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Generations Winter 2021 - Qualified Opportunity Zones: Common Questions and Misconceptions

As part of the 2017 Tax Cuts and Jobs Act (Jobs Act), Congress introduced a new set of tax incentives designed to encourage investment in certain low-income communities throughout the United States designated as "qualified opportunity zones." The rules that govern the program are complex and constantly evolving, but there is still a high degree of investor interest in this program due to the significant tax benefits. The purpose of this article is to highlight some of the common questions and misconceptions that have arisen in this emerging space.

- **Qualified Opportunity Funds.** In order to participate in the program (which is codified as Section 1400Z of the Internal Revenue Code), an investor must invest in a qualified opportunity zone through a vehicle called a "qualified opportunity fund" ("QOF"). The word "fund" has a certain connotation to it, leading some to assume that a QOF needs to be a complex investment vehicle that raises outside capital. While those types of QOFs certainly exist, a QOF just needs to be a corporation or partnership formed for the purpose of investing in "qualified opportunity zone property" (which, at a very high level, is tangible property located in a qualified opportunity zone or equity in a business that operates in a qualified opportunity zone). Thus, a QOF can take the form of a partnership with as few as two partners or a corporation with only one shareholder. Many QOFs are formed as partnerships by one primary investor with a large capital gain he or she wishes to defer, bringing along a business partner or a family member holding only a small interest in order to qualify the QOF as a partnership.
- **The Need for Capital Gains.** An investor can benefit from the Qualified Opportunity Zones program only by making a "qualifying investment" in a QOF – a capital contribution of cash or property that relates to an "eligible gain" within 180 days of the sale or exchange that triggered the eligible gain. An eligible gain is broadly defined as a capital gain recognized upon the sale or exchange of a capital asset to an unrelated party. Numerous details and limitations apply to this requirement, but here is a simple example: Suppose Taxpayer sells publicly traded stock on January 1, 2021, and recognizes a $10,000 long-term capital gain. If Taxpayer invests up to $10,000 in a QOF by June 30, 2021, that investment constitutes eligible gain (assuming all other requirements are met) and qualifies for qualified opportunity zone benefits (described below). This raises a key distinction: Any investor can invest in a QOF, but only investors who invest eligible gain in a QOF can benefit from the qualified opportunity zone program. As a practical matter, many QOFs prohibit investors from participating unless they certify that they are investing eligible gain, in order to avoid the creation of a "mixed fund" and the complications resulting from that status under the QOF rules.
- **The Tax Benefits.** An investor who makes a qualifying investment in a QOF can achieve three distinct tax benefits. First, the investor can defer recognition of the eligible gain until the earlier of (i) disposition of the QOF investment or (ii) December 31, 2026. Second, if the investor invests by December 31, 2021, and holds his or her QOF investment for at least five consecutive years, the investor can exclude 10 percent of the deferred gain forever. Third, if the investor holds his or her QOF investment for at least 10 years, any gain generated by disposing of the QOF between the 10-year

anniversary and December 31, 2047, is tax-free to the investor. To build off the prior example: Suppose Taxpayer invested all $10,000 of gain from her sale of publicly traded stock into a QOF on April 16, 2021. Taxpayer does not need to pay tax on the $10,000 gain in connection with her 2021 tax return because she can defer the gain until December 31, 2026. If Taxpayer holds her QOF investment until at least April 16, 2026, she can pay tax on $9,000 of gain on her 2026 tax return (i.e., she can exclude 10 percent under the five-year rule). At that point, Taxpayer has $10,000 of basis in her QOF investment. Suppose Taxpayer sells her QOF investment for $50,000 in 2035. Absent the exclusion of gain provided by the qualified opportunity zone rules, Taxpayer would trigger a $40,000 gain, but in this case the $40,000 gain is excluded from income and becomes tax-free to Taxpayer. These rules create an incentive to invest in a QOF by the end of 2021 in order to qualify for the 10 percent gain exclusion under the five-year rule. The rules currently provide that an investor must invest in a QOF by December 31, 2026, so the program will only remain available for a few more years absent action by Congress. The example illustrates that the QOF program is designed to incentivize long-term investments in qualified opportunity zones by providing the greatest benefit to those who hold their QOF investment for at least 10 years.

- **Alternative to Section 1031 Exchanges.** One common misconception about the qualified opportunity zone program is that it is limited to real estate investments. Many QOFs are engaged in lines of business other than real estate. That said, there was a surge of activity in 2020 from real estate investors who planned to participate in Section 1031 like-kind exchanges but were unable to acquire suitable replacement property during the pandemic. Section 1031 and the Qualified Opportunity Zones program have much in common. Both sets of rules allow investors to defer capital gains. One key advantage of a Section 1031 exchange over investing eligible gain in a QOF is that Section 1031 does not trigger recognition of any of the deferred gain by the end of 2026. The qualified opportunity zone program, however, does offer several advantages over Section 1031. First, the qualified opportunity zone program is not limited to real estate, whereas the scope of Section 1031 was narrowed to real estate under the Jobs Act. Second, the qualified opportunity zone program does not have any of the escrow, qualified intermediary or tracing requirements that apply to a Section 1031 exchange. Using the example above, Taxpayer could use the $10,000 of proceeds from her sale of publicly traded stock and spend it on whatever she wanted and then contribute $10,000 from another source to the QOF. Third, and perhaps most notably, Section 1031 provides only for deferral of gain, not permanent exclusion of gain, whereas the qualified opportunity zone program provides for the opportunity to exclude gain from tax completely if the five- and 10-year holding period requirements are met.
- **Potential Impact of a Biden Presidency.** The results of the 2020 election have led many to speculate as to how the tax laws will change under the new Biden administration. The Trump administration frequently championed the qualified opportunity zone program, while some Democrats criticized the program for not doing enough to benefit underserved communities. Democratic members of both houses of Congress introduced bills in 2019 to amend Section 1400Z in order to increase transparency and social impact, but neither bill reached President Trump's desk. That said, it is generally considered highly unlikely that the Biden administration will attempt to eliminate the qualified opportunity zone program – the tax plan Biden released on the campaign trail did not propose to eliminate it. Rather, the Biden tax plan would add a requirement that investors demonstrate how their QOF benefits the community. It is worth noting that the qualified opportunity zone program began as a bipartisan white paper and that one of its co-authors, Jared Bernstein, is a high-ranking economic advisor to President Biden. It is conceivable that investments in QOFs will actually increase under the Biden administration, because the Biden tax plan suggests increasing the capital gains rate for high-income taxpayers from 20 percent to 37 percent, potentially making deferral of capital gains even more valuable. In addition, the Biden tax plan suggests eliminating Section 1031 exchanges, which, if enacted, would leave real estate investors with fewer options for deferring their capital gains.

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