7 Most Frequently Asked Questions About Opportunity Zones.

Qualified Opportunity Zones were included as part of the Tax Cuts and Jobs Act which became law in December 2017. The zones were originally introduced as the Investing in Opportunity Act sponsored by South Carolina Senator Tim Scott and are meant to encourage investment in economically distressed communities.

Opportunity Zones have generated a lot of interest and even more questions. This alert attempts to answer the most frequently asked questions we are hearing from clients.

1. What is the opportunity?

The opportunity is for investors with long-term capital gains to defer paying tax on those gains for a period of time while also investing in underserved communities that need capital.

2. Where are we in the process? What has happened so far?

Legislation creating the Opportunity Zones and setting forth the associated tax benefits has been passed. The deadline for state governors to propose the census tracts to be designated as Opportunity Zones was March 21, 2018. On April 9, the U.S. Treasury Department and the IRS validated census tracts in 18 states and territories.

3. What's next in establishing Opportunity Zones and Opportunity Funds?

The U.S. Treasury Department is tasked with promulgating regulations defining and refining certain requirements set forth in the legislation. Those regulations are expected this summer and are anxiously awaited as the deferred tax arising out of the Opportunity Zone investments will come due no later than the tax year ending December 31, 2026. Thus the earlier an investment is made, the longer the tax can be deferred.

4. Who should be most interested in Opportunity Zones?

Anyone with long-term capital gains they want to defer should be interested in Opportunity Zones. Investments in Opportunity Zones are made through Qualified Opportunity Funds. When the legislation was passed, most analysts believed the certification of Opportunity Funds would be performed through a structured process, perhaps administered by the Treasury Department's Community Development Financial Institutions (CDFI) Fund.

However, in a series of frequently asked questions published by the IRS on April 24, 2018, the Service said a Qualified Opportunity Fund can self-certify and "no approval or action by the IRS is required."

If this holds true, individuals with smaller gains may be able to reinvest them without having to worry about potential costs associated with investing in a larger, institutionally-managed fund. This process could make Opportunity Zone investing more efficient than similar incentives directed at low-income communities, such as the New Markets Tax Credit program or the Low-Income Housing Tax Credit (LIHTC).

The Tax Cuts and Jobs Act restricted the availability of tax-deferred exchanges under Section 1031 of the Internal Revenue Code to exchanges of real property, which may increase the attractiveness of Opportunity Zone investing to taxpayers holding personal property that would have been eligible for Section 1031 treatment prior to the passage of the Act.

5. How is this program not just a vehicle for gentrification?

The challenge facing Opportunity Zones is there is not necessarily a carrot and a stick in the statute for the investments to benefit anyone other than the investor. Unlike many state-level incentives, there are no requirements included regarding number of jobs, amounts of wages, or a certain percentage of hires of residents within the designated zone. Institutional funds from larger banks do pay attention to local outcomes.

The investments could serve as the seed for transforming these communities but might not, in and of themselves, effect the desired outcomes without additional requirements imposed on the success of such investments.

6. How can the impact of Opportunity Zones be maximized for the investor?

Assuming the investor has the liquidity to pay the tax when it comes due in 2026, the longer she holds the investment, the greater the benefit. Under the Opportunity Zone legislation, if the investor holds her Opportunity Zone investment for at least ten years, she will have a step-up in basis to the fair market value of the investment when it is eventually sold. In other words, while tax will always come due on her initial deferred gain (at least under the statute as currently in effect), the taxpayer could potentially avoid any tax on future appreciation in the investment.

7. How should investors begin planning for Opportunity Zones?

Investors have only 180 days within which to reinvest their deferred gain in a Qualified Opportunity Fund. Investors who are, or think they may be, in a position to have qualifying gains are encouraged to begin active due diligence on designated zones and businesses in which to invest. Opportunity Zone investments do not have to be made in the state where the investor lives. There are a number of states that have set up websites with information on the designated zones; e.g. South Carolina Opportunity Zones.

Opportunity Zones represent an exciting and potentially valuable economic and community development tool. Whether the potential impact comes to fruition remains to be seen. With respect to any individual taxpayer, careful analysis should be done to determine whether an Opportunity Zone investment is the right fit for their portfolio.

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