Big Tax Savings Ahead with Opportunity Zones

by Tony Perricelli, CPA

When investors search for the best overall performance for their capital, they are often faced with a choice between investment flexibility and tax efficiency. It is not often that they have the potential to achieve both in the same vehicle. Although beginning in 2018, there is an arrangement that will allow for tremendous flexibility in investment options combined with a surprisingly generous array of tax benefits. Passed as part of the Tax Cut and Jobs Act of 2017 in December 2017, “Opportunity Zones” have the potential to provide huge benefits to those who use them.

So what are they and how do they work? Opportunity Zones are designated census tracts located in all 50 US states and 5 US territories. The zones were chosen by the states primarily as a means to encourage economic development in low income communities and were then certified by the US Treasury. To gain access to the tax benefits of Opportunity Zones, investors roll capital gains from an existing investment into the zones by means of Qualified Opportunity Funds, which are entities set up and maintained specifically to invest in the zones. Permitted entity types include C Corporations, S Corporations, Partnerships, LLCs taxed as either partnerships or corporations, REITs, and RICs.

The tax benefits of investing in Qualified Opportunity Funds fall into two categories.

- First, capital gains tax on the re-invested gain can be deferred for several years and even reduced if the new investment is held for at least 5 years. The deferral works similarly to a Section 1031 like-kind exchange used to roll over gains on real estate investments. Once an investor sells at a gain, he or she has 180 days to re-invest funds equal to the gain into a Qualified Opportunity Fund. This timely re-investment qualifies for the initial deferral until the new Opportunity Zone investment is sold, or through December 31, 2026—whichever comes first. If the Qualified Opportunity Fund investment is held at least five years, then the deferred gain is reduced by 10%. If held for another two years for a total of seven years after the initial re-investment, then the reduction goes to 15%.
- Second, gains earned after the initial investment is rolled into the Qualified Opportunity Fund can be sold without any capital gains tax if the fund is held for at least 10 years and the fund maintains its status as a Qualified Opportunity Fund. This includes gains earned on the money used to immediately invest in qualified property or stock/partnership interests as well as additional working capital consumed within 30 months of the initial setup of the Qualified Opportunity Fund if designated and used for qualifying costs such as property improvements.

The next biggest question is this—how does an entity qualify as a Qualified Opportunity Fund and stay qualified? The answer is that there are multiple requirements that need to be satisfied. Let’s take a look.

- **Formation/Certification** – a qualifying entity, as described earlier, is either formed or has its governing documents amended to designate it as a Qualified Opportunity Fund. Once this formation or amendment occurs, the entity can designate any month between that time and the initial investment of rollover gains into the fund as its certification date. Only rollover gains invested on or after the certification date qualify for the tax benefits mentioned above. The entity must then annually file Form 8996 as an attachment to its US income tax return to maintain its status.
- **Assets** – There are two asset requirements that must be met to remain certified. First, the Qualified Opportunity Fund must have at least 90% of its assets invested in Qualified Opportunity Zone investments. Second, the underlying Opportunity Zone business must have at least 70% of its physical assets located in a designated Opportunity Zone.

- **Allowable Investments** – There are two categories of allowable investments Qualified Opportunity Funds are permitted to make and remain certified.
  - First, funds can invest in Qualified Opportunity Zone Property (QOZP). QOZP is tangible property located in an Opportunity Zone that is acquired after 12/31/17 and after the certification date of a Qualified Opportunity Fund. The original use of the property must begin with the fund. To meet this requirement, the QOZP can be either a newly constructed property that the fund acquires, or an existing structure that the fund substantially improves. A substantial improvement occurs when the fund invests at least as much as the original purchase price of the building portion in renovations and improvements. The QOZP can either be used in an operating business or available for rent or lease.
  - Second, funds can invest in Qualified Opportunity Zone Stock or Partnership Interests. Qualified stock can be common or preferred and must be acquired from the corporation in exchange for cash after 12/31/17. Qualified partnership interests can be any capital or profits interest, including special allocations, in a domestic partnership or LLC taxed as a partnership. The stock or partnership interest have been organized for the purpose of being a qualified opportunity zone business, must be a Qualified Opportunity Zone Business when the interest is acquired, and must remain as such while the fund owns the stock or partnership interest.
- **Qualified Opportunity Zone Business** – As mentioned above, the stock or partnership interest acquired by the Qualified Opportunity Fund must be organized specifically to invest in a Qualified Opportunity Zone Business (QOZB). A QOZB is a business in almost any industry (see exceptions below) where:
  - At least 70% of its owned or leased property is Qualified Opportunity Zone Property
  - At least 50% of its gross income is generated from the active conduct of a trade or business
  - The business uses a substantial part of its intangible property in the active conduct of its trade or business, and
  - Less than 5% of its original tax basis in business property is nonqualified financial property.
- **Not Allowable Business Types –** Certain types of businesses are not allowed as Qualified Opportunity Zone Businesses including:
  - Shell Companies or Financial Services/Banks
  - Private or Commercial Golf Courses and Country Clubs
  - Massage Parlor/Hot Tub Facility/Suntan Facility
  - Racetrack or other gambling business
  - Liquor Stores

Clearly, the rules governing Qualified Opportunity Funds are complex and must be considered as part of the cost of benefiting from the generous tax incentives available for such investments. Even so, Qualified Opportunity Funds have the potential to allow investors to accomplish many of their investment goals while also driving new capital into areas of the country that need new capital to improve their communities. While they will not necessarily work in every situation, Qualified Opportunity Funds will likely become an important part of many investors' portfolios because of the multitude of benefits that can be derived from them.

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Tony graduated Cum Laude from Winthrop University with a Bachelor of Science in Accounting and earned a Master of Taxation degree from the University of South Carolina. He is a member of the American Institute of Certified Public Accountants (AICPA) and the South Carolina Association of Certified Public Accountants (SCACPA). He is a 2006 graduate of Leadership Columbia.

Tony was born and raised in the Columbia area and currently lives in Irmo with his wife, daughter, and two sons. He is active in his church and community, coaching youth sports and volunteering with service organizations.