

Southcoast Opportunity Zones Provide Opportunities for Investors To Defer And Possibly Exclude Capital Gains From Federal Income Taxation

The Tax Cuts and Jobs Act signed into law late last year created a tax incentive aimed at increasing economic development in low-income communities. Both real estate developers and investors can benefit from the new Opportunity Zone tax incentive program enacted as part of that legislation, presenting the opportunity for significant tax savings.

Developers and investors may be familiar with current tax deferral programs such as section 1031 exchanges and the new markets tax credit, but the new Opportunity Zone tax incentive program allows not only tax deferral, but the potential for capital gain exclusion as well.

The Opportunity Zone tax incentive program provides three potential tax savings opportunities for investors (assuming a timely election is made on their tax return and other eligibility requirements are met):

- 1) immediate deferral of gain if proceeds from the sale of any property (including stocks and real estate) are invested in a Qualified Opportunity Fund within a given time period,
- 2) permanent exclusion of 10 to 15 percent of the deferred gain from taxation depending on how long the investment is held, and
- 3) exclusion from taxation on any appreciation in the fund if the investment is held for at least 10 years prior to sale.

The tax incentive requires an investment in a “Qualified Opportunity Fund.” A Qualified Opportunity Fund is an investment entity organized as a domestic corporation or partnership that invests in businesses or properties located in a qualified opportunity zone — a low-income area designated by the governor of a state and approved by the U.S. Department of Treasury. There is no size requirement for the investment entity, it can hold a single property or business or multiple properties or businesses, and can have few investors or many investors. However, in order to qualify as a Qualified Opportunity Fund the entity has to invest at least 90 percent of its assets in qualified opportunity zone businesses, and the rules generally require the entity be tested twice a year to confirm that requirement is met. A qualified opportunity zone business is generally any trade or business in which substantially all of the tangible property owned or leased by the business is located in a qualified opportunity zone. The rules prevent investment in certain businesses such as golf courses, gambling facilities, and package stores.

Gain Deferral and Exclusion

An investor who defers gain by investing in a Qualified Opportunity Fund will recognize the deferred gain in income on the earlier of the date the investment is sold or December 31, 2026. If the investment in the fund is held for at least seven years, the investor can exclude 15 percent of the deferred gain from taxation when the investment is sold. If the investment in the fund appreciates, the investor has the opportunity to exclude 100 percent of the appreciation from taxation if the investment is held for at least 10 years. This 100 percent exclusion only applies to the appreciation in the value of the investment since any deferred gain will be recognized by December 31, 2026, even if the investment is not sold.

The following illustration shows how the tax incentive works:

A building owner has a tax basis in her building of \$1,000,000 and sells it to an unrelated person on October 1,

2018, for \$2,000,000. Ordinarily she would have to pay taxes on a \$1,000,000 capital gain on her 2018 tax return. However, on January 15, 2019, along with a partner, she purchases a building in a qualified opportunity zone. They form a limited partnership as a Qualified Opportunity Fund to purchase the building, and she invests her \$1,000,000 gain in the fund. The fund buys the building on January 15, 2019. If she holds onto the investment until January 15, 2024, and then sells her share for \$1,500,000, she would only have to pay taxes on a \$1,400,000 gain, excluding 10% of the original deferred gain from taxation. If she held onto the investment until January 15, 2026, and then sells it for \$1,500,000, she would only have to pay taxes on a \$1,350,000 gain, excluding 15 percent (\$150,000) of the original deferred gain from taxation. However, if she holds onto her interest until January 31, 2029, and then sells it for \$1,500,000, her total taxable gain would only be \$850,000. Under the rules, the \$850,000 gain (15% of the original \$1,000,000 deferred gain) would automatically be recognized on December 31, 2026. Since she held onto the property for at least ten years, any appreciation after the original purchase would escape taxation. She would receive \$1,500,000 at the time of sale, but would not pay any more taxes on the receipt of that cash (she already paid taxes on the deferred gain). She would receive \$650,000 that is not subject to federal income taxes! (This all assume the income tax code does not change before then.)

Southcoast Qualified Opportunity Zones

In Massachusetts, 138 areas are designated as Qualified Opportunity Zones, including areas in Boston, Brockton, Cambridge, Fall River, Framingham, Lowell, New Bedford, Quincy, Springfield and Worcester. Specifically on the Southcoast there are eligible tracts of land in Fall River, Fairhaven, New Bedford and Somerset. The policy goal of creating these opportunity zones is to benefit the designated communities by providing an incentive for new businesses to be established or property redeveloped.

Investors and developers should keep the opportunity zone tax incentive in mind when they are considering projects where they can reinvest in a property or business. This is just a highlight of some of the main requirements of the opportunity zone tax incentive and the IRS has not issued any underlying regulations that may clarify or change some of the requirements. Prior to creating or investing in a Qualified Opportunity Fund an investor should become familiar with all of the requirements and any further guidance the IRS may issue once the program becomes more established.

A version of this article was published in the August 27 edition of Banker & Tradesman. That version can be viewed here. To view it on the Banker & Tradesman site, please [click here](#) (subscription required).

Date Created

September 11, 2018