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TAX ALERT

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IRS proposes regulations for Opportunity Zone tax incentives

The Tax Cuts and Jobs Act (TCJA) includes a provision to bring capital investments to distressed areas throughout the country. It allows taxpayers to defer tax on capital gains by investing in these Opportunity Zones, which now have newly released proposed regulations from the IRS.

Overview of the Opportunity Zone Tax Incentive

A new section of the TCJA establishes Opportunity Zones within low-income communities, which lasts until December 31, 2028. More than 8,700 communities in all 50 states, the District of Columbia, and five U.S. territories have been designated as qualified Opportunity Zones through Section 1400Z.

Investors can form private investment vehicles, known as qualified opportunity funds (QOFs), for funding development and redevelopment projects in these zones.

QOFs must maintain at least 90% of their assets in qualified Opportunity Zone property with periodic certification required (IRS Form 8996), including investments in:

- New or substantially improved commercial buildings,
- Equipment and multifamily complexes, or
- Qualified Opportunity Zone businesses.

QOF investors are eligible for tax benefits if they meet certain criteria. They can defer short- or long-term capital gains on a sale or disposition if they reinvest the gains in a QOF (the Deferral Benefit).

The deferral election is temporary, and the "old gain" is deferred until the earlier of:

- The date the qualified opportunity fund investment is sold or exchanged, or
- December 31, 2026.

If the investment runs five years, an investor will enjoy a step-up in tax basis equal to 10% of the original gain, meaning the investor will owe tax only on 90% of that gain. An additional 5% in basis is added at the seven-year point, cutting the taxable portion of the original gain to just 85%.

The invested gain will retain the attributes and character it held when it was initially deferred (i.e., short-term capital gain, long-term capital gain, etc.). The tax rate that will apply is the tax rate in effect when the "old gain" is realized, that is 2026 or when the investment is sold if earlier.

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In addition to the capital gain deferral, an investor is eligible for an increase in the basis of some or all of the interest in the QOF investment up to its fair market value on the date it's sold or exchanged, if the investment in the QOF is held by the investor for at least 10 years (the Exclusion Benefit). Thus, no gain ("New Gain") will be realized on that sale or exchange.

The tax benefits can be further enhanced when combined with other credits, such as the Low Income Housing tax credit and the New Markets tax credit.

Clarification on Rules for Investors

The proposed regulations make clear that only capital gain from a sale to, or exchange with, an unrelated person qualify for tax deferral. The term "capital gain" includes short-term gains and gains treated as capital gain under Section 1231 and unrecaptured Section 1250 gain (gain attributable to certain prior depreciation on real estate). Until there is further guidance, it does not appear that "capital gain" includes Section 1245 and Section 1250 depreciation recapture taxed at ordinary income tax rates.

For gains experienced by pass-through entities, the rules generally allow either the entity or the partners, shareholders, or beneficiaries to elect deferral. The proposed regulations also clarify that an investment in a QOF must be an equity interest, including preferred stock or a partnership interest with special allocations. A debt instrument doesn't qualify. A taxpayer can, however, use their QOF investment as collateral for a loan.

Qualifying for Deferral
To qualify for deferral, investors must invest in a QOF during the 180-day period beginning on the date of the sale that generates the gain. For amounts considered a gain, the first day of the period is generally the date that the gain would otherwise be recognized for federal income tax purposes.

For partnership gains not deferred by the entity, a partner's 180-day period generally begins on the last day of the partnership's taxable year. That's the day the partner would otherwise be required to recognize the gain. If a partner knows both the date of the partnership's gain and its decision not to elect deferral, the partner can begin its own period on the same date as the start of the entity's 180-day period. The same rules apply to other pass-through entities.

The manner of making elections by partnership and partners is not laid out in the Proposed Regulations; presumably such procedures will be detailed out in future guidance.

What Happens After the Opportunity Zone Designations End
The IRS noted that the expiration of Opportunity Zone designations at the end of 2028 raises questions about QOF investments that are still held at that time. For example, can investors still make basis step-up elections after 10 years for QOF investments made in 2019 or later?

The proposed regulations preserve the ability to make the election until December 31, 2047. Because the latest gain subject to deferral would be at the end of 2026, the last day of the 180-day period for that gain would be late June 2027. A taxpayer deferring such a gain would reach the 10-year holding requirement only in late June 2037.

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Why the extra ten years? They're provided to preempt situations where a taxpayer would need to dispose of a QOF investment shortly after completion of the 10 years to obtain the tax benefit, even though the disposal would otherwise be disadvantageous from a business perspective.

If an investor disposes of its entire original interest in a QOF, which would normally trigger inclusion of the deferred gain, the investor can continue the deferral by reinvesting the proceeds in a QOF within 180 days. This allows investors to escape bad deals without forfeiting the deferral benefit.

New Rules for QOFs

The proposed regulations from the IRS address several issues related to QOFs. For example, they exclude land from the determination of whether a purchased building in an Opportunity Zone has been "substantially improved," which is defined as doubling the basis, or investing an amount at least equal to the purchase price. Improvement is measured only by the QOF's additions to the adjusted basis of the building.

This is helpful to investors; for example, if a QOF buys a $3 million property, with $2 million assessed for the land and $1 million for the building, it's required to invest only $1 million to improve the building.

Section 1400Z also allows QOFs to invest in qualified Opportunity Zone businesses, rather than directly owning property, as long as "substantially all" of the business's leased or owned tangible property is qualified Opportunity Zone business property. The proposed regulations recently released by the IRS clarify that "substantially all" means at least 70% of the leased or owned tangible property.

Additional proposed rules cover self-certification of QOFs, valuation for purposes of the 90% asset test, and other matters.

Qualified Opportunity Zones in California

With states allowed to designate 25% of eligible census tracts (using various poverty qualifiers) as opportunity zones, California now has 879 participating tracts. Governor Jerry Brown utilized three main criteria when making his selections, including:

- Poorest areas within each county
- At least 30 business establishments in order to drive more investment
- Geographic diversity

All of the governor's nominated tracts were approved by the U.S. Department of the Treasury. Maps and other resources can be found on the California Department of Finance website at http://dof.ca.gov/Forecasting/Demographics/opportunity_zones/.

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David Sacarelos is a CPA with over 30 years of experience and has worked with a variety of clients over the years, including real estate investors and developers; high-net-worth individuals and multi-generational families; private foundations and public charities; privately owned businesses ranging from early-stage to mature; and many others. He is one of the firm's most senior tax professionals, and a leading specialist in real estate matters. David serves on the firm's Executive Committee and helps oversee the firm's initiatives around growth and thought leadership.

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