DESPITE DECREASED TAX BENEFIT, INVESTOR INTEREST IN OPPORTUNITY ZONES INCREASING

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Since its creation within the 2017 Tax Cuts and Jobs Act, the Opportunity Zone program has been slow to pick up momentum due to lack of clarity, has been criticized as a tax shelter for the wealthy and is currently the subject of a Treasury Department investigation prompted by the very politicians behind its genesis.

But these would-be impediments are not deterring investors—rather, the opposite is taking place. We are seeing more confidence around, and thus interest in, opportunity zones. This is in part thanks to final regulations that the IRS issued in December, which demystified some of the larger points of uncertainty around the program.

The uptick in investment activity at the end of 2019 was not surprising, as one of the program’s tax benefits expired on December 31. The next deadline to take advantage of certain tax benefits is December 31, 2021, and we expect interest will continue to rise until that date as investors look to capitalize on the unique tax exclusions and savings.

FINAL REGULATIONS OFFER CLARITY, CONFIDENCE

While investments to date fall short of the $100 billion of investment Treasury Secretary Steven Mnuchin estimated the Opportunity Zone program would attract, the program is still relatively new. The program officially runs until December 31, 2047, which marks the final date to dispose of an opportunity zone investment in order to receive a step-up in basis to fair market value, thereby eliminating taxes on appreciation which would otherwise result in capital gains.

Nearer term attractive tax benefits, however, are still available. Investors can defer taxes by reinvesting capital gains from an
unrelated party asset sale into a qualified opportunity fund (QOF); the capital gains remain tax-free until the QOF is divested or until December 31, 2026, whichever comes first. On top of that, if the investment is held for five years, investors receive a 10% exclusion of the deferred gain. That exclusion increases to 15% for investments held for seven years. While December 31, 2019, was the deadline to be able to qualify for an exclusion that would allow investors to pay tax on only 85% of the original capital gain, investors are still able to benefit from the 10% exclusion until December 31, 2021.

After publishing two rounds of proposed rules around opportunity zones, the IRS released the final regulations on December 19, 2019, less than two weeks before the additional 5% exclusion was set to expire. The final regulations largely finalized the proposed rules, but also added several new ones favorable to taxpayers. The final regulations include allowances for:

- Eligibility of gains from Section 1231 property with taxpayer favorable measurement dates.
- Eligibility for deferral of gain arising from an inclusion event even though the taxpayer retains a portion of the qualifying investment after the inclusion event.
- Flexible rules for deferring capital gains resulting from installments sales.
- Favorable aggregation rules for purposes of calculating the substantial improvement requirements.
- Favorable refinements to the working capital safe harbor rules for qualified opportunity zone businesses (QOZBs).
- Favorable rules relating QOZB property used in and out of the qualified opportunity zone (QOZ) area.
- Preexisting entities to qualify as QOFs or QOZBs, provided that they satisfy all QOF requirements.
- Land not needing to meet the original use requirement or the substantial improvement requirement to be treated as QOZB property.
- How C corporations can invest in opportunity zones.
- Sin businesses to comprise no more than 5% of a QOZ property.

The final regulations also clarify the treatment of transactions in which a taxpayer engages in a sale to or exchange of property with a QOF or a QOZB and subsequently contributes the proceeds of the sale or exchange to the QOF.

**WITHOUT PRECEDENT, NUTS AND BOLTS COULD GET STICKY**

Through opportunity zones, investors may escape taxes on capital gain, which may be of interest especially to properties that have a 10-year hold horizon. But in order to recognize the program’s tax benefits, taxpayers will need to keep rigorous records throughout the 10 years. The potential for complications in record keeping compounds as transactions may take place during that time period, for example, with an acquisition or change of formation.

Without any precedent or interpretive guidance, the opportunity zone program holds significant potential for discrepancies in record keeping to have a negative impact on the receipt of tax benefits. As with any new tax law, precedent will begin to be established as taxpayers move through the program and/or begin to exit their investments. At that point, the IRS may audit, invalidate or otherwise evaluate the self-certification forms for QOFs (Form 8996). Investors looking to minimize such discrepancies should work closely with their tax and accounting departments and consultants to coordinate proper record keeping.

Real estate, a long-term asset class by nature, has shown strong performance amid the longest bull market of more than 10 years, and QOFs are marketed as a safe place for longer-term investments. But to date, funds largely comprise single investments or focus on certain classifications of real estate, such as student housing or beachfront property, which may deter some investors looking for a more diversified portfolio. Furthermore, given the retail industry’s recent challenges and their impact on real estate, some developers are having trouble finding tenants for their properties.

**2020 PRESIDENTIAL ELECTION UNLIKELY TO AFFECT PROGRAM**

In his State of the Union address on February 5, President Trump touted the success of the Opportunity Zone program. But the program is being put under the microscope for potentially being a windfall for wealthy investors. Though Corey Booker (D-NJ) and Ron Kind (D-WI) helped to create the program, they also called for an investigation into whom the program is actually benefiting. These are developments worth monitoring and could result in continued negative press. Regardless of public perception, it is our belief that a change in political party in the Oval Office is unlikely to scuttle the Opportunity Zone program, as it enjoyed bipartisan support when it was created.

Investors who have been sitting on the sidelines are more confidently stepping into the opportunity zone space, though it is worth cautioning that while opportunity zones offer enticing benefits, tax savings should not be the only factor influencing
investors’ decisions—not all qualified investments are necessarily worth pursuing, after all. As investors scope out opportunity zones, they should apply the same level of due diligence they would use for any other investment: Are the area’s property values and income levels likely to grow? Does the developer or business have an established track record?

With final regulations in place and the next deadline set for December 31, 2021, we expect continued investment activity in opportunity zones, with a likely surge of investment taking place in the run-up to that deadline, as it did at the end of 2019. It remains to be seen, however, whether that investment activity will begin to resemble the $100 billion that the program was predicted to attract.

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