



BDO KNOWS

Federal Opportunity Zones

INVESTMENT AND TAX DEFERRAL STRATEGY

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The opportunity zones program is part of the 2017 tax reform legislation. Many taxpayers view this program as one of the most ambitious federal tax incentive programs in decades. The purpose of the program is to use private funds to promote economic development in underserved communities.



TAX DEFERRAL AND INVESTMENT STRATEGY

Tax reform legislation known as the Tax Cuts and Jobs Act provides a significant opportunity for investors to defer capital gains tax owed. The benefits are for those capital gains that arose in the last 180 days of 2017 or prospectively in 2018 and future years.

Qualified Opportunity Zones (QOZs) allow investors to defer tax on capital gains by investing in Qualified Opportunity Funds (QOFs), which in turn make investments in QOZ property (stock, partnership interest or tangible personal property) in the designated QOZ.





OPPORTUNITY ZONES

Each state nominated census tracts in low-income and otherwise distressed areas that were subsequently approved by the Treasury.

There are more than 8,700 opportunity zones with qualifying census tracts available for investment. They are located within all 50 U.S. states, the District of Columbia, and five territories, including the entire island of Puerto Rico.



SIGNIFICANT ELEMENTS

- ▶ Taxpayers have 180 days from the date when the capital gain is triggered to invest their portion of the gain in the QOF. For flow thru investments (partnerships and S-corporations) that issue K-1s the investor's 180-day countdown starts at the statutory due date of the entity's tax return for the year the gain is recognized. COVID-19-related relief extended the deferral payment. If a taxpayer's 180th-day investment requirement falls between April 1, 2020, and March 31, 2021, the taxpayer has until March 31, 2021, to invest that gain into a QOF. The December extension does not apply to partnerships and S-corporations that have a March 15 deadline.
- ▶ A QOF is an investment vehicle that must invest at least 90% of its assets in businesses that operate in a QOZ, either by acquiring stock or a partnership interest or QOZ tangible property. COVID-19 relief provides relief for a QOF's failure to pass the 90% investment standard test on any semiannual testing dates from April 1, 2020, through March 31, 2021.
- ▶ Most existing property has been used by another business or entity/person prior to being acquired by the QOF. As a result, the QOZ rules require substantial improvements. Currently, substantial is defined as improvements that are more than the original investment in the QOF property, exclusive of land.
- ▶ QOZ property can be in the form of corporate stock, partnership interests, or tangible property, so long as substantially all of the property is located within the QOZ.

Benefits to Be Gained

The tax benefits can be significant. An investor must invest the capital gains from a prior, unrelated party sale into a QOF within 180 days of the sale of the investment. The capital gains may come from the sale of stock, bonds, real estate, or a company. The key is that the gain is treated as a capital gain on the federal tax return. The taxpayer does not have to invest the full amount of the proceeds, rather, only the capital gain (or a portion of that gain) is required to be invested. There are no intermediaries required and the funds are not traced.

Investing in a QOF has three potential tax incentives:

- 1. Tax Deferral** – Tax deferral on capital gain invested in QOF to the earlier of an inclusion event or December 31, 2026 (at the tax rates existing at that time, not at the time of the investment).
- 2. Exclusion of Tax on Capital Gains Deferred** – If the investor holds its qualifying investment for five years, the basis of the qualifying investment is increased on the fifth anniversary by 10%. Because the investment part of the program ends on December 31, 2026, investments must be made by December 31, 2021 to obtain this benefit.
- 3. Exclusion of Investment Appreciation** – If the investment in the fund is held for 10 or more years, then the appreciation of the QOF investment (not the original deferred capital gain, but the post-acquisition capital gain) is exempt from taxes. The investment must be sold by December 31, 2047.

EXAMPLE SCENARIOS

5-Year Holding

A family office realizes a \$10 million capital gain in May 2018 and during the same month invests the entire capital gain in a newly created QOF. In August 2018, the family office invests the \$10 million in a newly constructed retail shopping center in a qualified opportunity zone. If the QOF is held at least five years, the tax on the original capital gain is reduced to \$1.8 million resulting in a tax exclusion of \$200,000 (assuming a 20% capital gain rate). This is a result of the 10% basis increase for holding the QOF at least five years. The underlying tax on the original gain is still deferred as far as April 2027 when filing for calendar year 2026 tax returns. This does not take into consideration any new capital gain on the QOF property if sold in tax year 2023 (the fifth investment year). The 5-year holding period 10% exclusion benefit expires on December 31, 2021.

7-Year Holding

Assume the same facts as the 5-year holding, except the family office holds onto the QOF investment for seven years. The tax on the original capital gain is reduced to \$1.7 million resulting in a tax exclusion of \$300,000. This is a result of the additional 5% basis increase (total of 15%) for holding the QOF for at least seven years. The underlying tax on the original gain is still deferred as far as April 2027 when filing for calendar year 2026 tax returns, not taking into consideration any new capital gain on the QOF property if sold in tax year 2025 (the seventh investment year). **Note:** The 7-year holding period 5% exclusion benefit expired December 31, 2019.

10-Year Holding

Assume the same facts as above, except the family office holds the QOF at least 10 years. The same holds true as the previous example, with the tax on the original capital gain being \$1.7 million versus the standard \$2.0 million. This tax is still deferred as far as April 2027 for calendar year filers. Now assume in year 11, the QOF is sold for an appreciated value of \$15.0 million. The QOF will get a step-up in basis to the fair market value (or sales price) and thus permanently eliminate any income tax on the appreciation.

BDO Services

Tax

- ▶ Business and tax structuring
- ▶ Tax compliance – federal and state tax reporting
- ▶ Qualifying and structuring QOFs - self-certification, qualification testing, and reporting
- ▶ Credits and incentives – identify other federal, state, and local opportunities
- ▶ Financial modeling – reflecting after-tax QOF benefits and tax planning strategies
- ▶ Implementation of REIT structures; tax provisions and quarterly and annual REIT testing requirements
- ▶ Cost segregation studies to accelerate depreciation recovery

Assurance

- ▶ Audit compliance
- ▶ Information systems assurance
- ▶ SEC reporting

Advisory

- ▶ Quality of earnings analysis – business acquisitions and dispositions
- ▶ Outsourced bookkeeping and administrative fund services
- ▶ Lease audits and common area maintenance reviews
- ▶ Asset management
- ▶ Purchase price allocations
- ▶ Financial and tax due diligence



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