Why 2019 Will Be the Year of Opportunity (Zones)

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One of the more significant additions to the Tax Code under the 2017 Tax Cuts and Jobs Act was the creation of an incentive program for investment in certain low income communities called “Opportunity Zones.” The program is designed to spur economic investment in distressed areas by allowing investors to defer taxation on capital gains when investing the gains in a “Qualified Opportunity Fund” (“QOF”). Tax on the reinvested gains will be deferred until December 31, 2026 (or earlier if the QOF investment is sold before then), and the program builds in additional breaks for investments held for 5, 7 and 10 years. To take full advantage of the program, taxpayers looking to defer capital gains by investing in a QOF should do so before December 31, 2019.

The Treasury Department and IRS recently released proposed regulations and other guidance related to the program, and are expected to issue additional guidance and final regulations by the end of 2018. With many QOF sponsors awaiting final guidance before opening funds for investment, investors will have a one-year window in 2019 to take full advantage of the Opportunity Zone program.

Below is a summary of the provisions of the Opportunity Zone program, both as it relates to investors looking to defer capital gains and the structuring of Qualified Opportunity Funds.

Tax Deferral for Opportunity Zone Investments

The Opportunity Zone program provides two distinct tax advantages. The first is the temporary deferral of capital gains tax from the sale of property held by a taxpayer to an unrelated party, if the taxpayer reinvests the capital gain in a Qualified Opportunity Fund within 180 days of the sale. Unlike a like-kind exchange under § 1031 of the Code, taxpayers may reinvest capital gains from the sale of any type of asset in a QOF, and taxpayers are not required to “park” the gain with a qualified intermediary until reinvested. To defer the gain, the taxpayer makes an election on the tax return for the year in which the gain would otherwise have been recognized by attaching a Form 8949 to the return. A draft of this form is available on the IRS website here: [Draft Form 8949]. There is no dollar limit on the amount of gain that can be deferred.

For example, assume Taxpayer A sells stock and realizes a gain of $1 million on February 1, 2019, and on June 1, 2019 (within 180 days of the date of sale), A invests $1 million in a QOF. If A makes a temporary deferral election when she files her 2019 tax return, she is not required to include the $1 million of realized gain in her gross income for 2019.

The deferred gain is included in gross income on the earlier of the date on which the QOF investment is sold or December 31, 2026. If the QOF investment is held for 5 years, the basis in the investment is increased by 10 percent of the amount of gain deferred. If held for 7 years, the investment’s basis is increased another 5 percent, to 15 percent of the deferred gain. Because only the gain portion of the property sale proceeds is required to be reinvested, a QOF investment will start with a basis of zero. So, if Taxpayer A in the example above holds her investment in the QOF until December 31, 2026, she will recognize a gain of $850,000 ($1 million initial deferred gain, less a basis of $150,000, or 15 percent of the deferred gain). If a QOF has depreciated in value to less than the amount of the deferred gain as of the date it is sold or on December 31, 2026, the taxpayer is only required to recognize gain up to the value of the investment at that time.

In order to take advantage of the full 7-year, 15 percent basis step-up prior to recognizing the deferred gain on December 31, 2026, taxpayers will need to invest in a QOF before December 31, 2019. In addition to losing the basis step-up, the longer a taxpayer waits to defer capital gain, the shorter the period of deferral due to the hard 2026 deadline.

The other primary tax advantage under the Opportunity Zone program is that, if the taxpayer holds its QOF investment for at least 10 years, the gain attributable to the appreciation of the QOF investment is permanently excluded from gross income. More specifically, if held for at least 10 years, the basis of a QOF investment is stepped up to the fair market value of the investment as of the date it is sold. Because a taxpayer will have recognized at least 85% of the temporarily deferred and reinvested gain on December 31, 2026, prior to being eligible for the full step up in basis, this step up only eliminates gain on the appreciation in value of the QOF investment.

The proposed regulations released in October clarify a number of issues regarding the gain deferral for QOF investors, including the following:

- Eligible taxpayers Almost all types of taxpayers - including individuals, C and S corporations, partnerships, trusts, estates, RICs, and REITs - are eligible to participate in the Opportunity Zone program.
- Eligible Gain Both short and long-term capital gains are eligible for deferral. However, neither ordinary income nor depreciation recapture are eligible.
- QOF Investment may be Pledged as Collateral Deferred gain must be invested as an equity interest in the QOF, including preferred stock or a partnership interest with special allocations, and cannot be a debt instrument. However, an eligible equity interest may be pledged as collateral for a loan, whether a purchase-money borrowing or otherwise. In other words, a taxpayer may elect to defer capital gain, but borrow the funds for reinvestment in a QOF so long as the QOF investment is pledged as collateral.
- Additional Reinvestment If an investor sells its interest in a QOF before December 31, 2026, it may reinvest in another QOF within 180 days of the sale and continue to defer the built-in gain in the investment.
- Gains of Pass-Through Entities A partnership itself may elect to defer gain and reinvest in a QOF, or it may distribute eligible gain to its partners who may independently elect to reinvest their distributive share. A partner's 180-day period generally begins on the last day of the partnership's tax year, because that is the day on which the partner would be required to recognize the gain if the gain is not deferred. However, the proposed regulations provide an alternative for situations in which the partner knows (or receives information) of both the date of the partnership's gain and the partnership's decision not to elect deferral. In that case, the partner may choose to begin its own 180-day period on the same date as the start of the partnership's 180-day period. Analogous rules also apply for other pass-through entities, such as S Corporations, trusts and estates, and their shareholders or beneficiaries.

Qualified Opportunity Funds

A Qualified Opportunity Fund is any investment entity organized as a corporation or a partnership for the purpose of investing in “Qualified Opportunity Zone Property” (defined below), and that holds at least 90% of its assets in QOZ Property, measured twice each tax year. An eligible entity “self-certifies” as a QOF by filing Form 8996 and designating the tax year and month it becomes a QOF.

QOZ Property includes business property as well as stock or partnership interests in a business in which substantially all of the tangible property owned or leased by the business is QOZ business property. QOZ business property means tangible property used in a trade or business of the taxpayer which (i) was acquired by the QOF by purchase after December 31, 2017; (ii) the original use of the property in the QOZ commences with the QOF or the QOF substantially improves the property; and (iii) during the QOF's holding period for the property, substantially all of the use of the property was in a QOZ. The proposed regulations provide that "substantially all" for this purpose means that 70 percent of the property must be located within a QOZ. There are many other technical rules for qualification as a QOF and QOZ property, and some are still subject to further clarification and guidance.

The Treasury's Community Development Financial Institutions (CDFI) Fund has worked with state legislatures and governors to designate Opportunity Zones throughout the country based on poverty rates determined during the most recent census. A map of the Opportunity Zones can be found on the CDFI Fund's website here: Opportunity Zone Map. There are many Opportunity Zones throughout Arkansas, including within many of the state's largest cities, including Little Rock, North Little Rock, Fayetteville, Springdale, Jonesboro, Pine Bluff and many others.

If you or your clients are interested in taking advantage of the Opportunity Zone program, whether as a taxpayer deferring capital gain, or as a QOF sponsor, now is the time. Due to the hard deadline for deferral set for the end of 2026, and a 7 year holding requirement to get a full 15 percent basis step up, calendar year 2019 will certainly be the best time to take advantage of Opportunity Zones.