Taking Advantage of the New Opportunity Zones Tax-Free Investment Program
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Beginning in 2018, investors can earn tax-free capital gains by investing in qualified Opportunity Zone Funds. In addition, investors can defer tax on capital gains realized now and eventually eliminate paying tax on a portion of that gain by investing in these funds. These funds are companies specifically setup to invest in businesses in specially designated opportunity zones in economically distressed communities. The investment must be held for at least 10 years to realize tax-free gains, but a portion of any initial, deferred capital gains invested will become tax-free after years 5 and 7, until 12/31/2026 when the deferral period ends. So, by investing in Opportunity Zones, you can reduce your tax on current capital gains and receive a tax-free gain when you sell the investment property after holding it for at least 10 years.

Here are some points to consider about this program:

1. Either short term or long term capital gains can be deferred and these gains can be generated by the sale of any type of capital asset, such as stocks, bonds, or real estate.
2. You must invest your capital gains in an Opportunity Zone Fund within 180 days of selling your property with a gain to defer paying tax on that gain in the current year. If you receive a capital gain from a pass-through entity, your gain is considered earned on the last day of the company's tax year, so your 180-day period begins on that date. For many pass-through entities that date is 12/31.
3. The various States select areas or "zones" that qualify for this program.
4. You make your investment in an "Opportunity Zone Fund", which is an LLC or corporation that you designate as a fund. The company must file a separate tax return, so no single-member LLCs.
5. The Articles of Organization or Incorporation for your company that you plan to use for the fund must state that the purpose of the company is to invest in qualified opportunity zone properties and include a description of the qualified opportunity zone business of the company.
6. If the Opportunity Zone Fund purchases real property, the property must be acquired after 12/31/2017. If a fund purchases an existing building in an Opportunity Zone, then over a 30-month period, it must substantially improve the building by investing at least an amount equal to the adjusted basis of the existing building that was purchased by the fund.
7. The total value of the assets held by the company at the end of its tax year must average 90% as invested in qualified opportunity zone property, which essentially means that it cannot invest in any other property, including holding large sums of cash (unless the cash is being used as short-term working capital for renovations).
8. You receive up to three benefits for investing in a qualified Opportunity Zone Fund (**See Page 2 for an example of how this works**).
    a. First is temporary tax deferral on any capital gains invested in the fund. The tax is deferred until the investment is sold or until 12/31/2026, when you will be required to pay tax on the remaining capital gains that you deferred.

  b. Secondly, you can exclude up to 15 percent of the original capital gains from tax, if you hold your investment for 7 years. You get a step-up in basis for 10 percent of capital gains after the fifth year and another 5 percent after the seventh.
  c. Finally, you can <u>permanently</u> exclude any capital gains earned on the investment itself from tax if you hold the investment for at least 10 years.

9. Presently, this incentive program expires on 12/31/2028. Meaning that 2028 is the last year that you can invest into Opportunity Fund Zones for these tax benefits.
10. Presently, the program's benefits will continue through 2047, meaning that if you waited until that year to sell your investment, you could exlude the entire gain from tax!
11. Any funds you invest in a qualified Opportunity Zone Fund will get the tax-free gain treatment if the investment is held for 10 years.
12. Any capital gains initially invested will retain their nature (ie. short-term or long-term) and will be taxed at those respective rates when the deferral period ends.
13. Any profits or losses from the operation of the fund (ie. rental income) will be taxed as ordinary income, depending upon how it is structured, either at the corporate level or as a pass-through to the investor.
14. Finally, this information is based on the IRS proposed regulations and there will be clarifications.
15. CAUTION: Politicians and bureaucrats are generally terrible at real estate investing and want others to invest in depressed areas hoping that it will generate taxes for the government. So, I recommend that you only consider investing in an Opportunity Zone Fund property if the property will generate an operating profit regardless of the tax benefits of this law. Saving tax by losing money goes against one of my fundamental principles!

<u>Here's an example of how this would work (the numbers are simplified to make the math easier)</u>:

You sold an investment property (ie. rental property, shares of stock, etc) for $500,000 on December 1, 2018. Your basis in that property was $200,000, for a capital gain of $300,000. We'll assume that your capital gain is long-term for this example.

1. Within 180 days, you invest the $300,000 in a qualified opportunity fund.
2. You make the election on your 2018 tax return to defer the $300,000 in capital gain income, meaning no taxes are due on this gain in 2018.
3. Your basis in this investment is $0 initially, since the capital gain was deferred and hasn't been taxed.
4. After 5 years, your deferred capital gain is reduced by 10% to $270,000 (by receiving a step-up in basis in your investment of $30,000).
5. After another 2 years (total of 7 years), your deferred capital gain is reduced by another 5% (of the original amount) to $255,000 (by receiving another step-up in

basis in your investment of $15,000). You now have a basis in this investment of $45,000, which means $45,000 is now permanently excluded from tax!

6. On 12/31/2026, you will owe capital gains tax on the remaining $255,000 of your deferred gain, assuming that the fair market value of the fund has not decreased.
7. You pay tax of $38,250, which is 15% on this $255,000 and you have saved tax of $6,750, which is 15% on the $45,000 of gain that was permanently excluded.
8. <u>You owe this tax whether or not you have actually sold your investment</u>. We'll assume that you have not sold your investment for the rest of this example.
9. Now that you have paid the tax on the remaining deferred capital gain, your basis in the investment is now $300,000.
10. If you hold the investment for at least another 3 years (for a total of 10 years), then you will receive a step-up in basis to the fair market value of the investment when you sell it.
11. This means any capital gains earned on the investment is tax-free after 10 years!
12. Let's say that you sell the investment 11 years later and it has grown in value to $500,000.
13. Your gain on the investment is $200,000, but because you get a step-up in basis to the fair market value (sales price!), your gain is <u>tax-free</u> and you walk away with $500,000 in cash (less closing costs).
14. Now, <u>imagine that your original investment was used as the 20% down payment</u> for a property within the fund and the fund borrowed $1.2 million in additional funds to purchase and improve the property originally. If this property increased in value over the 11 years in our example to say $2.5 million, then your gain in this property would be around $1.4 million! Tax-Free!
15. Of course, you'd have to pay off the debt and you'd have closing costs, but you would walk away from this investment with over $1.3 million in tax-free cash!

See some Helpful Links on the Next Page

Helpful Links:

IRS FAQs
https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

Louisiana and National Designated Opportunity Zones
https://www.opportunitylouisiana.com/business-incentives/opportunity-zones

About the Author:

Bob Norton, CPA, is The Real Estate Tax Pro[SM] and has over 13 years' real estate investing experience and over 28 years' experience managing small businesses in a variety of industries. He works primarily with real estate professionals and small business owners and has clients with active investments and operations in over 10 states. His core purpose is to help his clients build their wealth through real estate investing and by structuring their operations to minimize their business income and self-employment tax. He's licensed in Louisiana as a CPA and a real estate broker.

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