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Zoning In: New Tax Benefits of Investing in Opportunity Zones

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Overview

If you're a taxpayer who recently realized a short-term or long-term capital gain, you may be looking for ways to avoid recognizing that capital gain and the associated tax bill. Thanks to a new tax incentive program, a taxpayer who has realized capital gains may have the opportunity to invest qualifying capital gains[1] in certain qualifying investments and (i) defer the recognition of such capital gains until December 31, 2026, (ii) reduce the amount of the capital gains required to be recognized by up to 15%, and (iii) entirely avoid paying any capital gains tax on any additional capital gains realized from such an investment. This article summarizes this new incentive, more commonly known as the opportunity zone tax incentive.

Legislation

The Tax Cuts and Jobs Act (the "Act") was signed into law on December 22, 2017. The Act is an extensive piece of tax legislation that includes new incentives designed to direct capital investments to qualified opportunity zones[2] through favorable tax treatment (the "Opportunity Zone Tax Incentive"). The Opportunity Zone Tax Incentive encourages investments in qualified opportunity zones by offering taxpayers an opportunity to defer, reduce and even avoid recognition of capital gains related to certain investments in qualified opportunity zones.

Deferred Recognition of Capital Gains

A taxpayer may elect to defer paying tax on capital gains (both long-term capital gains and short-term capital gains) from the sale or exchange of property by investing the capital gains in a qualified opportunity fund ("QO Fund") within 180 days of the taxpayer realizing the capital gains.

A QO Fund is a corporation, partnership, or multi-member limited liability company that invests at least 90% of its assets in qualified opportunity zone property, which consists of (i) equity interests in qualified

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[1] The capital gain must not arise from a sale or exchange with a related person as defined in section 1400Z-2(e)(2) of the Internal Revenue Code.

[2] Opportunity Zones are economically-distressed communities located throughout the United States where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Secretary of the U.S. Treasury via his delegation of authority to the Internal Revenue Service.

opportunity zone businesses[3] or (ii) qualified opportunity zone business property[4], which may include real estate located in a qualified opportunity zone, land that is located in a qualified opportunity zone and substantially improved by a QO fund or qualified opportunity zone business, or equipment used in a trade or business of a qualified opportunity zone business.

The taxpayer's deferral period ends the earlier of (i) the date the taxpayer sells or disposes of its equity interest in the QO Fund, (ii) the date the capital gains are no longer invested in a qualifying QO Fund, or (iii) December 31, 2026, at which time the taxpayer must recognize the capital gains, subject to the applicable reductions described below.

Reduction of Capital Gains

In addition to deferred recognition of capital gains, the Opportunity Zone Tax Incentive also provides for a potential reduction in the amount of capital gains that must be recognized by the taxpayer. This reduction is based on how long the qualifying capital gains remain invested in a QO Fund. The Opportunity Zone Tax Incentive provides that a taxpayer's initial tax basis in the QO Fund investment is zero. If a taxpayer remains invested in a QO Fund for five years, the taxpayer's tax basis in the QO Fund investment is increased by 10% of the amount of the deferred capital gains. If the taxpayer remains invested in a QO Fund for seven years, the taxpayer's tax basis in the QO Fund investment is increased an additional 5% of the amount of the deferred capital gains. By investing in a QO Fund, and complying with the provisions of the Opportunity Zone Tax Incentive, a taxpayer could potentially defer recognition of capital gains until December 31, 2026 and could receive up to a 15% reduction in the amount of capital gains required to be recognized on such date.

Avoidance of Capital Gains

In addition to deferred recognition of capital gains, and a potential 15% reduction in the amount of capital gains the taxpayer is required to recognize, the Opportunity Zone Tax Incentive also provides a substantial benefit to those taxpayers who invest their qualifying capital gains in a QO Fund for at least 10 years. Such taxpayers may elect to increase the taxpayer's tax basis in its QO Fund investment to the fair market value of the QO Fund investment on the date the taxpayer sells or exchanges its QO Fund investment. The taxpayer may make this election any time prior to December 31, 2047. This step-up basis election could lead to substantial tax savings for a taxpayer. As long as a taxpayer (i) invests its

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[3] A qualified opportunity zone business is a trade or business in which:

- 70% of its tangible property, owned or leased, is qualified opportunity zone business property;
- At least 50% of its total gross income is derived from the active conduct of its business;
- A substantial portion of its intangible property is used in the active conduct of its business; and
- Less than five percent of the average of its aggregate unadjusted bases of the property is attributable to nonqualified financial property.

Additionally, the following businesses do not qualify as qualified opportunity zone businesses: (i) any private or commercial golf course, (ii) country club, (iii) massage parlor, (iv) hot tub facility, (v) suntan facility, (vi) racetrack or other facility used for gambling, or (vii) any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

[4] Tangible property used in the trade or business of a qualified opportunity zone business if the original use of the property commences with the QO Fund or the QO Fund "substantially improves" the property, and the property is acquired by purchase after December 31, 2017.

qualifying capital gains in a QO Fund investment for a minimum of 10 years and (ii) sells or exchanges its QO Fund investment prior to December 31, 2047, the taxpayer will recognize no taxable gain on the sale of the QO Fund investment.

Illustrative Example

To illustrate the benefits of the Opportunity Zone Tax Incentive, assume that a taxpayer realizes $1 million in qualifying short-term capital gains on January 1, 2019 and further assume that the taxpayer is subject to a 32% short-term capital gains tax rate and a 15% long-term capital gains tax rate.

On January 1, 2019 the taxpayer invests its $1 million capital gain in a QO Fund that invests in an apartment building that qualifies as qualified opportunity zone property. The taxpayer’s basis in its QO Fund investment on January 1, 2019 is zero. As long as the capital gains remain invested in the QO Fund, the taxpayer will be able to defer recognition of the capital gains until December 31, 2026. On December 31, 2026 the taxpayer will be required to recognize the capital gains. However, because the capital gains have remained invested in the QO Fund for more than seven years, the taxpayer now has a tax basis in the QO Fund investment equal to $150,000 (15% of the amount of the invested capital gains). The taxpayer will only be required to recognize $850,000 of its capital gains. In addition to the advantages of deferring the tax liability arising from the capital gains until December 31, 2026, the 15% increase in basis results in a tax savings of $48,000. After 10 years, the QO Fund liquidates its investment in the apartment building for $2.5 million and distributes the proceeds to the taxpayer. The taxpayer elects to step up its tax basis in the QO Fund investment to the fair market value of the QO Fund investment. As a result, the taxpayer will not be required to recognize any capital gains on the $1.5 million increase in the value of the taxpayer’s initial $1 million investment, which results in a tax savings of $225,000.

Conclusion

Proposed regulations regarding the Opportunity Zone Tax Incentive (the “Proposed Regulations”) were released by the Treasury Department and Internal Revenue Service on October 19, 2018. While the Proposed Regulations do provide some clarification and guidance on important aspects of the Opportunity Zone Tax Incentive, the Opportunity Zone Tax Incentive remains a very new incentive program with limited regulatory and statutory guidance. Given that the Opportunity Zone Tax Incentive is in its infancy, there is no consensus among business owners, developers, or practitioners as to how the Opportunity Zone Tax Incentive can best be implemented as part of traditional deal structures. Despite the uncertainties that surround certain details of the Opportunity Zone Tax Incentive, the Opportunity Zone Tax Incentive still offers taxpayers a valuable opportunity to defer, reduce, and even avoid recognition of capital gains related to certain investments in qualified opportunity zones.

This article is for educational purposes only and is not intended to give, and should not be relied upon for, legal advice in any particular circumstance or fact situation. No action should be taken in reliance upon the information contained in this article without obtaining the advice of an attorney.

For more information about the Opportunity Zone Tax Incentive, please contact Jonathan Jenkins, Jimmy Haynes, or Andrew Steffensen.