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Client Alert

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End of Year Deadline for Opportunity Zone Investments

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The Tax Cuts & Jobs Act (TCJA) created Opportunity Zones ("OZ") which offer investors the chance to defer and eliminate capital gains based on investments in designated zones that meet certain requirements and hit specified milestones. The first milestone is fast-approaching December 31, 2019.

Overview of OZ Benefits

Individuals, C corporations, including regulated investment companies (RICs), and real estate investment trusts (REITs), partnerships, S corporations, and trusts and estates can all elect to defer capital gains arising from transactions with unrelated parties if those gains are invested in a qualified OZ fund ("QOF") within 180 days after the gain arises. If elected, the taxpayer defers paying tax on those gains until the earlier of the date the taxpayer exits the investment or December 31, 2026. Investments made before December 31, 2021 held through December 31, 2026 will receive a step-up in basis on the deferred tax in the amount of 10 percent of the amount deferred. Investments made before December 31, 2019 and held through December 31, 2026 will get an additional five percent for a total elimination of 15 percent of the deferred gains.

After paying the deferred tax on December 31, 2026, the basis in investments held for at least 10 years will be stepped-up to fair market value upon disposition, thereby eliminating capital gains on the investment's appreciation after 2026 up through December 31, 2047 – when the OZ's expire.

Requirements for a QOF

A QOF is a corporation or partnership that holds at least 90 percent of its assets in qualified OZ property. Qualified OZ property includes stock, partnership interests, and qualified OZ business property.

The QOF must acquire qualified OZ stock and partnership interests from the entity in exchange for cash, and the stock and partnership interests must be in an active qualified OZ trade or business that meets the asset and income tests set out in the regulations. The asset test is met if at least 70 percent of the property owned or leased by the trade or business is qualified OZ business property. The income test is met if at least 50 percent of the trade or business's gross income is derived from the active conduct of a trade or business in a qualified OZ and the regulations provide safe harbors for meeting this test based on the number of hours, amount of wages, and locus of management inside versus outside of the OZ. For example, the regulations state that a landscaping business headquartered and managed from an OZ with its assets in an OZ can qualify even if most of its gross income comes from customers outside of the OZ.

A QOF can also directly hold qualified OZ business property under certain conditions. First, the property must be tangible property that is used in the active conduct of a trade or business. Certain real estate investments can qualify, however merely entering into a triple-net lease fails to qualify as an *active* trade or business under the regulations. In addition, the QOF (or qualified OZ corporation or partnership) must have acquired the property after December 31, 2017 and the original use of the property in the OZ must commence with the QOF's (or qualified OZ corporation's or partnership's) acquisition. If a building or other property fails to meet the "original use" requirement, the entity can alternatively "substantially improve" the property by investing at least the same amount as is allocated to the unadjusted basis of the property within the first 30 months after acquisition.

How to invest

Some investors hesitate to explore OZ benefits because the Department of Treasury (Treasury) has yet to finalize regulations in the area. Other investors hesitate due to the regulatory complexities of maintaining an OZ fund. Although final regulations are still pending, Treasury has published enough guidance for QOF managers and potential investors to create and maintain their QOF investments. A self-created QOF is a viable investment with the right legal guidance, but some investors may instead choose to rely on large institutional QOFs that invest in the numerous OZs created under the TCJA.