



OPPORTUNITY ZONE LEGISLATION

The Tax Cuts and Jobs Act of 2017 introduced a new tax incentive provision that permits taxpayers to defer the capital gains tax on an investment if they reinvest the capital to benefit economically distressed communities. **BY JAMES W. RINIER, CPA, EA, AND ANTHONY P. CURATOLA**

THE INTERNAL REVENUE CODE (IRC) has provided tax incentives to encourage economic growth and investment in certain distressed urban and rural areas, including empowerment zones, the District of Columbia Enterprise Zone, and the New Market Tax Credit (NMTC) Program. There also are tax incentives that provide tax credits for employers who hire qualifying employees in low-income communities, increased \$179 tax deductions on qualifying equipment, and provided tax-exempt bond financing. Last year,

the Tax Cuts and Jobs Act (TCJA) introduced other incentives for such investments, effective December 22, 2017, until December 31, 2026. The incentives are designed to encourage taxpayers to provide funding to sponsoring organizations that will develop economically distressed communities designated as Qualified Opportunity Zones (QOZ) within states, U.S. possessions (i.e., territories), and the District of Columbia.

INVESTMENT INCENTIVES

Section 13823 of the TCJA added new IRC §1400Z-2, which provides the special rules for the tax incentives for taxpayers who roll over the capital gains from an investment into a QOZ fund. To participate in this program, a taxpayer needs to have a capital gain resulting from the sale of an investment. Next, the taxpayer has 180 days to invest some or all of the capital gain from the sale into a QOZ fund.

There are two potential tax benefits from the transaction. The first is that it defers the capital gains tax that the taxpayer would have incurred from the sale of the investment until he or she sells the QOZ investment or December 31, 2026, whichever comes first. If the taxpayer maintains the investment in the QOZ fund for at least five years, the basis of that investment increases by 10% of the deferred capital gains amount. Furthermore, if he or she maintains that investment for an additional two years (i.e., seven years in total), then the

investment's basis can be increased further by another 5% of the deferred capital gains. Thus, a taxpayer who holds the QOZ investment for seven years or until December 31, 2026, incurs a capital gain tax on only 85% (with a 15% total basis increase) of the capital gains that he or she initially rolled over into the QOZ fund.

To unlock the second tax benefit, the taxpayer must continue to maintain the QOZ fund investment for at least 10 years. In this case, the basis in the investment is equal to the fair market value of the investment on the date that the taxpayer sells or exchanges it. Put another way, there is no tax on the appreciated capital gains to the QOZ fund. And since the new law makes no reference to what would happen if the taxpayer sells or exchanges the investment for a loss, then a reasonable assumption is that the taxpayer has a capital loss.

To appreciate the tax consequences of this incentive, consider the following example: Taxpayer A sells an existing investment for \$220,000 on July 1, 2018. The investment generated a \$100,000 capital gain. Next, the taxpayer invests the entire \$220,000 into the QOZ fund on August 1, 2018.

Result 1: If taxpayer A liquidates his or her QOZ fund in 2021 (less than five years) for \$500,000, the result is a taxable capital gain of \$280,000 (\$100,000 of deferred capital gains and \$180,000 of appreciated capital gains). The only benefit here is the taxpayer has deferred the capital gains tax on the initial \$100,000.

Result 2: If taxpayer A liquidates the QOZ fund holdings in 2024 (more than five years) for \$500,000, the result is a taxable capital gain of \$270,000 (\$90,000 of deferred capital gains, which is the initial \$100,000 minus the \$10,000 increased basis and the \$180,000 of appreciated capital gains). The benefit here is the taxpayer has deferred the capital gains tax and reduced it to \$90,000 (compared to the initial \$100,000).

Result 3: If taxpayer A continues to maintain the QOZ fund holdings on December 31, 2026 (more than seven years), the result is a taxable capital gain of \$85,000 (\$85,000 of deferred capital gains, which is the initial \$100,000 minus the \$15,000 increased basis) even though the taxpayer didn't liquidate the QOZ fund.

Result 4: If taxpayer A liquidates his or her QOZ fund holdings after July 1, 2028 (more than 10 years), for \$500,000, the result is a taxable capital gain of \$85,000 (the initial \$100,000 minus the \$15,000 increased basis for the 2026 tax year) and no capital gains tax on the \$280,000 appreciated capital gains in 2028 when the taxpayer liquidates the QOZ investment.

QUALIFIED OPPORTUNITY ZONES

The IRS released Revenue Procedure 2018-16 (2018-9 IRB 383) to provide guidance to chief executive officers (generally the governor or equivalent) of any state, possession (or terri-

tory) of the United States, and the District of Columbia regarding the procedures for designating a census tract to qualify under this provision of the tax code. The Bipartisan Budget Act of 2018 (P.L. 115-123, 2/9/2018) stipulated a special rule for Puerto Rico designating every population census tract as a QOZ.

States had until March 21, 2018, to petition the IRS to designate census tracts within their jurisdictions as QOZs, with a 30-day extension if needed. In a Department of the Treasury release on April 9, 2018, the IRS announced the first round of Opportunity Zone designations in 18 states that initially submitted a nomination. The complete list of all population census tracts that are designated as a QOZ for the purpose of this tax incentive is in Notice 2018-48, 2018-28 IRB.

ISSUES TO CONSIDER

On the surface, this type of investment appears to be quite attractive as a tax management tactic. But there are issues that taxpayers need to consider before transferring current investments into QOZ funds:

1. A taxpayer may be compelled to hold his or her QOZ investment if capital gains tax rates are increased in future years instead of selling* or exchanging the investment before that tax rate increase takes effect.
2. Does a taxpayer want to tie up investment capital for 10 years? It's unclear whether money can be trans-

ferred between QOZ funds without any consequences given that the law states tax is due when the taxpayer sells or exchanges the investment. But even if the tax continues to be deferred by the transfer of capital from one QOZ fund to another, the funds are still locked into this type of investment.

3. What are the estate tax consequences if the taxpayer dies?
4. What type and level of risk is the taxpayer accepting by investing in a QOZ fund?
5. Finally, what firms are sponsoring this type of investment, and what fees are they charging?

These are questions that all taxpayers face. But the long holding period adds a new layer of concern to a taxpayer. Hopefully there will be a significant increase in long-term capital investments for low-income rural and urban communities as this new tax law intends to encourage. **SF**

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