

## #37: Opportunity Zones

The Tax Cuts and Jobs Act of 2017 (TCJA) created important tax benefits for investments in opportunity zones (IRC § 1400Z-2). The Act provides three incentives for rolling capital gains on the sale or exchange of property into new investments in low-income communities: (1) deferral of gain recognition on the original investment, (2) basis step up on the original investment and (3) permanent exclusion of gain on the opportunity zone investment.

### Deferral of Gain Recognition

If a taxpayer elects to reinvest capital gain from another investment in an opportunity zone, the gain isn't included in income until the earlier of the date on which the opportunity zone investment is disposed of or December 31, 2026 (IRC § 1400Z-2(b)(1)). There is no dollar limit on the amount of gain that can be deferred.

**Example 1.** Art sells stock with a basis of \$200,000 for \$300,000 on December 15, 2023. Instead of recognizing the \$100,000 gain and paying tax on it, Art reinvests the \$100,000 in an opportunity zone in January 2024 and is able to defer recognizing the gain.

### Basis Step-Up

The taxpayer's basis in the original investment is zero for purposes of the opportunity zone rules. If the investment is held for at least five years, this basis is increased by 10% of the deferred gain. If the investment is held for at least seven years, this basis is increased by 15% of the deferred gain (IRC § 1400Z-2(b)(2)(B)).

**Example 2.** Assume the same facts as in Example 1 except that Art sells the opportunity zone investment on December 20, 2028. Because he held the opportunity zone investment for over five years, Art is given a basis equal to 10% of the deferred gain. This reduces the gain on the stock to \$90,000 and the tax payable to \$21,400 (.238 x \$90,000). If Art had held the stock for seven years or more, the gain would have been reduced to \$85,000 and the tax payable to \$20,230 (.238 x \$85,000).

### Permanent Exclusion of Gain on Opportunity Zone Investment

If the opportunity zone investment is held for at least 10 years, no gain is recognized when the opportunity zone investment is sold (IRC § 1400Z-2(c)).

### Return on Opportunity Zone Investment vs. Return on Investment in Stock Portfolio

The following examples illustrate how the three tax benefits described above combine to increase the return on investment.

**Example 3.** Jane has \$100,000 of unrealized gains in her stock portfolio. On December 31, 2019, she reinvests this \$100,000 into an opportunity zone fund. Jane

holds the investment for 10 years. Assume that the investment grows in value by eight percent each year. The following chart shows how much Jane ends up with from the investment after 10 years.

Initial value .....	\$100,000
Value on December 31, 2027.....	\$185,093
Tax payable (.238 x \$85,000) .....	\$20,230
After-tax amount.....	\$164,863
Value on December 31, 2029.....	\$192,296
Return on investment .....	6.76%

**Example 4.** Assume the same facts as in Example 3 except that instead of investing in the opportunity zone fund, Jane keeps the \$100,000 of capital gain in the stock portfolio investment and sells it after 10 years.

Initial Value .....	\$100,000
Value on December 31, 2029 .....	\$215,892
Tax payable.....	\$51,382
After-tax amount.....	\$164,510
Return on investment.....	5.10%

Examples 3 and 4 assume that the opportunity zone and the stock portfolio produce the same return, isolating the tax benefit. If the opportunity zone investment produced a higher return than the stock portfolio, the advantage of the opportunity zone would be greater. On the other hand, if the stock portfolio produced a higher return, the return advantage of the opportunity zone investment would either be less or the stock portfolio would produce a higher return.

**Example 5.** Assume the same facts as in Example 4 except that the stock portfolio produces an 11% return.

Initial Value .....	\$100,000
Value on December 31, 2029 .....	\$283,942
Tax payable.....	\$67,578
After-tax amount.....	216,364
Return on investment.....	8.02%

### Qualification Requirements

To qualify for the tax benefits illustrated above, a taxpayer must reinvest the capital gain portion of a sale or exchange within 180 days in a “qualified opportunity fund” (IRC § 1400Z-2(a)). The gain can’t arise from a sale or exchange with a related person. For purposes of § 1400Z-2, persons are related to each other if such persons are described in § 267(b) or 707(b)(1), determined by substituting 20% for 50% each place it occurs in such sections (IRC § 1400Z-2(e)(2)). Nor is there deferral for gain from a position that is or has been part of an offsetting-positions transaction (Prop. Reg. § 1.1400Z-2(b)(2)(iv)).

### Qualified Opportunity Fund (QOF)

A qualified opportunity fund is any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property that holds at least 90% of its assets in qualified opportunity zone property (IRC § 1400Z-2(d)(1)).

### Qualified Opportunity Zone Property

Qualified opportunity zone property is property that is qualified opportunity zone stock, a qualified opportunity zone partnership interest, or qualified opportunity zone business property (IRC § 1400Z-2(d)(2)). A list of qualified opportunity zones can be found in IRS Notice 2018-48.

### Eligible Taxpayer

An eligible taxpayer is any person that may recognize gains for purposes of Federal income tax accounting. Thus, eligible taxpayers include individuals; C corporations, including regulated investment companies (RICs) and real estate investment trusts (REITs); partnerships; S corporations; trusts and estates (Prop. Reg. § 1.1400Z-2(a)-1(b)).

### Eligible Interest in a Qualified Opportunity Fund

An eligible interest in a QOF is an equity interest issued by the QOF, including preferred stock or a partnership interest with special allocations. Thus, the term eligible interest excludes any debt instrument within the meaning of § 1275(a)(1) and § 1.1275-1(d) (Prop. Reg. § 1.1400Z-2(a)-1(b)(3)(i)).

### Election Procedure

The election to defer gain is made on the return on which the tax on that gain would be due if it wasn't deferred (IRS Website--Opportunity Zones Frequently Asked Questions). The Commissioner may prescribe in guidance published in the Internal Revenue Bulletin on the manner in which the election is to be made.

Disclosures

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