Spring, 2019

Opportunity Zone Investments
Provide Potentially Attractive Tax Benefits

The Tax Cuts and Jobs Act, enacted in December 2017, includes a new temporary tax incentive intended to encourage investment in low income areas of the United States that are designated as "qualified opportunity zones" (QOZ).

To be eligible for the tax incentive, a taxpayer must:

- incur a capital gain on the sale or exchange of property to an unrelated person, and
- invest all or a portion of the realized gain in a "qualified opportunity fund" (QOF), generally within 180 days after the sale or exchange.

There are several potential tax benefits associated with QOF investments:

- tax on the gain may be deferred until the QOF is sold (or until 2026, if earlier); [1]
- 10% of the deferred gain is permanently excluded if the QOF is held for at least for at least 5 years;
- 15% (10% + 5%) of the deferred gain is permanently excluded if the QOF is held for at least 7 years; and
- tax on the appreciation of the QOF is permanently excluded if the QOF is held for at least 10 years.

These rules are most readily understood through a simple example. Assume that Ed purchased stock in VIP Corp. years ago for $1.5 million. Ed sells all of his VIP stock in February 2019 for $2.5 million cash, realizing a capital gain of $1 million. Ed invests the $1 million in a QOF within 180 days of selling the VIP stock. Ed has use of the $1.5 million recovery of basis immediately while deferring tax on the $1 million that he invests in the QOF. Assume under all circumstances that Ed sells the QOF investment for $4 million. Depending on when Ed sells the QOF, he derives some or all of the tax benefits described above.

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1 If the fund is not sold by December 31, 2026, the taxpayer must include the deferred gain in 2026 income. Therefore, one potential drawback of the program can be tax without cash, also known as "dry income" or "phantom income."

Ed sells QOF in:	Recognized gain:	Tax benefit:
March 2023 (QOF held < 5 years)	$4 million in 2023	Deferral of tax on $4 million gain
March 2024 (QOF held ≥ 5 years but < 7 years)	$3.9 million in 2024 $4,000,000 <u>less</u> $100,000 ($1,000,000 x 10%)	Deferral of tax on $3.9 million of gain Elimination of tax on $100,000 of gain
March 2026 (QOF held ≥ 7 years but < 10 years)	$3.85 million in 2026 $4,000,000 <u>less</u> $150,000 ($1,000,000 deferred gain x 15%)	Deferral of tax on $3.85 million of gain Elimination of tax on $150,000 of gain
March 2027 (QOF held ≥ 7 years but < 10 years and sale occurs after December 31, 2026)	$850,000 in 2026 $1,000,000 deferred gain reduced by $150,000 (15% of $1,000,000) $3 million in 2027 $4,000,000 <u>less</u> $1,000,000 basis	Deferral of tax on $3.85 million of gain Elimination of tax on $150,000 of gain
March 2029 (QOF held ≥ 10 years)	$850,000 in 2026 $1,000,000 deferred gain reduced by $150,000 (15% of $1,000,000)	Deferral of tax on $1 million of gain Elimination of tax on $3 million of gain

Very generally, a QOF is an entity that satisfies certain rules concerning investment in businesses that operate in a QOZ. For example, a real estate investment fund that invests in real estate located in a QOZ may be structured as a QOF.

QOZs have already been designated for purposes of the program. A list and map of designated QOZs by state, county and census tract can be found here: https://www.cdfifund.gov/pages/opportunity-zones.aspx.

The Opportunity Zone program offers potentially significant tax benefits to investors. Of course, investors must also evaluate potential QOF investments from an overall economic perspective. It is possible that if perceived tax benefits drive many investors to QOFs in a particular geographic area, property prices in that area may become artificially inflated, thereby reducing or perhaps eliminating those potential tax benefits.

If you are considering a QOF investment, please feel free to contact Mark Hamilton, Esq.

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