Opportunity Zones: Boom or Bust?

BY STEVE WYATT

OPPORTUNITY ZONES ALLOW INVESTORS WITH UNREALIZED CAPITAL GAINS TO SELL THOSE ASSETS AND REINVEST THE GAIN IN A QOZ WITH A BIGGER AFTER-TAX RETURN.

"President Biden want to raise the combined capital gains tax rate and NIIT rate to 43.4 percent. If Congress enacts that provision, opportunity zones become that much more attractive."

— STEVE WYATT, SENIOR COUNSEL, CHAMBERLAIN HRDLICKA

Congress occasionally provides incentives aimed at encouraging economic growth and investment in distressed communities by providing Federal tax benefits to businesses located within designated boundaries, including empowerment zones, the District of Columbia Enterprise Zone, and the Gulf Opportunity Zone among others.

Against this background, the specific opportunity zone idea first emerged in the form of the "Investing in Opportunity Act", introduced in Congress in 2017. The bill sought to "provide tax incentives for investments in the [opportunity] zones, including deferring the recognition of capital gains that are reinvested in the zones."

Congress created this tax-favored opportunity in the Tax Cuts and Jobs Act of 2017 to help address the belief that persistent poverty and uneven economic recovery left too many American communities behind. Since then, many investors, developers, real estate and other entrepreneurial types, and other investors have used this Congressionally sanctioned investment opportunity to invest in otherwise distressed areas designated as "opportunity zones." The Internal Revenue Service explicitly recognizes the inherent opportunity zone purposes of "spur[ing] economic growth and job creation in low-income communities while providing tax benefits to investors".

The recent 2020 election and the seemingly inflationary economic climate may portend changes in many previously favored tax provisions. However, to this point, no proposal mentions rolling back or eliminating this particular tax benefit. Can taxpayers expect opportunity zone investments to boom in 2021?

The federal government designated over 8,700 low-income census tracts, chosen by state governors and certified by the Treasury Department, where investors can use capital to finance various investments in return for tax advantages. This map indicates the various zones.

Investors must invest in these designated opportunity zones through opportunity funds, essentially funds that invest at least 90 percent of their assets in qualified opportunity zone property, which means (i) qualified opportunity zone stock, (ii) qualified opportunity zone partnership interest, and (iii) qualified opportunity zone business property. The remainder of this article assumes a qualifying opportunity fund. The Treasury Regulations under Section 1400Z-1 and -2 set out requirements for these tax-favored opportunities in copious detail.

As constructed, the opportunity zone may represent the most generous such tax incentive to date. Investing realized capital gains in an opportunity zone through an opportunity fund provides (i) a temporary tax deferral, (ii) a basis step-up, and (iii) a permanent exclusion from recognition of any gain accrued on the investment in the opportunity fund (not the original gains).

Temporary tax deferral: assume an investor sells an investment portfolio with a $1 million capital gain; at that moment, the investor realizes the capital gain. But, investing the $1 million realized capital gain in an opportunity zone fund within 180 days after the sale defers recognition of that gain until the earlier of (i) the date the opportunity zone investment gets sold and (ii) December 31, 2026. If the original sale takes place in 2021, the opportunity zone investment defers recognition of the $1 million realized gain to December 31, 2026, assuming no earlier sale.

Basis increase: that $1 million investment in the opportunity fund has zero basis immediately after acquisition. However, holding that initial investment in the opportunity zone for five years results in a 10 percent increase in basis, here decreasing the realized gain from $1 million to $900,000. If this sale and investment occurred on or before December 31, 2019, for a holding period of at least seven years, the opportunity zone rules would have added another five percent basis increase and thus

reduced his realized capital gain to $850,000. Now, taxpayers do not have time before December 31, 2026, to hold the investment for seven years.

Permanent exclusion: Holding the opportunity fund investment for at least ten years, without regard to the December 31, 2026 date, results in a complete exclusion of any gains accrued on the opportunity fund investment itself – if the taxpayer properly elects such treatment. For example, if the $1 million investment in the opportunity zone fund grows to $2.5 million in ten years, the taxpayer still pays tax on the appropriate portion of the initial $1 million invested capital gain, but not on the $1.5 million gain on the opportunity zone asset itself. Right now, depending on the type of investment, that exclusion saves somewhere between 15 percent and 20 percent of that additional $1.5 million gain, plus the net investment income tax (NIIT) of 3.8 percent, or somewhere between $282,000 and $357,000 in taxes, assuming no recapture. Note this exclusion does not apply to dispositions occurring after December 31, 2047, so plan accordingly. This provision still generally allows a taxpayer to exclude up to 30 years' worth of capital appreciation.

The recent Biden budget proposal includes an increase in the capital gains rate to 39.6 percent for married taxpayers filing jointly with more than $1 million of income, raising the combined capital gains tax rate and NIIT rate to 43.4 percent, taking effect as of the date of the announcement. If Congress enacts that provision opportunity zones become that much more attractive.

Take the $1 million gain example above. The new tax on that sale increases to $434,000 for a married taxpayer instead of $238,000, so the opportunity zone now defers an additional $196,000 of realized capital gain. If the taxpayer again holds the investment for ten years and receives $1.5 million of appreciation, the opportunity zone investment now saves $651,000 in capital gains taxes. Of course, the deferred tax due increases as well.

Conversely, if the markets fail to continue their pre-COVID gains, then the opportunity zone still results in a better after-tax return, but the exclusion of the gain on the opportunity zone investment itself will not be as attractive. But tax avoidance remains tax avoidance.

If you have significant unrealized capital gains, selling those assets, realizing the gain, and investing the gain in the right opportunity zone investment results in a greater after-tax return compared to simply selling the appreciated assets and paying the tax—assuming an identical reinvestment opportunity in terms of risk and return. BF

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