



Opportunity Zones

Summary of Opportunity Zone Legislation

As part of the Tax Cuts and Jobs Act passed in December of 2017, Congress created a new, but temporary, tax opportunity: IRC § 1400Z-2. Under this tax code section, a taxpayer who realizes capital gains from the sale or exchange of any type of property can defer paying taxes on that gain by reinvesting the profits in a Qualified Opportunity Fund ("QOF") within 180 days of the date that the original property was sold. The QOF, in turn, must invest its funds in specific types of businesses or business property within opportunity zones ("OZs"). OZs are census tracts that meet certain low-income criteria and that have been designated as opportunity zones by the governor of the state or territory where those tracts are located. All US states and territories have not less than 25 OZs.

The deferred gain will eventually be recognized as of the earlier of (a) the date on which the taxpayer sells or exchanges its interest in the QOF or (b) December 31, 2026. The recognition of deferred gain on December 31, 2026 will occur even in the absence of a liquidity event.

The taxpayer's initial basis in a QOF investment will be zero. In the case of an investment held for at least five years, the taxpayer's basis in the QOF will be increased by ten percent (10%) of the deferred gain. If the QOF interest is held for at least seven years, the taxpayer's basis will be increased by an additional five percent (5%) of the deferred gain (for a total of 15%). In addition, if the taxpayer holds its interest in the QOF for at least ten years, and, if the taxpayer liquidates its interest in the QOF on or before December 31, 2047, then the taxpayer can elect to increase the basis of its interest in the QOF at the time of liquidation to the fair market value of that interest, so that no capital gain on the QOF investment will be recognized.

Currently, no preliminary filing is required to become a QOF. However, there is a proposal in Congress to require QOF's to measure and report the social impact its investment is having. However, under the current law the QOF is

required to file a tax certification concerning its qualification as a QOF and its first six months of operations and to file annual tax returns that demonstrate that the QOF continues to meet these standards:

- *A QOF must be an investment vehicle organized as a corporation or a tax partnership for the purpose of investing in and holding at least 90% of its assets in "opportunity zone property" ("OZ Property").*
- *A QOF must, in fact, hold 90% of its assets in OZ Property on each testing date. OZ Property includes original-issue stock and partnership interests in OZ Businesses as well as direct ownership by the QOF of Opportunity Zone Business Property ("OZ Business Property"). OZ Business Property may include commercial and residential rental real estate located in an "OZ." OZ property must be used in a trade or business. OZ Business Property cannot be passive investments.*
- *A QOF cannot hold more than 5% of its assets in nonqualified financial property. However, the proposed regulations treat cash that has been contributed to the QOF, but not yet deployed as qualified OZ Property, if the following requirements are satisfied: (i) there is a written plan that identifies the cash as property held for the acquisition, construction, or substantial improvement of tangible property in an opportunity zone, (ii) there is a written schedule that the cash will be used within 31 months, and (iii) the QOF substantially complies with that schedule.*

The first use of OZ Business Property within the OZ must be made by the QOF. Alternatively, if the QOF buys property that has already been used within the OZ, i.e., equipment or real property within the OZ, then that property can qualify as OZ Business Property only if it is substantially improved by the QOF within 30 months of the acquisition of the property by the QOF. Substantial improvement means an increase in the adjusted basis of that property in the hands of the QOF that exceeds the initial basis of the property when it was acquired by the QOF. What that means, in essence, is that the cost of improvements to the property must equal or exceed the cost of acquiring the property. However, the Regulations make an exception for land. This cost of improvements test, when applied to real property is based only on the value of the improvements on the land at the time that the property was acquired, and not based on the value of the land, itself. For example, if the QOF acquires real property within the OZ for \$1MM, of which \$600k represents the value of improvements to the land at the time it was acquired, and \$400k represents the value of the land, itself, then the QOF would have time make \$600k in improvements to the real property to meet the requirements of this test.

The main benefits of QOF investments are the following:

- 1. Temporary deferral of capital gains that are reinvested in qualified OZ property:** Taxpayers can defer capital gains tax due upon sale or disposition of an asset if the profits from the sale of that asset are reinvested within 180 days of the date that the capital gains can be determined in a Qualified Opportunity Fund ("QOF").
- 2. Step-up in basis for investments held in QOFs:** If the investment in the QOF is held by the taxpayer for at least five years, the basis on the original gain is increased by 10% of the original gain. If the OZ asset or investment is held by the taxpayer for at least seven years, the basis on the original gain is increased by an additional 5% of the original gain. However, the remainder of the gain will be taxed as of December 31, 2026. If the QOF investment has not met the five-year or seven-year holding period by that date, it will not qualify for the step-up in basis.
- 3. Exclusion of capital gains tax on qualified OZ investment returns held for at least 10 years:** The basis of a QOF investment maintained for at least 10 years, will be eligible to be marked up to the fair market value of that investment on the date that the investment is sold or liquidated. That sale or liquidation must occur on or before

December 31, 2047. It is hard to overstate the value of this tax benefit. One hundred percent of the gains on appreciation of a QOF investment can be sheltered from tax if this test is met.

There are opportunity zones in EVERY state, and within most major cities and metropolitan areas. The IRS has listed every OZ census tract at https://www.irs.gov/irb/2018-28_IRB#NOT-2018-48. This listing is comprehensive and authoritative, but somewhat difficult to use because it is necessary look up the description of each designated tract, which can be done easily enough for single tracts. However, the process is time consuming for looking up multiple census tracts. Most states and some less official sources have provided more user-friendly interactive maps.

Factors to Consider

Every taxpayer has a different situation, there is no single answer on which method of deferral is better. For an investor with gains from marketable securities, an OZ is the only option. However, if the investors gain is from real estate, an analysis of depreciation recapture, liquidity of the new investment, anticipated holding period and more must be done to determine which method of deferral is best.

Based on the most recent set of Proposed Regulations it does not appear that investors need to immediately choose between an investment in a QOF or the use of 1031 since the 180 days to invest in a QOF only begins on the day that net capital gains can finally be determined, which in many cases is the taxpayers year-end. Therefore, a taxpayer can enter into a 1031 without losing the opportunity to also invest in a QOF, or may use taxable boot from the 1031 exchange (other than recapture) to invest in a QOF. Furthermore, investors must truthfully assess if they are able to complete the required reporting and record-keeping required for that reporting, particularly if social impact reporting will be required.

The following questions should be analyzed by investors to help them determine the optimal strategy:

1. When the tax is owed in 2027 on the deferred capital gains, will the investor have the liquidity needed to pay the tax due?
2. What will the tax rates be on capital gains in 2026?
3. Is there enough capital to "substantially improve" the property?
4. What is the nature of the investment? Operating business? Real estate? Both?
5. What is the anticipated holding period?
6. How much depreciation recapture does the property have, and is there enough liquidity to pay that tax?
7. What are the investor's long term plans for this investment/capital?
8. Can the investor maintain the proper records to maintain QOF status?

For further information or questions regarding Opportunity Zones and 1031's please reach out to our experts at Madison by calling 1-800-970-1031 or by emailing info@madison1031.com

