A Practical Approach: The Opportunity Zones Program Under the Tax Cuts & Jobs Act

You are interested in diversifying your holdings by investing in private equity deals but, your only way to raise the capital needed is to sell highly appreciated securities in your investment portfolio. The question often asked is, “Do I bite the bullet” and recognize the unrealized gains or instead pass on this new investment strategy? A program established under the Tax Cuts and Jobs Act may allow you to make such investments while keeping the unrealized gains intact.

Under the Opportunity Zones program, taxpayers may be able to receive very favorable tax treatment on the sale of currently held investments if the proceeds are reinvested in business property and/or real estate located in a “Qualified Opportunity Zone” within 180 days.

An Example of How It Works -

In 2018, a taxpayer sells marketable securities held for more than one year for $2.5 million, with a tax basis in those securities of $500,000, resulting in a $2 million long-term capital gain. Within 180 days after the sale of the securities, the taxpayer invests up to $2 million - the long-term capital gain amount - in a specific type of fund known as a Qualified Opportunity Fund (or a QOF) whose holdings consist primarily of business property and/or real estate located within a Qualified Opportunity Zone.

What are the tax benefits?

- If the business property and/or real estate is held for less than 5 years, the $2 million in long-term capital gain on the marketable securities is deferred until the QOF is sold.

- If the business property and/or real estate is held more than 5 years but less than 7 years, the $2 million in long-term capital gain on the marketable securities is deferred until the QOF is sold. **However**, only 90% of this gain is recognized. Thus, the actual long-term capital gain recognized (after being deferred for up to seven years) is $1.8 million.

- If the business property and/or real estate is held more than 7 years but less than 10 years, the $2 million in long-term capital gain on the marketable securities is deferred until the sooner of the date the QOF is sold or December 31, 2026. **However**, only 85% of this gain is recognized. Thus, the actual long-term capital gain recognized (after being deferred for up to eight years) is $1.7 million.

- If the business property and/or real estate is held more than 10 years, the $2 million in long-term capital gain on the marketable securities is deferred until December 31, 2026. **However**, only 85% of this gain is recognized. Thus, the actual long-term capital gain recognized (after being deferred for up to eight years) is $1.7 million. **In addition**, the long-term capital gains on the sale of the business property and/or real estate in the Qualified Opportunity Zone is 100% excluded.

What is a Qualified Opportunity Fund (QOF)?

- Must be certified by the U.S. Treasury Department as such.
- Is organized as a separate entity (corporation or partnership) whose purpose is to invest in Qualified Opportunity Zone business property and/or real estate.
- Must invest at least 90% of its assets in Qualified Opportunity Zone business property and/or real estate.

What is Qualified Opportunity Zone business property and/or real estate?

- Includes newly issued stock or a partnership interest in any business property and/or real estate located in a Qualified Opportunity Zone.
- Loans are not eligible for tax incentives.
- Real estate is subject to substantial rehabilitation requirements.

Where are Qualified Opportunity Zones Found?

Each state may choose up to 25% of that state's eligible low-income areas to become Qualified Opportunity Zones. Click on the following to be directed to a continually updated list of eligible areas. – https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

Consult Your Tax Advisor

Due to the relative newness of the program, additional clarification is still required. As always, the complexity involved when undertaking transactions such as this requires strict adherence to the rules. If you are considering this type of investment or want to learn more, please call us.