Robinson+Cole

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Deferring Capital Gains Taxes – Opportunity Zone Investments

On October 19, 2018, the IRS issued proposed regulations and other guidance on the eligibility and procedures for taxpayers to elect to defer capital gains by investing in economically distressed communities throughout the United States designated as Qualified Opportunity Zones ("Opportunity Zones").

The Tax Cuts and Jobs Act of 2017 created Opportunity Zones[1] to spur economic development and job growth in distressed communities by attracting private capital investment to those communities. Federal income tax benefits are available to taxpayers[2] who reinvest their capital gains[3] in a Qualified Opportunity Fund ("QOF") – an investment vehicle organized as a corporation or partnership.

More than 8,000 Opportunity Zones throughout the United States (including Puerto Rico) have been designated for investment by the IRS[4]. Opportunity Zones keep their designation for 10 years. After the Opportunity Zone designation expires, however, taxpayers may elect to step-up their basis in an QOF investment that they have held for 10 years. The deadline to make the election extends through 2047. Investors do not need to live, work or conduct business in an Opportunity Zone to take advantage of the tax benefits – they only need to invest in a QOF. The QOF is capitalized with investors' capital gains realized from other investments, such as proceeds from the sale of a business or stock.

Each year, a QOF must satisfy a 90 percent investment standard – that is, at least 90 percent of its assets, directly or indirectly, must be "qualified opportunity zone property" (other than another QOF)[5]. Qualified opportunity zone property includes "qualified opportunity zone business property," which generally is tangible property used in a trade or business of the QOF that was acquired by the QOF by purchase and either the original use of such property in the Opportunity Zone commences with the QOF or the QOF substantially improves the property by doubling its basis in the property.

If the property acquired by the QOF consists of land and a building, the substantial improvement requirement applies only to the building and not the land on which the building is situated. Thus, the QOF only has to double its basis in the building by investing in improvements equal to the building's cost. For example, QOF pays $900 million for property within an Opportunity Zone, where the land is worth 60 percent, or $540 million, and the building is worth $360 million, or 40 percent. The taxpayer would have to invest only a minimum of $360 million for improvements to the building for both the land and building to receive tax benefits under the Opportunity Zone program. Measuring the amount of improvement by using the cost basis attributable only to the building means that investments in urban areas where the cost of land is high will be more attractive.

Investors have 180 days from the date of sale of their stock or business to roll over all or some of the gain into a QOF. A taxpayer who invests less than their entire gain during the 180-day period may elect to defer tax on that portion of the gain, up to the amount that they invested in the QOF. There is

no cap on the amount of gain that can be deferred. Taxpayers who make a deferral election and meet certain requirements may defer capital gains taxes until December 31, 2026, and potentially reduce their capital gains by as much as 15 percent by investing in a QOF. An investor may exclude from tax the appreciation in value of the QOF, provided it holds its QOF investment for at least 10 years.

IRS approval or certification is not required to create a QOF. A corporation or partnership certifies on IRS form 8996 (Qualified Opportunity Fund) that it is organized to invest in qualified opportunity zone property. Form 8966 is filed annually to report that the QOF meets the 90 percent investment standard or to compute the penalty for each month it failed to meet that standard. A QOF files Form 8996 with its Form 1120 (U.S. corporate income tax return) or Form 1065 (U.S. partnership income tax return) by the due date of the tax return (including extensions).

Investors must hold an equity interest in a QOF. Equity interests include preferred stock or a partnership interest with special allocations (and thus excludes debt instruments). Investors may use their QOF equity interest as collateral for a loan provided they remain the owner of the equity interest for Federal income tax purposes. Deemed contributions of money to a partnership pursuant to Section 752(a) do not constitute investment.

Provided certain holding periods and other requirements are met, investors may realize the following U.S. federal income tax benefits from investing in a QOF:

- The amount of capital gains initially invested that is subject to tax is reduced by 10 percent if the QOF investment is held for five years and 15 percent of the QOF investment is held for seven years.
- 100 percent exclusion of capital gains realized from appreciation of the QOF interest if the investment is held for more than 10 years. Thus, an investor may exit the QOF tax-free (with no tax on appreciation) if the investment in the QOF is held for at least ten years[6].
- Tax deferral of capital gains reinvested in an Opportunity Zone through a QOF until December 31, 2026, (or the sale of the QOF, if earlier).

Additional IRS regulations are expected to be issued before year end. Those regulations are expected to address issues concerning the ongoing operations of a QOF. Robinson+Cole will continue to monitor developments in this area.

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1. Code Sections 1400Z-1 and 1400Z-2. All section references are to the Internal Revenue Code of 1986, as amended.
2. Individuals, C corporations (including RICs and REITs), partnerships, S corporations, and trusts and estates.
3. Gain treated as a capital gain for Federal income tax purposes that would be recognized before January 1, 2027, and does not arise from a sale or exchange with a person related to the taxpayer.
4. For a complete list of population census tracts that the Secretary of the Treasury has designated as qualified opportunity zones, see IRS Notice 2018-48 (Designated Qualified Opportunity Zones under Internal Revenue Code Section 1400Z-2) or click here to view the list.
5. Qualified opportunity zone property means property that is either qualified opportunity zone stock, qualified opportunity zone partnership interest, or qualified opportunity zone business property.
6. The tax basis in the investment is increased to the fair market value of the investment on the date it is sold.

For more information, or if you have questions about how the issues raised in this legal update might affect your business, please contact any of the Robinson+Cole lawyers listed below:

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