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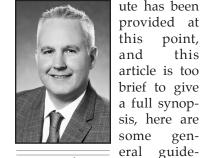
Law & Accounting

Opportunity zones: Tax reform's least-publicized incentive

Part of the Tax Cuts and Jobs Act that recently came into law includes new incentives for investments into economically distressed areas designated by states choosing to participate. As most aspects of the TCJA discussion have focused on the provisions that include, among other things, repatriation of earnings held in foreign jurisdictions and the 20 percent business income deduction (which includes benefits for real estate businesses), almost no attention has been given toward incentives regarding opportunity zones.

The new statute defines a "qualified opportunity zone" as a population census tract that is a low-income community designated as a qualified opportunity zone. The U.S. Treasury Department recently approved 126 census tracts, which were designated/nominated by the state of Colorado as eligible for investment incentives. Additional information on opportunity zones and a map for Colorado can be found at https://choosecolorado.com/oz/. As of now, opportunity zones have been approved by the U.S. Department of Treasury in 20 states and four territories.

Although little additional guidance outside of the stat-



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in regards to the qualified opportunity zone(s):

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■ If property is located in a qualified opportunity zone, the investment needs to be made into a "qualified opportunity fund." Based on the statute, a qualified opportunity fund is defined as an entity organized as a partnership or a corporation of which 90 percent of assets are located inside of the qualified opportunity zone.

If gains from the sale of "any" property are reinvested into a qualified opportunity fund, those gains, by election, are deferred. This deferral is a concept similar, although much less restrictive, to those of a 1031 exchange. Unlike 1031 exchanges, where generally all of the proceeds from a sale are required to be reinvested into replacement property in order to defer gain, in the case of investments into a qualified opportunity zone the

reinvestment amount is based of rate from (presumably) 20 on the amount of gain, rather than proceeds.

For example, if the sale of property for \$1 million in 2018 generates gain of \$200,000, a taxpayer may elect to defer the \$200,000 gain by investing \$200,000 into a qualified opportunity fund. The excess \$800,000 is unrestricted and irrelevant to the deferral. By statute, a taxpayer has 180 days after the recognition of gain to reinvest into a qualified fund to qualify for deferral - similar to 1031 rules but without restrictions of a qualified intermediary.

■ If the reinvested funds (investment) are held for at least five years, then the initial deferred gain is reduced by 10 percent. If the investment is held for seven years, an additional 5 percent reduction in the gain is available. If the investment still is held at Dec. 31, 2026, 85 percent of the original deferred gain would be recognized in that year (i.e., 2026 tax year), with the remaining 15 percent gain being excluded permanently. If the investment hits both the five- and seven-year milestones, there is the immediate benefit of a deferral of any payment of taxes until 2026, coupled with additional benefits of both a time value of money component and an effective reduction

percent down to 17 percent after the two reductions are applied. Lastly, if the investment in the fund is held for at least 10 years, any additional gain, beyond the 85 percent already recognized, is deemed to be zero.

To put it in more simple terms, if a taxpayer has gain from any property in 2018 and reinvests the gain amount (not to be confused with the total proceeds) into a qualified fund, such gain would be nontaxable in 2018. If the taxpayer holds the investment for at least 10 years, he would recognize 85 percent of the original gain amount in year 2026, and any additional gains that are realized/recognized after the 10-year holding period would be completely tax free for federal income tax purposes – what can amount to a windfall to long-term investors if market values increase substantially during the 10-year (or more) hold.

Similar to various real estate credits, there can be a requirement for the fund to substantially improve property in order to qualify. Substantial improvement has the meaning that "during any 30-month period beginning after the date of such 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."

For private equity-based real estate development companies that have, or will have, property inside an opportunity zone, the ability to attract capital, theoretically, should increase incrementally. The ability for investors to invest pretax dollars into a fund can increase their returns, and potentially make terms more favorable in favor of the sponsor.

Although this article is based on real estate investment opportunities, other businesses located inside a zone also may qualify, even if they don't directly own the real property it sits on. In any case, it is important to be aware of where the zones exist, and whether a business strategy is available to reduce or eliminate gains on the exit of investments that fall within the zone. More guidance will be available in the near term, but it is important that taxpayers consult their tax advisers on this issue if they are contemplating new development or business ventures that might fall within an opportunity zone.▲