

Bond Case Briefs

Municipal Finance Law Since 1971

Incentives for Qualified Opportunity Zone Investments: Check Your Locations

In Short

The Background: The Tax Cuts and Jobs Act created a new tax incentive program to encourage investments in qualified opportunity zones (“OZs”). Taxpayers seeking to redeploy gains from other sources can obtain favorable tax deferral and tax reduction if the gains are reinvested in OZs.

The Development: All of the OZs have been designated, and both developers and investors should determine if their projects are in those zones, as the tax benefits can be substantial.

Looking Ahead: Taxpayers may take advantage of this new program for property disposed of through 2026.

The Tax Cuts and Jobs Act created a new tax incentive program to encourage investors to reinvest gains from other sources in qualified OZs. OZs are low-income communities identified by specific census tracts that were selected by the governor of each state and approved by the Secretary of the U.S. Treasury. There are more than 8,000 OZs in urban and rural areas. Investors, developers, investment funds, and other businesses should review the locations of OZs to determine if they encompass existing or future investment plans.

Gains from dispositions of property may receive preferential tax treatment if a taxpayer reinvests those gains in an OZ. Reinvestment must be made through a qualified opportunity fund (“OZ Fund”) within 180 days of the property’s disposition. A taxpayer may elect this treatment of gains for any property disposition occurring through December 31, 2026. Gains may be short- or long-term from dispositions of any type of property. Because deferred gains are reinvested, a taxpayer’s initial basis in an OZ Fund investment would be zero. A taxpayer’s potential tax benefits from an investment are:

- Deferral of tax on reinvested gains until earlier of disposition of the investment or December 31, 2026;
- If held five years, a step-up in basis of 10 percent of the reinvested gain, thereby reducing the tax eventually payable on the deferred gain;
- If held seven years, an additional step-up in basis of 5 percent; and
- If held 10 years, an election to have the investment’s basis be equal to its fair market value, thereby potentially eliminating recognition of gain on the investment.

The value of the tax benefits may be significant. For a corporate taxpayer subject to a 21 percent marginal rate, net present value of the tax deferral for an investment made in 2018 and disposed in 2026 could be 9 percent to 11.5 percent of the deferred gain assuming a range of discount rates of 6 percent to 10 percent. For an individual whose gain is subject to a 37 percent marginal rate (e.g., on short-term capital gains), net present value could be 16 percent to 28 percent of the deferred gain assuming the same discount rates. Naturally, actual benefits would vary from these simple estimates.

If a taxpayer holds a OZ Fund investment through 2026, the taxpayer must recognize the deferred gains (after reduction for any basis step-ups) at the end of 2026 equal to the lesser of (i) the remaining deferred gain or (ii) the fair market value of the investment. Therefore, if the OZ Fund continues after 2026, the taxpayer would need sufficient funds from sources outside of the OZ Fund to pay the taxes from this recognition event.

An OZ Fund must maintain at least 90 percent of its assets in qualified OZ property. Qualified property includes specific types of real estate and other tangible property, as well as equity interests in qualified businesses in the OZ. Specific types of “sin” properties and businesses are excluded such as golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks, gambling facilities, and liquor stores. There are a number of other technical rules that apply. Failure to comply with all requirements would subject the OZ Fund to annual penalties and cause investors to lose tax benefits.

To foster new investments, qualified property must be acquired after 2017 and must either be substantially improved or used for the first time by the OZ Fund or its subsidiary. An OZ Fund’s property may also qualify under other programs (such as the tax credit programs for low income housing, new markets, and historic rehabilitations) that may enhance the investment potential. An OZ Fund may receive funds that are not reinvested gains (and do not qualify for the new program’s benefits), in which case the sources of capital need to be separately tracked.

Investors and business owners should consider the potential benefits of the new program for any OZ investment. Each investment should be reviewed to determine if the new program is consistent with the investment’s business plan and the investors’ goals. That evaluation should include a careful analysis of whether the investment qualifies under the new program and is structured to maintain compliance with the program’s conditions.

But all analyses begin with a simple question of whether or not the business is located in a qualified OZ. If so, the possible tax benefits should be evaluated.

Further guidance from the IRS is expected on this program.

Two Key Takeaways

1. Evaluate all investments to determine if they are located in OZs.
2. Any project or business in an OZ that anticipates obtaining capital from taxpayers (instead of tax-exempt investors) should determine if the investment would benefit from qualifying under the program.

Jones Day

August 31, 2018