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Opportunity Zone Investing Can Cut Your Tax Bill

Taxes are an *expense* we all have, not really an *opportunity*. Yet if you play your cards right, tax savings and opportunities can now go together in a big way. The big federal tax bill passed in the closing days of 2017 is loved or hated by some, but few provisions have sparked as much debate as the creation of Opportunity Zones. The idea is to try to encourage people to invest in distressed areas called Qualified Opportunity Zones (QOZs), giving them big tax incentives for doing it. Investors get the tax benefits, so let's look at the basics. How big are the tax benefits? Business or individual investors can elect to temporarily *defer* federal income taxes on capital gains if they timely invest their gain in a Qualified Opportunity Fund (QOF). You can defer the tax on your invested gain amounts until the date you sell your QOF investment, or December 31, 2026, whichever is earlier. And wait, there's more. investing in Opportunity Zones isn't just tax deferral. How *long* you hold your QOF investment determines other tax benefits. If you hold the QOF investment for at least five years, the basis of your QOF investment increases by 10% of the deferred gain. So, when you sell your QOF investment later, you never have to pay tax on that portion. Hold it longer, the tax deal from the IRS gets even better.

So say you just sold a piece of real estate and you are worried about the big tax bill. Or maybe you sold your business and have a big tax bill there. As long as you invest in a QOZ within 180 days of your sale, you can delay the tax until as long as December 31, 2026. Think of it as rolling over your gain from selling one investment into another. You pay taxes later. If you hold the QOF investment for at least seven years, your tax basis in the QOF investment increases to 15% of the deferred gain. Again, no tax on that amount ever. And if you hang on to your investment in the QOF for at least ten years, you can elect to adjust the basis of your QOF investment to its *fair market value* on the date you sell your QOF investment. Assuming that you sell your investment at fair market value, that means no tax on your QOF gain.

What kind of sales proceeds and gains qualify for rolling into a QOF? Can you get paid a big bonus at work, and roll that in? Nope, whether you are an employee or independent contractor, pay from your work doesn't qualify. But selling stocks, real estate, or even your personal residence (except for the tax exclusion portion of your residence) can qualify. Low income communities and certain communities near them can qualify as Opportunity Zones. A state, the District of Columbia or a U.S. territory must nominate them for that designation, and the U.S. Treasury must certify that nomination. Following the nomination process, 8,764 communities in all 50 states, the District of Columbia and five U.S. territories were certified as Qualified Opportunity Zones (QOZs). Congress later designated each low-income community in Puerto Rico as a QOZ effective Dec. 22, 2017. You can find a list of each QOZ in IRS Notices 2018-48 and 2019-42. A map of the census tracts designated as QOZs is visible at Opportunity Zones Resources.

The gains that can be deferred are called "eligible gains." They include both capital gains and so-called qualified 1231 gains for businesses and investor. (If you have investment real estate, it's technically 1231 property.) However, only gains that would be recognized for federal income tax purposes before Jan. 1, 2027 qualify. Gains triggered by a transaction with a related person don't qualify. So, you can't sell something to your relative and plow the proceeds into a QOF.

Once you have eligible gain, you must timely invest—that means within 180 days of when you sold assets triggering gain—in a QOF. And your investment must be an *equity* interest in the QOF. Then you tell the IRS about it and claim the tax deferral on your tax return. Can you wait until *after* the end of the tax year where you had the big gain, and invest next year but before you file your tax return?

Yes, if you meet the 180-day rule. Say you sell something triggering gain in November, can you decide to invest in a QOF the following April? Yes, that's fine, since it's within 180 days. It's even OK if you *already* filed your tax return and *reported* the gain you had in November. You just have to quickly amend (remember the 180-day rule). You have to make the election to roll over your gain, in whole or in part as part of your tax return and on IRS Form 8949. Check out the IRS Form 8949 instructions.

What's a Qualified Opportunity Fund? You'll see lots of QOFs marketed these days. A QOF is an investment vehicle that files either a partnership or corporate tax return that is organized to invest in QOZ property. To become a QOF, an eligible corporation or partnership self-certifies as a QOF by annually (and timely) filing Form 8996 with its federal income tax return. An LLC can also be a QOF, if it elects to be treated either as a partnership or corporation for federal tax purposes.

To be a qualifying ownership interest in a corporation or partnership, (1) the interest must be acquired after Dec. 31, 2017, solely in exchange for cash; (2) the corporation or partnership must be a QOZ business; and (3) for 90% of the holding period of that interest, the corporation or partnership was a QOZ business. The IRS has details on these rules in its Form 8996 instructions. QOZ property is a QOF's qualifying ownership interest that operates a QOZ business in a QOZ, or certain tangible property of the QOF used in a business in the QOZ.

QOZ business property is tangible property that a QOF acquired by purchase after 2017 that is used in a trade or business, where either (1) the original use of the property in the QOZ commenced with the QOF or QOZ business; or (2) the property was substantially improved by the QOF or QOZ business. In either event, during 90% of the time the QOF or QOZ business held the property, substantially all (generally at least 70 percent) of the use of the property was in a QOZ.

In short, there is lots of line-drawing in the QOZ rules. If you invest in a QOF, you want to be assured that your investment qualifies so you don't have to worry about your tax benefits. In some cases, even leased property can qualify as QOZ business property, if the lease is at market rate and entered into after Dec. 31, 2017.

Qualified opportunity zone business. The tax benefits are big, so there are ongoing maintenance requirements too. Each year, a QOZ business must earn at least 50% of its gross income from business activities within a QOZ. These days it can be hard to say where business is coming from in the country or even the world. However, IRS regulations provide three safe harbors that a business can use to meet this test. These safe harbors take into account any of the following: (1) Whether at least half of the aggregate hours of services received by the business were performed in a QOZ; (2) Whether at least half of the aggregate amounts that the business paid for services were for services performed in a QOZ; or (3) Whether necessary tangible property and necessary business functions to earn the income were located in a QOZ.

If you want more specifics, the IRS has rolled out a great deal of information about Opportunity Zones. Check out their Opportunity Zone FAQs, or the special IRS Opportunity Zone Website. For more technical reading, there is TD 9889, OZ Final Regulation, Proposed regulation 115420-18, and Proposed regulation 120186-18. You can read Revenue Procedure 2018-16 and Revenue Ruling 2018-29. The tax forms themselves are here, Form 8949, Form 8996, and Form 8997. Finally, there's IRS Publication 544 on Sales and Dispositions of Assets.

Check out my website.