New Incentivized Investment: Opportunity Zones

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In the recently passed Tax Cuts and Jobs Act, Congress has added an opportunity to encourage investors to start new businesses in economically depressed areas. The incentives are threefold: (1) gains from the sale of any property are deferred to the extent they are invested in an "opportunity zone" fund; (2) the amount of the deferred gain is reduced if the investor maintains the investment for at least five years; and (3) all profits from the new investment escape tax altogether as long as it is held for at least 10 years.

Introduction

While the main purpose of the Internal Revenue Code is to set out the laws that impose taxes to raise funding for the operation of the government, Congress also uses the Code to encourage certain behaviors and investments. The Tax Cuts and Jobs Act added a new type of investment with tax incentives;[1] newly added Code Sections 1400Z-1 and 1400Z-2 encourage investments in "qualified opportunity zones," which are economically depressed areas. The government is now providing incentives to investors to start businesses in these areas.

The New Tax Incentive Rules

Deferred Recognition of Gain. Basically, an investor can defer the recognition of any gain recognized from the sale or exchange of any property to an unrelated party, if the amount of the gain is reinvested in a qualified opportunity fund within 180 days after the sale of such property.[2] The gain on

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[1] P.L. 115-97.

[2] IRC § 1400Z-2(a)(1). Unlike some other rollover provisions, which generally require a reinvestment of an amount at least equal to the proceeds in order not to recognize any gain, see, e.g., IRC § 1033, IRC § 1400Z-2(a) and (b) require only that the amount of *gain* be reinvested.

qualifying sales will be deferred until the earlier of (1) the date on which the investment in the fund is sold, or (2) December 31, 2026.[3]

Potential to Escape Some or All Tax on Gain. In addition to the deferral described above, the amount of gain to be recognized may be decreased as well, as set out below:

- At the time the funds are invested in the fund, the basis of the fund will be equal to zero.
- After five years, the amount of the basis will be increased by 10 percent of the amount of gain deferred.
- After seven years the basis will be increased by an additional 5 percent of the amount of the deferred gain.[4]
- If the investment is held for at least 10 years, the basis of the investment will be equal to its fair market value on the date it is sold or exchanged.[5]

The tax savings potential for such investments is huge. If the investor holds the fund for at least seven years prior to December 21, 2026, not only is the gain deferred but 15 percent of the gain would escape tax forever. And, if the investor holds the property for at least 10 years, in addition to the deferral of the original gain, all gain with respect to the investment will not be subject to tax.

The following example illustrates how these rules will work:

Example: To start, assume that Irene sells property for a realized gain of $1 million, and then (1) forms a partnership that qualifies as a qualified opportunity fund, and (2) contributes her $1 million gain to the fund. Irene's ultimate tax owed will depend on what happens next. Some possible tax outcomes are set out below:

Scenario 1: Assume that, after five years, Irene sells the fund for $5 million, with the following result:

Sales Price	$5,000,000	
Basis	100,000	(i.e., 10 % of the deferred gain)
Gain Recognized	$4,900,000	

[3] IRC § 1400Z-2(b)(1).

[4] IRC § 1400Z-2(b)(2).

[5] IRC § 1400Z-2(c).

The gain is comprised of $900,000 of the net deferred gain after the basis bump and $4 million of gain from the new investment.

Scenario 2: Assume that as of December 31, 2026, there has been no sale, the investment was held for at least seven years, and fair market value (FMV) on that date is $5 million, with the following result:

Deemed Sales Price	$1,000,000	
Basis	150,000	(i.e., 15 % of the deferred gain)
Gain Recognized	$850,000	

Only the deferred gain of $1 million less 15 percent is recognized because there was no sale of the fund.

Scenario 3: Assume that as of December 31, 2026, there has been no sale, the investment was held for at least seven years, and FMV on that date is $750,000. In this case the result is:

Deemed Sales Price	$750,000	
Basis	150,000	(i.e., 15 % of the deferred gain)
Gain Recognized	$600,000	

Since in this scenario the investment has fallen in value, the amount of deferred gain is reduced by the loss in value. The 15 percent increase in basis is retained and only $600,000 of the original $1 million gain has to be recognized.

Scenario 4: Assume the investment has been held for more than 10 years and then is sold for $5 million, with the following result:

Sales Price	$5,000,000
Basis	5,000,000
Gain	0

Of course, the appropriate percentage of the deferred gain has already been recognized in 2026, but all of the appreciation on the qualified fund investment is earned tax-free.

What Kind of Investment Qualifies for Special Treatment?

In order to qualify for the benefits described above, the proceeds must be invested in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle that invests in qualified opportunity zone property.[6] Qualified opportunity zone property can be (1) qualified opportunity zone stock, or (2) an interest in a qualified opportunity zone partnership, or (3) qualified opportunity zone business property.[7] Basically the corporation or partnership whose interests qualify for this treatment will be making investments in qualified opportunity zone business property. Qualified opportunity zone business property is defined as tangible property used in a trade or business that was acquired after December 31, 2017, where either the original use of the property commences with the fund or the fund substantially improves the property, and while the fund is holding the property all of the use of such property was in a qualified opportunity zone.[8]

A qualified opportunity zone has to be designated as such by the governor of the state in which it is located and has to be approved by the Secretary of the Treasury.[9] The zone must be a population census tract that is a low-income community. A low-income community is one in which the poverty rate for such tract is at least 20 percent, or the median family income in the tract is less than 80 percent of the median family income for the state, or less than 80 percent of the family median income of the metropolitan area if it is located in a metropolitan area.[10]

Summary

The Tax Cuts and Jobs Act added Sections 1400Z-1 and 1400Z-2 to encourage investors to make investments in businesses in economically depressed areas. Basically, investors can invest the amount of gain recognized on the disposition of a capital asset and defer the recognition of the gain until the time that they dispose of the investment but no later than December 31, 2026. If they hold the investment for more than five years, they can exclude 10 percent of the deferred gain and if they hold it for more than seven years, 15 percent of the deferred gain. To qualify for the five-year basis increase, benefit purchases will need to be made by December 31, 2021. To qualify for the seven-year basis increase, purchases must be made by December 31, 2019. If an investor holds the opportunity zone investment for at least 10 years, all of the gain from the investment will be excluded from income. There is no maximum amount of gain that may be deferred or excluded from income under this provision, nor is there a limit on the size of the business to be started in the zone.

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[6] IRC § 1400Z-2(d)(1).

[7] IRC § 1400Z-2(d)(2)(A).

[8] IRC § 1400Z-2(d)(2)(D).

[9] IRC § 1400Z-1(b)(1). A list of qualified opportunity zones can be found in Notice 2018-48, 2018-28 IRB 9.

[10] IRC §§ 1400Z-1(c)(1); 45D(E).