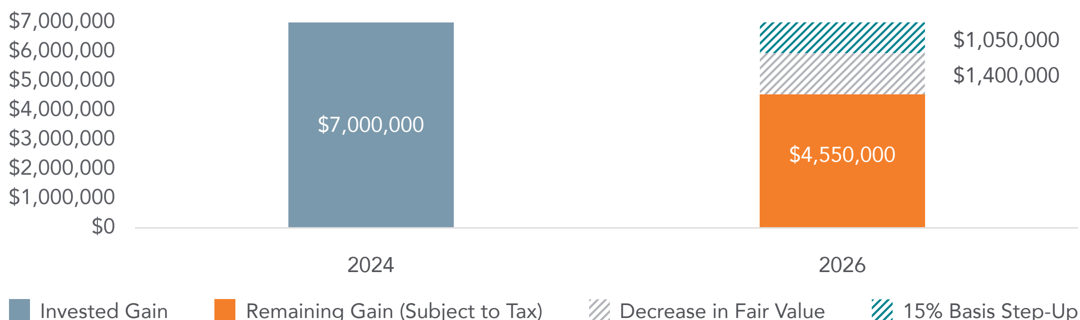
Generally, QOZ investors must recognize their deferred gains on their 2026 federal tax return. Under the Internal Revenue Code (the Tax Code 1400z-2(b)(2)(A)), the gain to be recognized will be (A) the lesser of the amount of gain excluded or the fair market value of the investment in the QOF, minus (B) the investor's basis in the QOF as of December 31, 2026, taking into account only IRC Section 1400z-2(b)(2)(B). Under Section 1400z-2(b)(2)(B), the investor's initial basis is zero but for purposes of determining the amount of deferred gain subject to tax, the basis may be increased by 10% or 15% if the investor holds their interest in the fund for at least five and seven years, respectively, before an inclusion event (which occurs on December 31, 2026, unless the investor disposes of their investment before that date).

Case Study #3

John sells his Operating Business in 2024 for $10 million, triggering a $7 million long-term capital gain. John invests in a QOF that is deploying capital over the 2024-2025 time period, and in 2026, the QOF holds a portfolio that represents a combination of assets in various stages of pre-development, development, and lease-up. Due to the J-Curve of the development process and the various stages of construction completion across the portfolio, the QOF reports John's investment value in 2026 at $5,600,000. Given that the 2026 value of $5,600,000 is less than the $7,000,000 initial investment, tax on the deferred gain invested in the QOF would be due on the $5,600,000 value, not the $7,000,000. As a result, John only pays tax on 80% of the gain invested in the Fund.



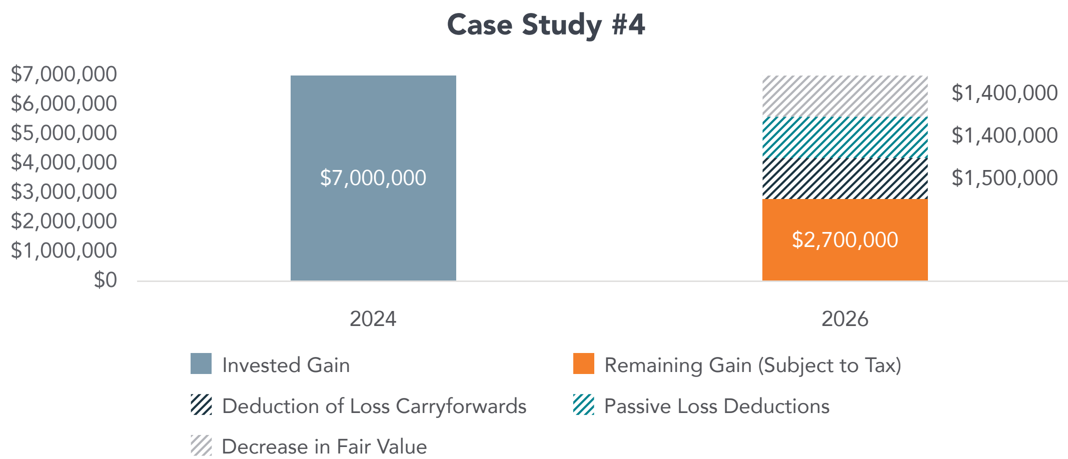
If John had invested in the QOF on or before December 31, 2019, he would qualify for a 15% step-up in basis on the deferred gain he invested in the Fund. This 15% equates to $1.05 million, which would then be deducted from the fair value of the investment as of December 31, 2026. As a result, John would pay capital gains tax on only $4.55 million ($5.6 million less $1.05 million) or 65% of the gain he invested in the Fund.



Maximizing the Power of Deferral

Case Study #4

While these tax minimization concepts are powerful, the combination of such strategies can be even more impactful. Take, for example, John's situation. John has a $7 million Passive gain from a partnership that he invested in the QOF in 2024, deferring recognition of the gain until the end of 2026. Because of the J-Curve of the QOF strategy in which John invested, the sponsor reports a value of John's investment in 2026 at $5,600,000. Further, John was allocated $1.4 million in Passive losses from the QOZ and was able to accumulate $1.5 million of loss carryforward from other sources over the 2024, 2025, and 2026 tax periods. As a result, the amount of gain subject to tax at the end of 2026 will be equal to the $5.6 million fair value of his QOF investment, less $1.4 million of Passive losses less $1.5 million of other loss carryforwards, resulting in John only having paying tax on $2.7 million of gain. Therefore, John has not only pushed out his tax liability for three tax periods but will also only have to pay tax on 38.6% of his original gain.



Summary

QOZs offer investors with capital gains a variety of tax benefits, including deferral of capital gains recognition, elimination of capital gains on the growth of the QOF investment if held for at least 10 years, and the potential to generate very tax-efficient income. For savvy investors and the professionals that serve them, combining these incredibly unique benefits with thoughtful tax and financial planning strategies like those outlined herein can be a differentiating and powerful strategy that helps investors to keep more of their hard-earned capital.

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This information should not be construed as tax advice or a guarantee of the performance of any QOF investment. Actual results may differ materially. In addition, certain exceptions may apply. Investors should consult with their own tax advisors to determine their individual benefits in a QOF investment.

THIS IS NEITHER AN OFFER TO SELL NOR A SOLICITATION OF AN OFFER TO BUY ANY SECURITIES. AN OFFERING IS MADE ONLY BY A PRIVATE PLACEMENT MEMORANDUM. THIS LITERATURE MUST BE READ IN CONJUNCTION WITH A PRIVATE PLACEMENT MEMORANDUM IN ORDER TO UNDERSTAND FULLY ALL OF THE IMPLICATIONS AND RISKS OF SECURITIES TO WHICH IT MAY RELATE. A COPY OF A PRIVATE PLACEMENT MEMORANDUM MUST BE MADE AVAILABLE TO YOU IN CONNECTION WITH AN OFFERING. THIS MATERIAL DOES NOT CONSTITUTE TAX ADVICE TO ANY PERSON. A PERSON MUST CONSULT WITH HIS OR HER OWN TAX ADVISORS REGARDING THE TAX CONSEQUENCES TO THEM OF ACQUIRING AND OWNING AN INVESTMENT IN MULTIFAMILY PROPERTIES.

Not all investors are suitable or qualify to invest into a QOF. You should always read the offering memorandum of any QOF and consult with your financial professional before investing into a QOF.

IMPORTANT RISK FACTORS

An investment in a Qualified Opportunity Zone Fund is not suitable for all investors and is subject to various risks, including but not limited to:

- No public market currently exists, and one may never exist, for the interests of any Qualified Opportunity Zone Fund. Qualified Opportunity Zone Funds are not liquid.
- Qualified Opportunity Zone Funds offer and sell interests pursuant to exemptions from the registration provisions of federal and state law and, accordingly, those interests are subject to restrictions on transfer.
- There is no guarantee that the investment and tax objectives of any particular Qualified Opportunity Zone Fund will be achieved.
- Investments in real estate are subject to varying degrees of risk, including, among other things, local conditions such as an oversupply of space or reduced demand for properties, an inability to collect rent, vacancies, inflation and other increases in operating costs, adverse changes in laws and regulations applicable to owners of real estate and changing market demographics.
- The actual amount and timing of distributions paid by a Qualified Opportunity Zone Fund is not guaranteed and may vary. There is no guarantee that investors will receive distributions or a return of their capital.
- Qualified Opportunity Zone Funds depend on tenants for their revenue and may suffer adverse consequences as a result of any financial difficulties, bankruptcy or insolvency of their tenants.
- Disruptions in the financial markets and challenging economic conditions, including as a result of a pandemic such as the outbreak of COVID-19, could adversely affect a Qualified Opportunity Zone Fund.
- Investing in a QOF is considered speculative involving substantial risks. Federal and State regulations to real estate, investment portfolios, and investors are subject to change at any time. There are a number of criteria that must be met for the investor to receive a benefit. Read a fund's private offering memorandum fully, and understand the risks involved.
- An investment in a Qualified Opportunity Zone Fund is highly speculative.

Before purchasing interests, prospective investors should review a fund's offering memorandum, as may be supplemented from time to time, for a more complete description of the risks and other disclosure related to participating in the offering.

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