Opportunity Zones Program Overview

WHITE PAPER

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Overview: The Opportunity Zones program was established by Congress in the Tax Cuts and Jobs Act as an innovative approach to spurring long-term private sector investments in low-income, urban and rural communities nationwide. The program is based on the bipartisan Investing in Opportunity Act.

The program establishes a mechanism that enables investors with capital gain tax liabilities across the country to receive favorable tax treatment for investing in Opportunity Funds that are certified by the U.S. Department of the Treasury. The Opportunity Funds use the capital invested to make equity investments in businesses and real estate in Opportunity Zones designated by each state.

The designation as an Opportunity Zone remains in effect for the period beginning on the date of the designation and ending at the close of the 10th calendar year beginning on or after such date of designation. All Opportunity Zone designations will be made in 2018; thus, all designations will be effective through December 31, 2028. Investments made before this date in the currently designated Opportunity Zones will continue to qualify even when these designations expire.

Favorable Tax Treatment

The Opportunity Zones program allows taxpayers to defer capital gains on the sale of stock, business assets or any other property (whether or not the asset sold was located in or related to a low-income community) by investing the proceeds in an Opportunity Fund within 180 days of the sale or exchange in an amount equal to the gain to be deferred. For example:

- If an individual sells stock with a tax basis of $200,000 for $1 million, the entire capital gain of $800,000 could be deferred if at least $800,000 of the proceeds were invested in a timely manner into an Opportunity Fund.
- If the taxpayer instead chooses to only invest $500,000 of the proceeds into an Opportunity Fund, then $300,000 of the gain would be taxed in the year of the sale, and $500,000 of gain would be deferred.
- If the taxpayer invests the entire $1 million of proceeds in an Opportunity Fund, then the investment would be treated as two separate investments. The $800,000 in capital gain would be eligible for the Opportunity Zones program, while the additional $200,000 would be considered a normal investment.

The investor's original deferred gain (less any amount forgiven) will be subject to tax on whichever date comes first: either December 31, 2026 or when the investor sells interest in an Opportunity Zone Fund.

In addition to the deferral of capital gains, the Opportunity Zones program includes holding period benchmarks that result in greater tax benefits. Ten percent of the deferred gain is forgiven for Opportunity Fund investments held for five years, and fifteen percent is forgiven if the investment is held for seven years. For an Opportunity Fund investment held for 10 years, the tax basis of the new investment (not including the original deferred gain) is deemed to be its fair market value when sold.

Analysis

Deferral and Eventual Recognition of Capital Gains

> *Taxpayers will have **180 days** from the date on which the gain would be recognized for federal income tax purposes to invest in a Qualified Opportunity Fund.*

Any taxpayer who recognizes capital gains for federal income tax purposes is eligible to elect to defer an unlimited amount of capital gain from the sale or exchange of property to an unrelated person by making an equity investment of part or all of the proceeds related to the gain in an Opportunity Fund. Eligible taxpayers include individuals, C corporations (including RICs and REITs), partnerships and certain other pass-through entities. Taxpayers will have 180 days from the date on which the gain would be recognized for federal income tax purposes to invest in a Qualified Opportunity Fund.

The deferred gains are taxable when the investment in the Opportunity Fund is sold or, if earlier, December 31, 2026. The requirement that all deferred gains be included in income on December 31, 2026, whether or not the investment in the Opportunity Fund has been sold, creates a phantom income issue in which the taxpayer is forced to report income without receiving the benefit of having the cash to pay the tax.

The amount of deferred gain subject to tax is adjusted by a loss on the sale of an investment in an Opportunity Fund. Only the actual gain realized is subject to tax, which is calculated by taking the lesser of the amount of deferred gain or the fair market value of the taxpayer's investment in the Opportunity Fund as of the date of gain recognition minus the taxpayer's basis in the Opportunity Fund. The taxpayer's basis in the deferred capital gain proceeds invested in the Opportunity Fund is deemed to be zero at initial investment. The basis is increased by the amount of the deferred gain included in the taxpayer's income.

The attributes of the deferred gain are preserved through the holding period of the investment in the Qualified Opportunity Fund and are taken into account when the deferred gain is recognized. It is anticipated that the deferred gain will be taxed at the rate in effect in the year of gain recognition.

Five- and Seven-Year Holding Periods

As previously discussed, if a taxpayer holds an investment in an Opportunity Fund for five years, then ten percent of the deferred gain is forgiven. If a taxpayer holds an investment in an Opportunity Fund for seven years, then fifteen percent of the deferred gain is forgiven. For example:

Five-Year Holding Period

On July 1, 2018, a taxpayer sold stock having a tax basis of $200,000 for $1 million, invested the $800,000 of proceeds in an Opportunity Fund in a timely manner and then sold his Opportunity Fund investment on August 15, 2023. Only $720,000 (i.e., $800,000 – [10% of $800,000]) of the $800,000 deferred gain would be subject to tax.

Seven-Year Holding Period

Consider the same facts as the five-year period, but the sale of the Opportunity Fund investment was instead made on August 15, 2025. Only $680,000 (i.e., $800,000 – [15% of $800,000]) of deferred gain would be subject to tax.

It remains unclear whether investors would receive the benefits of these holding periods if they straddle the December 31, 2026 recognition date. However, it does appear that an investor would receive the step-up in basis and be able to offset some appreciation on the Opportunity Fund investment if the interest is sold before the 10–year holding benchmark (at which point the tax basis would equal the fair market value of the investment). For example:

If the stock was sold and the Opportunity Fund investment was made on July 1, 2022, neither the five-year nor the seven-year holding period would be met by December 31, 2026, and so, on that date, the taxpayer would have to include the entire $800,000 of gain in income for the 2026 taxable year. The taxpayer's basis in the Opportunity Fund would be increased from zero to $800,000. If the taxpayer continued to hold the investment until August 15, 2027 and then sold his or her interest for $1.5 million, it appears that his or her basis would be further increased by $80,000 (10% of the original deferred gain), and, thus, the gain on the sale would be $620,000 ($1,500,000 – $880,000).

Ten-Year Holding Period

In addition to the benefits received for holding an Opportunity Fund investment for five or seven years, another potentially valuable benefit can be attained by holding the investment for at least 10 years. If a taxpayer holds an investment in an Opportunity Fund for at least 10 years, then the tax basis of the investment is deemed to be the fair market value at the time of sale. Only investments made in connection with a proper deferral election are eligible for the step-up in basis. Because of the mandatory recognition date of December 31, 2026, it appears that the intent of this provision is to forgive gain on appreciation of the investment in the Opportunity Fund. For example:

> Consider the same facts from the seven-year holding period example, but the taxpayer held such investment until August 15, 2028. He previously included $680,000 in income on December 31, 2026 (because he met the seven-year holding period at that time) and, in return, stepped up his basis to the original deferred gain amount of $800,000. When the taxpayer sells the investment for $1.5 million, his basis would be stepped up from $800,000 to $1.5 million, and he would recognize no gain on the sale, so the effect of the 10-year provision is to entirely exclude tax on appreciation.

Qualified Opportunity Funds

A Qualified Opportunity Fund is an investment vehicle that is recognized as either a partnership or a corporation for federal income tax purposes and is used for investing in eligible Qualified Opportunity Zone Property. A Qualified Opportunity Fund is required to hold at least 90% of its assets in such property.

Eligible entities will be able to self-certify as a Qualified Opportunity Fund by merely completing Form 8996, "Qualified Opportunity Fund", and attaching this form to the taxpayer's federal income tax return. As of this writing, Form 8996 is a draft form and should not be filed until finalized by the IRS.

It is currently anticipated by the IRS that eligible taxpayers will make deferral elections on Form 8949, which will be attached to their federal income tax returns for the taxable year in which the gain would have been recognized if it had not been deferred.

Qualified Opportunity Funds can elect their first month to be recognized as a Qualified Opportunity Fund. Absent an election, the first month is deemed to be the first month of the taxable year of the entity. Investments made before an entity is recognized as a Qualified Opportunity Fund are not eligible for the deferral election.

The 90% Asset Test is determined in the initial year by taking the average of the percentage of Qualified Opportunity Zone Property held by the Opportunity Fund as measured (i) on the last day of the first six-month period that the entity is recognized as a Qualified Opportunity Fund, and (ii) on the last day of the taxable year. If a calendar year Qualified Opportunity Fund elects its first month to be after June, then the only testing date in the initial year will be December 31. In subsequent years, the test is determined using the last day of the first sixth months of the taxable year and the last day of the taxable year. Taxpayers are required to use the value of the assets on their applicable financial statements for the 90% Asset Test. If no applicable financial statements are available, then taxpayers are required to use the cost of the assets.

If an Opportunity Fund fails the 90% Asset Test in any year, it is not disqualified as such, but it is required to pay apenalty for each month in which it fails to meet the requirement. The penalty is calculated by taking the difference between (i) 90% of the Opportunity Fund's assets and (ii) the amount of Qualified Opportunity Zone Property held by the Opportunity Fund (iii) multiplied by the federal underpayment rate in effect. Administrative rules related to this failure to maintain the 90% Asset Test will be covered in forthcoming regulations.

Qualified Opportunity Zone Property

Qualified Opportunity Zone Property is property that is (i) Qualified Opportunity Zone Stock, (ii) Qualified Opportunity Zone Partnership Interests or (iii) Qualified Opportunity Zone Business Property.

Qualified Opportunity Zone Stock

A Qualified Opportunity Zone Business is stock of any domestic corporation (i) acquired by the Opportunity Fund after December 31, 2017, at original issuance solely in exchange for cash, and (ii) which, at the time such stock is issued and during substantially all of the Opportunity Fund's holding period. A newly-formed corporation does not need to constitute a Qualified Opportunity Zone Business on the date the stock is issued, but it must have been organized for purposes of being a Qualified Opportunity Zone Business. Additionally, stock does not qualify if the issuing corporation redeemed a significant amount of its stock within the two-year period beginning one year before the issuance to the Opportunity Fund or redeemed any stock from the Opportunity Fund or a party related to the Opportunity Fund within a four-year period beginning two years before the issuance to the Opportunity Fund.

Requirements for Qualified Opportunity Zone Partnership Interests are substantially identical to the above requirements for Qualified Opportunity Zone Stock.

Qualified Opportunity Zone Business

To qualify as an Opportunity Zone Business, a trade or business is required to hold at least 70% of its tangible property, owned or leased, in Opportunity Zone Business Property. The trade or business is also required to derive at least 50% of its gross income from the active conduct of a trade or business in the Qualified Opportunity Zone and have less than 5% of its assets invested in nonqualified financial property. An entity must be a Qualified Opportunity Zone Business when the Qualified Opportunity Fund acquires its equity interest and during substantially all of the Qualified Opportunity Fund's holding period.

Nonqualified financial property is defined as debt, stock, partnership interests, options, future contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property. This includes bank accounts, checking accounts and other time and demand deposit accounts. It appears that cash would also be treated as nonqualified financial property, not including reasonable amounts of working capital held in cash, cash items or debt instruments with a term of 18 months or less.

The regulations provide for a working capital safe harbor for Qualified Opportunity Fund investments in a Qualified Opportunity Zone business that acquires, constructs or rehabilitates tangible business property, which includes both real and other tangible property used in a business operating in an Opportunity Zone. This working capital safe harbor includes cash, cash equivalents and debt instruments with a term of 18 months or less. Qualified Opportunity Funds will be able to apply this safe harbor for 31 months (1 month longer than the 30-month period in which substantial improvements must be made). Requirements to use the safe harbor include: a written plan that identifies the financial property as property held for acquisition, construction or substantial improvement of tangible property; a written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months; and that the business substantially complies with the schedule.

A trade or business will not qualify as Opportunity Zone Business if it is engaged in owning or operating any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

If any tangible property owned or leased by an Opportunity Zone Business fails to qualify as Opportunity Zone Business Property, it shall continue to be treated as such for the lesser of five years after the date on which it ceased to qualify or the date on which such property is no longer owned by the Opportunity Zone Business.

Qualified Opportunity Zone Business Property

Qualified Opportunity Zone Business Property is tangible property used in a trade or business that (i) is acquired by purchase after December 31, 2017, (ii) the original use of which in the Opportunity Zone commences with the Opportunity Zone Business, or the Opportunity Zone Business substantially improves the property, and (iii) substantially all of the use of which is in the Opportunity Zone.

Revenue Ruling 2018-29 provides clarity on the substantial improvements required when purchasing a building within an Opportunity Zone that is not beginning its original use with the Qualified Opportunity Fund. The ruling provides that tangible property is treated as substantially improved by the Qualified Opportunity Fund only if during any 30-month period beginning after the date of acquisition of the property additions to basis with respect to such property in the hands of the Qualified Opportunity Fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the Qualified Opportunity Fund. Most importantly, land is excluded when calculating the adjusted basis of the property.

For example:

> A Qualified Opportunity Fund purchases a building and the piece of land on which the building sits within an Opportunity Zone for $500,000 with the intent to improve the building. 60% of the purchase price is allocated to the land ($300,000) and 40% of the purchase price is allocated to the building ($200,000). Under this revenue ruling, the amount allocated to the land is excluded from the basis of the property. The Qualified Opportunity Fund is required to make at least $200,000 in improvements to the building within 30 months of the acquisition in order to satisfy the substantial improvement rule.

Property can be held directly by a Qualified Opportunity Fund.

Pre-Existing Entities

The regulations provide that pre-existing entities can qualify as Qualified Opportunity Funds or Opportunity Zone Businesses, providing they satisfy the necessary requirements. These requirements include the 90% Asset Test for a Qualified Opportunity Fund and the 70% Substantially All Test for an Opportunity Zone Business. The requirements for Qualified Opportunity Zone Business Property include (i) the property was acquired by purchased after December 31, 2017; (ii) the original use of the property in the Qualified Opportunity Zone commences with the Qualified Opportunity Fund, or the Qualified Opportunity Fund substantially improves the property; and (iii) during substantially all of the Qualified Opportunity Fund's holding period for the property, substantially all of the use of property was in in the Qualified Opportunity Zone. Because of the requirement that property be acquired after December 31, 2017, a number of businesses already within the Opportunity Zone would not qualify for the program. The U.S. Department of the Treasury and the IRS are requesting comments on whether there is a statutory basis for additional flexibilities that might facilitate qualification of a greater number of pre-existing entities.

Examples of Potential Opportunity Funds

A $100 million national private equity fund that provides growth capital to lower middle-market operating businesses located in Opportunity Zones

A $20 million local fund that provides the equity capital for the $100 million redevelopment of a closed shopping mall into a mixed-use development that includes new neighborhood retail and workforce housing

A $50 million disaster area fund that develops and leases new affordable housing for residents displaced by the 2018 hurricanes and forest fires

Topics Still to be Covered in the Next Round of Regulations

The U.S. Department of the Treasury and the IRS laid out some topics that will be covered in forthcoming regulations. These topics include:

- The meaning of "substantially all" throughout the provision;
- Transactions that would trigger the inclusion of deferred gain in income;
- The reasonable period in which Qualified Opportunity Funds will have to reinvest proceeds from the sale of qualifying assets and the treatment of any gains realized by these sales;
- Administrative rules for when a fund fails the 90% Asset Test;
- Conduct leading to decertification; and
- Information about reporting requirements.

Interested in learning more about Opportunity Zones?

If you are interested in investing in an Opportunity Zone Fund or expanding into an Opportunity Zone, Warren Averett can help you discover the options that are available to you and implement planning strategies to make the most of your investment.

Speak with a Warren Averett Tax Advisor ⟶