Opportunity Zone Investments—Practical Issues and Concerns

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Ever since the Tax Cuts and Jobs Act (TCJA) of 2017 created “Opportunity Zones,” there has been a lot of excitement about this new incentive to invest in distressed areas. Actual investment in qualified opportunity funds (QOFs) had slowed while tax professionals awaited regulations spelling out the details. We now have regulations that answer many of the open issues; other questions are still unanswered.

Deferral

Under the legislation, investors are allowed to roll over gains from profitable investments without incurring **current** taxation. Gains rolled into a QOF will be taxed in 2026, or earlier, if the QOF is sold before 2026. If, in 2026, the QOF is worth less than the amount rolled over, the gain that would be taxed in 2026 would be commensurately reduced.

Being taxed in 2026 on the amount rolled over is quite different than the treatment when rolling over a gain in a 1031 exchange that does not dictate a taxable event unless the replacement property is sold. However, the law does allow a 15% reduction in the rolled-over gain if the QOF is held for 7 years. Only investments made in 2019 could qualify for this tax break. Rolled-over gains will get a 10% tax reduction if held for 5 years, these investments must be made before December 31, 2021.

Hopefully, more impactful is the total forgiveness of tax on any profit above the rolled-over amount if the QOF is held for 10 years or more.

It is noteworthy that only the realized gain has to be rolled over into a QOF to qualify for the tax deferral. Whereas in a 1031 exchange, the investor must reinvest the proceeds of a sale, not just the gain.

All Capital Gains Are Eligible

It is important to note that all capital gains can be rolled into a QOF. That includes short-term gains, long-term gains, and even gains from collectibles. The deferral and 15% tax-holiday benefits of rolling over short-term gains is almost double the benefit of reinvesting long-term gains into a QOF. Many collectors were utilizing Section 1031 when managing their art or antique car collections. Now that Section 1031 is no longer available to them, QOFs might be useful in deferring their gains that might have been taxed at the 28/31.8% rate.

Optimize Opportunity Zone Investments

$1,000,000 in	short term gains	long term gains	collectible gains
Tax Deferred	408,000	238,000	318,000
15% savings	61,200	35,700	47,700
Value of 7 YR. Deferral@5%	142,800	83,300	111,300
Total After Tax Benefit	204,000	119,000	159,000

The regulations make clear that gains that are deferred keep their nature. This means that a short-term gain that is rolled over does *not* turn itself into a long-term gain by virtue of being rolled into a QOF.

<u>Net Gains or Gross Gains?</u>

An investor that has many transactions in a year *is* allowed to roll over gains they realize and not reduce the amount that can be rolled over by realized losses. This could prove quite lucrative to an investor with multiple trades that crystalize both short-term gains and losses.

Another possible source of short-term gains are profits from Section 1256 contracts. These 1256 contracts are automatically taxed as 60% long-term gain and 40% short-term gain no matter how long they are held and whether the positions were long or short positions. QOF investors can choose to roll over just the 40% that is short-term gain.

Section 1256 contracts include publicly traded futures contracts but also include publicly traded non-equity options. Index options are popular non-equity options, but so are options on the gold ETF, Master Limited Partnerships, etc.

However, the rules for netting are different for Section 1256 contracts; here all gains and losses are netted at year end, taxpayers cannot cherry pick gains and ignore losses as they can with stock trades.

It should be noted that the regulations include an anti-abuse provision that disallows the rollover of gains that were ever part of a straddle.

<u>Rollover Must Be Made Within 180 Days</u>

Similar to a 1031 rollover, the reinvestment into a QOF must be made within a specified window of time, in this case 180 days. The regulations allow an investor in an investment partnership to invest in a QOF within 180 days after the end of the year for the partnership. The investor does not need to make the QOF investment within 180 days from when the partnership took the gain.

Still unanswered is how an investor in a partnership might be able to reinvest gross gains realized by the partnership instead of the net gains reported on a K-1.

QOF vs. 1031?

We do not think that the opportunity to invest in QOFs will be the death knell of Section 1031 rollovers of real estate gains. Although QOFs only dictate the reinvestment of capital gains instead of sale proceeds, the QOFs do not allow the rollover of depreciation recapture. If one passes away while holding a QOF, the estate does not get a step-up in basis as it would if the investor rolled into a 1031. The forced realization of tax in 2026 also compares unfavorably to the ability to hold a replacement property until death, thereby extinguishing all gains and recapture of tax.

Opportunity Zone Investment vs. a 1031 Rollover

	OZ	1031
rollover	just gains	full proceeds
tax in 2026?	yes	no
15% tax reduction	yes	no
depreciation deferral?	no	yes
step-up at death	not if <10 years	yes

Still Unanswered Questions

The gain forgiveness on a QOF investment held for more than 10 years is only valid when disposing of the QOF, not the underlying investments. Does this mean each investment should be in its own QOF? What if a QOF sold a property, will it then allocate taxable gain to its investors?

The creation of the Opportunity Zone incentive in the TCJA was not meant to spur only real estate investment. The idea was to revitalize distressed areas. Toward that end, investments in businesses in a zone can also reap the tax benefits allowed. However, businesses operating within the zones must earn at least 50% of their gross income from active conduct within the zone. This seems a very limiting factor that needs to be explored unless the only hiring to be done is for retail establishments.

2019

The opportunity to invest in QOFs has received a lot of attention and created much financial activity in setting up such funds. Although actual investment has been lackluster the deadline to invest and receive the 15% tax holiday only is available to investments made this year. We expect investment to pick up as the year progresses, especially if the government issues a second set of regulations answering some of the issues left unresolved.

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