

More on the New Qualified Opportunity Zones - Significant Tax Benefits

June 13, 2018



This is the second in a series of alerts on the new Economic Opportunity Zones program created by the Tax Cuts and Jobs Act (TCJA) in December of 2017 to encourage and incentivize long term investments in qualified low-income communities nationwide. The program provides a tax incentive for investors to roll their capital gains into a Qualified Opportunity Fund (QOF) that in turn invests in economically distressed communities.

Taxpayers can take realized capital gains and re-invest cash representing the gains into these new funds during the 180-day period beginning on the date of such sale or exchange, in exchange for potentially significant tax benefits. Investors in QOF's can defer the tax on the gains rolled into the funds and, depending on how long they maintain the investments in such funds, they may receive an increase to their basis to reduce those gains as well as tax free treatment on additional gains earned from the cash invested in the fund.

If an investor holds the gain rolled over in a QOF for at least 5 years, then the basis of such investment will be increased by 10% of the amount of the gain deferred. If that investment is held by the taxpayer for at least 7 years, the basis is increased by

an additional 5% of the amount of the deferred gain. If the investor is still holding the investment in the QOF on 12/31/26 the original gain deferred (reduced for any increase in basis related to holding periods above) would then need to be recognized for tax purposes. If that investment is held for a period of at least 10 years, the basis of the investment in the QOF can be stepped-up to the fair market value on the date of disposal thus making all of the appreciation on the investment in the QOF tax-free!

Example:

Ted realizes a gain of \$5,000,000 from the sale of property on July 1, 2018. Reinvesting the gain of \$5,000,000 into a QOF by 12/31/18 will allow Ted to defer the taxable recognition of that gain. If Ted leaves the money in the QOF for 5 years he will increase the basis of his investment by \$500,000 (10% of the \$5,000,000 deferred gain). If he leaves the money in for 7 years he will increase the basis of his investment by a cumulative \$750,000 (15% of the \$5,000,000 deferred gain). If he is still invested in the QOF on 12/31/26 he will recognize taxable gain in 2026 of \$4,250,000 (the original gain reduced by the basis increase). If he leaves the money in for 10 years and then sells his investment for a fair market value of \$20,000,000, his basis in the investment is equal to the fair market value of \$20,000,000 resulting in zero additional taxable gain.

Where the taxpayer invests both gains and other cash into a QOF, the Act specifically states that the investment will be treated as two separate investments of which only the gain proceeds would be eligible for the basis increases and the 10 year gain exclusion.

Advantages of a QOF investment over a Section 1031 "Like-Kind" exchange:

There are two important advantages of investing in a QOF Fund as opposed to entering into a Section 1031 exchange:

- QOF Investments Require Less Investment to Defer Tax - To defer the tax on a gain, only the amount of the gain is rolled into a QOF within 180 days of the sale or exchange. The balance can be used elsewhere. A Section 1031 exchange requires the entire value of the original property be reinvested

into a new property in order to defer the tax on the gain. Section 1031 exchanges have a 45-day identification period and a 180 day window to complete the exchange.

- Example Ted has a building with a value of \$8,000,000 and has basis of \$5,000,000. The sale of the building would trigger \$3,000,000 of taxable gain for Ted. To defer the tax through a QOF Ted only needs to invest the \$3,000,000 gain into a QOZ Fund within 180 days. There are no restrictions on what the taxpayer does with the remaining proceeds of \$5,000,000. To defer tax on the entire \$3,000,000 gain in a Section 1031 exchange, Ted would need to roll the entire \$8,000,000 into a property that meets the 45 and 180 day requirements.
- Less Restrictions on Type of Gains Invested in QOF - The new QOZ law places far less restrictions on the type of gain eligible for deferment. It only requires that the capital gain stem from a sale or exchange to an unrelated person. Real estate, personal property, intangibles assets, and virtually any other capital asset should qualify. In contrast, under the TCJA, eligibility for Section 1031 exchange treatment is now restricted to gains from the sale of real estate only.

In the next alert on this topic, we will address the formation and operation of a QOF.

Additional guidance on Qualified Opportunity Zones is still needed from Treasury before Funds can be formed and capital can be invested. Opportunity Zones may present a significant new opportunity both for investors as well as developers and business owners.

To learn more about the Qualified Opportunity Zones program and how it might benefit you or your company, contact Anchin Partner & Tax Credits & Incentives Leader, Paul Gevertzman at (212) 840-3456 or via email at

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For a map of all designated QOZs go to:

https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml

To view all designated QOZs on the map, click on the “Layers” tab on the menu on the right hand side of the screen. Select “Opportunity Zone Tract” and unselect “2011-2015 LIC Census Tract.” You can then zoom in to a specific area on the map. Designated QOZs will appear in blue.