OPPORTUNITY KNOCKS

How You and Your Client Can Take Advantage of Opportunity Zones

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Buzz has been building in the investment and economic development communities about the new Opportunity Zones Program made law as part of the tax reform package at the end of 2017. The program's goal is to incentivize investment in distressed census tracts in communities around the country. However, since the program's creation, the federal government has been slow to introduce regulations, which has caused many to hold off on investing in an Opportunity Zone. Despite the slow adoption of rules, the potential tax savings through the next 10 years – and beyond – has created a tremendous amount of interest in the program – not just in the real estate investment community.

WHAT ARE OPPORTUNITY ZONES?

The Opportunity Zones Program was established in the Tax Cuts and Jobs Act of 2017 as a way to transform economically distressed rural and urban communities through development investment. Specific areas are designated (using the same standards as those for New Market Tax Credits) as certified census tracts by the U.S. Department of Treasury. States nominated up to 25 percent of their qualified census tracts based on a range of factors, including likelihood of attracting short- and long-term investment.

There are 8,764 certified opportunity zones, which include all 50 states, the District of Columbia, and Puerto Rico.

However, investors cannot just buy land or a building in an Opportunity Zone and receive the tax benefits. Investors must reinvest capital gains within 180 days of the gain realization event through a Qualified Opportunity Fund (QOF). The QOF is the investment vehicle, which is organized as either a corporation (both S- and C-corporations) or partnership (including limited liability companies, but not sin-

gle-member) for the purpose of investing in an Opportunity Zone. The QOF must hold at least 90 percent of its assets in Qualified Opportunity Zone (QOZ) property, which is a business property, stock or partnership interest.

The proposed regulations from the Internal Revenue Service issued Oct. 19, 2018, are almost exclusively geared toward real estate development (as opposed to operating businesses). This is primarily because the QOZ property needs to remain in the zone to receive the tax benefits.

The White House sees the importance of this program for breathing new life into economically distressed areas. President Trump signed an executive order Dec. 12, 2018, which established the White House Opportunity and Revitalization Council and directed federal agencies to prioritize funding (which includes loan guarantees, grant funding, infrastructure spending, and crime prevention funding) for Opportunity Zones.

ATTRACTIVE TAX ADVANTAGES

Both the Treasury Department and IRS issued proposed guidance in 2018 detailing how investments will be taxed and how other program elements will function. The proposed regulations clarify what gains qualify for deferral, the parameters for Opportunity Funds, which taxpayers and investments are eligible, and other guidance.

In announcing the proposed regulations, Treasury Secretary Steven Mnuchin estimated the program will lead to $100 billion in private capital invested in Opportunity Zone areas. How will the program attract enough investors and dollars to make this a reality? Through attractive tax advantages.

The Opportunity Zone Program provides three tax benefits when investing in a QOF – temporary deferral, partial exclusion, and permanent exclusion.

- Temporary deferral (for pre-investment gains) – Capital gains reinvested in a QOF will not be taxed until 2026, or when the investment is disposed of, whichever date comes first.
- Partial exclusion (for pre-investment gains) – An investor who keeps the reinvested capital gains in the QOF for five years can exclude 10 percent from taxation and can exclude 15 percent for a holding period of seven years.
- Permanent exclusion (for gains derived from QOF investment) – If the investor holds the investment in the QOF for at least 10 years, then the investor is eligible for an increase in basis of the QOF investment equal to its fair market value on the date that the QOF investment is sold or exchanged (meaning any gains the investor accrues, after the investment in the QOF, are permanently excluded after 10 years).

QOF INVESTMENT EXAMPLE

For example, if an investor sold land for $500,000 (held for more than 12 months with a tax basis of $100,000), then the investor would normally pay 23.8 percent (assuming a 20 percent long-term capital gains tax and 3.8 percent net investment income tax) in federal income tax, leaving $304,800 (before state taxes).

If the investor deploys the capital gains in a QOF within 180 days of the sale of the land, holds the QOF investment for 10 years, and then sells it for $2 million, the following will occur:

1. Temporary deferral of the $400,000 (pre-investment gain);
2. Partial exclusion of 15 percent on the pre-investment gain (pay long-term capital gains tax on $340,000); and
3. Permanent exclusion of $1.6 million (gain derived from QOF investment).

The partial exclusion of the pre-investment gain leads to a savings of $14,280 ($80,920 as opposed to $95,200 when the land was sold.) The exclusion for gain derived from the QOF investment leads to a savings of $380,800 (based on 23.8 percent rate) for a total savings of $395,080.

The program structure encourages long-term investing, so those who stick with a QOF investment for at least 10 years will receive the most financial benefit. The Opportunity Zones keep their designation for just 10 years, but under the proposed regulations, investors can keep their investments in a QOF through 2047 without losing tax benefits.

LURING INVESTMENT DOLLARS

States and municipalities are eager to capture the capital that could be infused in their communities as a result of this program. They have set up websites with information about how the Opportunity Zone Program works, seeking to lure investment dollars to their struggling areas. For example, a group of public and private entities created an online deal portal — called the Opportunity Investment Consortium of Indiana — for Opportunity Zone investment projects in Indiana.

Large institutions are also establishing QOFs. Goldman Sachs, Washington, D.C.-based Fundrise, and hedge fund firm EJF Capital have announced the creation of QOFs. PNC Bank has also created a QOF and will be investing gains owned by the bank into it.

The proposed regulations released in October 2018 are just the beginning of clarity on the Opportunity Zones Program. Comments on those regulations were due by Dec. 28, 2018, and the final rule should be issued in the coming months.

NEXT STEPS

Investors and their counsel should consider these factors when evaluating a potential Opportunity Zone investment:

1. Realized eligible capital gains must be reinvested by Dec. 31, 2019 to maximize the partial exclusion benefit (15 percent for pre-investment gains).
2. There are no special requirements for how the initial capital gains are utilized prior to making the QOF investment.
3. Although the long-term capital gains tax will be deferred, it will be due when the investor exits the QOF investment, so the investor should consider holding back some portion of their initial realized gains.

Once the federal government releases its final rule for the Opportunity Zones Program, more investors may be comfortable participating in the program. Those who invest in a QOF long-term could see substantial tax savings as well as positive growth in an economically distressed community. If you are interested in investing in a QOF, consult with your attorney and/or tax professional to determine what fund may be the right fit for your objectives.

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