Snell & Wilmer
LAW OFFICES

Opportunity Zones: Helping Communities or Wealthy Taxpayers? The Ups and Downs of an Evolving Tax Efficient Investment Strategy

By Mark E. Foster, Counsel

Every decade or so a new tax incentive program is introduced that leverages the insatiable desire of taxpayers to minimize tax liability to stimulate investment in programs prioritized by the Federal Government. (Think low income housing tax credits, renewable energy tax shelters, etc.) The Investment in Opportunity Act is the latest and potentially the most accessible and lucrative of such tax incentive programs.

Where did the Opportunity Zone program come from?
The Investment in Opportunity Act was passed in December 2017 as part of Tax Cuts and Jobs Act with the goal of encouraging private capital investment in economically distressed areas or Opportunity Zones.

What is an Opportunity Zone?
Opportunity Zones are low-income communities based upon census tract data that were nominated by the Governor of each state. In Orange County, Opportunity Zones can be found in parts of Fullerton, Placentia, Stanton, Santa Ana, Anaheim, Huntington Beach, Costa Mesa, San Juan Capistrano and San Clemente. There are 879 census tracts certified as Opportunity Zones in California (see https://opzones.ca.gov/oz-map for a statewide map) and over 8,700 nationwide.

What is an O-Fund?
To be eligible for the tax benefits under the Opportunity Zone program, investors must re-invest their unrealized capital gains into a dedicated Qualified Opportunity Fund (O-Fund), which in turn invests in a qualified business or real estate project located in an Opportunity Zone. O-Funds cannot invest in golf courses, country clubs, massage parlors, hot tub facilities, liquor stores, race tracks, gambling establishments or suntan facilities. Provided that an O-Fund meets certain program requirements (i.e., creates jobs and/or meets certain investment thresholds), investors can defer and potentially reduce taxation on capital gains. O-Funds are self-certified with the IRS and are subject to bi-annual testing to confirm compliance with program investment parameters.

What are the Tax Benefits?
The primary tax benefits to Opportunity Zone investors are: (1) temporary deferral of eligible capital gain realized from the sale or exchange of any property to an unrelated party until December 31, 2026, (2) partial reduction of deferred gain based upon how long the funds are invested in an O-Fund (five year hold results in a 10 percent increase in basis; seven year hold results in a 15 percent increase in basis), and (3) full forgiveness of additional gain applicable to the appreciation in the O-Zone investment if held for at least 10 years.

For example, if a taxpayer invests a capital gain of $100,000 in an O-Fund, after a five year hold the taxpayer would only have to pay taxes on $90,000. After a seven year hold the taxpayer would only have to pay taxes on $85,000. Moreover, if the taxpayer holds the investment for 10 years and sells the investment for $300,000, the $200,000 of appreciation would be free from capital gains tax.

Who Should Invest?
Taxpayers with significant capital gains who could hold an investment in an O-Fund for the long term should consider investing in O-Funds. Eligible taxpayers include individuals, corporations, partnerships (LLCs and LPs), REITs and trusts and estates. An O-Fund investment must be made within 180 days from the sale or exchange that gave rise to the capital gain and investors may invest in multiple funds. Based upon the current regulations, an investment in an O-Fund must be made by December 31, 2019, to take full advantage of the seven-year hold benefit since capital gains are only deferred until December 31, 2026.

What Can Go Wrong?
The Department of Treasury regulations related to O-Funds have been evolving over the past 18 months with the most recent update in April 2019. There remain unanswered questions relative to the O-Fund rules. As a result, investors should invest only in O-Funds that have been formed and have the appropriate criteria in place to avoid losing the O-Fund status. This can best be accomplished by engaging accounting and legal professionals who are up to date on the current regulations and the trends surrounding the program. A foot fault relative to O-Fund formation or administration can impose unanticipated tax liability on investors and undermine the significant tax benefits of the program. In addition, the relatively long hold period necessary to take full advantage of the program means that early withdrawal of investments could significantly reduce the tax benefits.

What types of investments are best for O-Funds?
To take advantage of the Opportunity Zone program, O-Funds must invest in business opportunities located in Opportunity Zones that are intended to improve and/or expand such businesses. The most qualified projects are; typically, real estate development in an Opportunity Zone that involves significant rehabilitation, opening a new business in an Opportunity Zone, acquiring an existing business and relocating it with expansion to an Opportunity Zone, or large expansion of businesses already located in an Opportunity Zone.

How are O-Funds impacting Opportunity Zones?
Although the Opportunity Zone program is relatively new, its effects are being felt throughout the Opportunity Zones in California. The most pronounced is the fact that O-Fund buyers are frequently able to pay a higher price for qualified businesses and/or real estate located in Opportunity Zones than their competition. This means that any existing business or real property owner located within an Opportunity Zone may find the highest bidder is an O-Fund.

The Opportunity Zone program continues to evolve as new regulations are adopted and investors and their advisors better understand the benefits and pitfalls of this tax incentive program with a social agenda. It remains to be seen whether the Opportunity Zone legislation will translate to large scale improvement in the quality of life for the low-income residents currently living in Opportunity Zones. There is no question, however, that many O-Fund investors will see a real tax benefit because of the program.

For more information about Opportunity Zones and Opportunity Funds services, contact Mark at 714.427.7435 or mfoster@swlaw.com.

Mark Foster
Mark Foster concentrates his practice on the representation of institutional owners, operators and developers in connection with joint venture formations, acquisitions and dispositions, leasing, and real estate-related lending. Mark's practice also includes zoning, land use planning, real estate entitlements, and special-use permitting on behalf of real estate developers, telecommunication providers, and other end users. His previous experience as in-house corporate and real estate counsel to major investment and development companies has provided him with unique insight into anticipating and addressing client needs with respect to their operational and real estate matters.