THE OPPORTUNITY ZONE PROGRAM

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As part of the Tax Cut and Jobs Act enacted by Congress on December 22, 2017, Congress created a new program designed to encourage long-term private capital investment in economically distressed communities through the creation of "Opportunity Zones."[1] In addition to other investment opportunities, the Opportunity Zone program provides a potential alternative to traditional 1031 exchanges for real estate developers and investors. As explained below, the program provides a vehicle whereby investors are able to defer taxes on existing capital gains and, in certain circumstances, investors may be able to realize tax-free gains on their Opportunity Zone investment.

What is an Opportunity Zone?

The Opportunity Zone program is based on U.S. Census track data and is administered by the U.S. Department of the Treasury. The program permits the governor of each state to nominate up to 25 percent of the state's "low income communities"[2] as Opportunity Zones. Based on Nevada's demographics, Governor Brian Sandoval was permitted to nominate up to 61 U.S. census tracts for designation as qualified Opportunity Zones. On June 14, 2018, Nevada was notified that the U.S. Department of the Treasury had certified the 61 U.S. census tracts, ultimately nominated by Governor Sandoval, as Opportunity Zones. The designated Opportunity Zones are located throughout Nevada, with many in and around Nevada's major population centers.[3]

How Does the Opportunity Zone Program Work?

Investors wishing to participate in the Opportunity Zone program can do so by rolling over capital gains on previously held assets into a Qualified Opportunity Fund within 180 days of the date of sale of such assets. Unlike a traditional 1031 exchange, only capital gains are required to be rolled over into the Opportunity Fund, and there are no "like-kind" requirements. This means that investors are no longer limited to real estate exchanges, but may now also roll over capital gains from the sale of stocks (or any other property) into a Qualified Opportunity Fund. To be an eligible investment vehicle, a Qualified Opportunity Fund must be organized as a corporation or partnership formed for the purpose of investing in Qualified Opportunity Zone Property and must hold at least 90 percent of its assets in Qualified Opportunity Zone Property. Qualified Opportunity Zone Property is generally defined as stock or partnership interests in a business located in an Opportunity Zone, or property (real or personal) located and used in the operation of a business located in an Opportunity Zone. To be clear, direct investment into a business or direct purchase of property or equipment is not eligible for participation in the program. The capital gains must be invested in a Qualified Opportunity Fund, and the Qualified Opportunity Fund must make the investment in the Qualified Opportunity Zone Property.

What are the Benefits of Investing in a Qualified Opportunity Fund?

The Opportunity Zone program provides the following incentives to investors that timely invest capital gains in Qualified Opportunity Funds:[4]

1. The investor is allowed to temporarily exclude the capital gains invested in the Qualified Opportunity Fund from inclusion as taxable income until the first to occur of (i) the date the investor's investment in the Qualified Opportunity Fund is sold or exchanged, or (ii) December 31, 2026.

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2. Depending on the length of time the investment in the Qualified Opportunity Fund is held, the investor receives a stepped-up basis in the capital gains originally invested. If the investment remains in the Qualified Opportunity Fund for five years, the basis in the original capital gains is increased by 10 percent. If the investment remains in the Qualified Opportunity Fund for seven years, the investor receives an additional 5 percent step-up in basis in the original capital gains. Therefore, if an investor holds their investment in a Qualified Opportunity Fund for seven years, the investor will receive a 15 percent increase in basis on the original investment, exempting 15 percent of the originally invested capital gains from taxation.
3. If the investor holds their investment in the Qualified Opportunity Fund for 10 years, the basis in their investment in the Qualified Opportunity Fund is increased to the fair market value of the interest at the time it is sold. Therefore, if the investment is held for 10 years, any capital gains realized at the time of the sale or exchange are permanently excluded from inclusion in the investor's taxable income. To be clear, while the capital gains realized on the investment in a Qualified Opportunity Fund may be permanently excluded from taxable income, this exclusion applies only to gains realized after the initial investment. The deferred tax on the capital gains originally invested in the Qualified Opportunity Fund must still be paid at the time set forth above.

How is a Qualified Opportunity Fund Certified for Participation in the Program?

To qualify as a Qualified Opportunity Fund, the eligible taxpayer self-certifies by completing a form provided by the IRS and attaching the form to the taxpayer's return for the taxable year. There is no pre-approval or pre-certification of Qualified Opportunity Funds by the IRS required. As of the date of the writing of this article, the IRS has not yet released the certification form, but it is expected sometime in the summer of 2018.

Qualified Opportunity Funds as Real Estate Investment Vehicles

While Qualified Opportunity Funds can invest capital by way of acquiring stock or membership interest in qualifying businesses, the focus of this article is on the use of Qualified Opportunity Funds as a vehicle for real estate investment. To be eligible for the tax incentives in regard to real estate investments, Qualified Opportunity Funds must invest in real property that meets the following specific requirements.[5] The real property:

1. Must be used in the trade or business of the Qualified Opportunity Fund;
2. Must be acquired by the Qualified Opportunity Fund by purchase from an unrelated party after December 31, 2017; and
3. The original use of the property must commence with the Qualified Opportunity Fund or the Qualified Opportunity Fund must substantially improve the property. Property is deemed substantially improved if, during any 30-month period beginning after the date of the acquisition of the property, the cost of the improvements to the real property equals or exceeds the purchase value of the property.[6]

From a real estate perspective, there are a multitude of projects across the development spectrum that can take advantage of the Opportunity Zone program. Developers can purchase abandoned and blighted properties in the Opportunity Zones and convert those properties to mixed-use projects. Developers may construct low-income housing in areas with the most need or establish business hubs in areas where there is currently little to no economic activity.

Unlike a traditional 1031 exchange program complete with "like kind" exchange requirements, Opportunity Zones are much less restrictive and offer much broader tax benefits. Rather than simply deferring gain, the Opportunity Zone program provides a mechanism whereby a developer may roll capital gains over from the sale of stock, or other non-real estate investments, into a Qualified Opportunity Fund for the purpose of funding the acquisition of qualifying real property. The investor will be entitled to defer capital gains, increase the basis in the capital gains deferred and ultimately realize tax-free appreciation of the underlying real estate asset. That said, the Opportunity Zone Program is new and fairly untested to date. It is expected that in the coming months the Department of the Treasury and IRS will provide additional guidance regarding the program. The lack of in-depth guidance and precedence may have a chilling effect on early investors, but once a level of comfort is realized, it is anticipated that the Opportunity Zone program will result in a significant increase in development activity in Opportunity Zone designated communities.

This article is meant to provide an informative overview only and does not constitute legal or professional advice. The Opportunity Zone program has many specific requirements that are beyond the scope of this article, and readers are encouraged to consult qualified professionals with any questions related to the topics discussed herein. **NL**

1. The Opportunity Zone program is found in the newly created I.R.C. Subchapter Z.
2. "Low income communities" is defined in I.R.C. §45D(e) and is the same definition used for New Market Tax Credits.
3. The official list of the census tracts receiving Opportunity Zone designation is available at: diversifynevada.com/documents/NV_Designated_OZ.pdf.
4. I.R.C. §1400Z-(a) through (c).
5. I.R.C. §1400Z-2(d)(2)(D).
6. I.R.C. §1400Z-2(d)(2)(D)(ii).

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