Opportunity Zones Summary

By now you have likely heard of the potential tax benefits of investing in development projects located in federally designated “Opportunity Zones.” While some confusion regarding the program remains, there is no denying the fact that federal opportunity zone tax incentives could provide a significant boon to investors in qualified investments.

What is an OZ Fund?
An OZ Fund can be an entity with multiple investors and a fund manager managing a national portfolio of qualifying investments. A OZ Fund can also consist of local investors looking to redevelop a single commercial property located in an Opportunity Zone in Louisville. An OZ Fund is simply an entity (partnership, LLC, or corporation) that serves as a vehicle for investors to deploy capital into qualifying businesses and property in opportunity zones. The OZ Fund self-certifies its status and does not need prior approval from the IRS to operate as an OZ Fund.

What Property can an OZ Fund Own?
At least 90% of the OZ Fund’s assets must consist of qualifying property. Generally, such property consists of either an equity interest in a business operating in an Opportunity Zone (an OZ Business) or tangible property (including real estate) used in a trade or business activity in an Opportunity Zone (QOZB Property). At least 70% of the tangible property owned or leased by an OZ Business must consist of QOZB Property. To qualify as QOZB Property, the OZ Fund or OZ Business must purchase the property from an unrelated party after December 31, 2017.

If the original use of the qualified tangible property does not begin with the OZ Fund or an OZ Business owned by the OZ Fund, the fund or business is required to substantially improve the property. Accordingly, if an OZ Fund purchases an existing commercial building in an opportunity zone that had been placed into service by a previous owner, the OZ Fund must substantially improve the property for it to qualify. However, original use only refers to the use of the property within a designated zone. Therefore, used property that has not previously been placed into service within a designated zone would be considered original use property when first used in an opportunity zone.

Substantial improvement requires capital improvements exceeding the purchase price to the property during the 30-month period after purchase. The IRS has issued guidance stating any portion of the purchase price attributed to the value of the underlying land won’t be included in the amount necessary to substantially improve the building located on the land. Additionally, IRS guidance provides for a 31-month working capital safe harbor (and potentially longer for “start-up” businesses) for cash held by an OZ Business consistent with a written plan for the acquisition, construction, or substantial improvement of opportunity zone property.

Undeveloped land does not have to be substantially improved to be qualifying property as long as the land is utilized in a trade or business activity in an opportunity zone. Such use would appear to imply some capital improvement to the property or an increase in the property’s economic output. Additionally, real property that has been vacant for a specified period prior to purchase may satisfy the original use requirement. Finally, subject to certain restrictions, leased property (even related party leases) can also qualify as QOZB Property.

Chris Coffman
Frost Brown Todd, LLC
CCoffman@fbtlaw.com

Stephen Lukinovich, CPA, PFS, CVA
MCM CPAs & Advisors
Andy.Ackermann@mcmcpa.com

Andrew Ackermann, CPA, CVA
MCM CPAs & Advisors
Andy.Ackermann@mcmcpa.com

WHAT ARE THE INCENTIVES?

The federal opportunity zone tax incentive offers substantial tax benefits to investors in qualified opportunity funds. Investors may also be entitled to similar tax benefits at the state level. These benefits are intended to encourage investors to access unrealized capital gain from their existing appreciated assets through a sale or other disposition and then use that gain to reinvest in businesses and development projects in economically distressed areas that the U.S. Treasury and IRS have designated as Opportunity Zones.

1. Temporary Deferral
Investors can defer recognizing the reinvested capital gain as income until the end of the 2026 tax year under certain criteria. They must reinvest the gain in a qualified opportunity fund (OZ Fund) within 180 days of when they would be required to recognize the gain for tax purposes (generally, when the asset is sold). However, special timing rules apply in limited situations, such as when the gain is generated within a passthrough entity. Any asset that generates capital gain when sold qualifies for deferral. This includes publicly traded stock, real property or a privately-owned business.

2. Reduction of Deferred Gain
Because an investor in an OZ Fund is acquiring an equity interest in the fund using tax deferred gain, the investor’s initial basis in the investment is zero. Investors who hold an interest in an OZ Fund for at least five (5) years receive a ten percent (10%) increase in their basis in the investment, which reduces the amount of the deferred gain the investor realizes at the end of 2026 by 10%. Therefore, an investor with an initial investment of $1 million that holds its interest for 5 years would only recognize $900,000 of the deferred investment in the 2026 tax year. To qualify for this incentive, the investor must invest in an OZ Fund on or before December 31, 2021.

3. Permanent Exclusion of Appreciation
The final, and perhaps most impressive, tax incentive provides a potential permanent exclusion of any gain from the investor’s eventual sale of its investment in the OZ Fund. Investors holding an interest in an OZ Fund for at least ten years can elect to exclude any appreciation in the value of the investor’s interest above the amount of its original OZ Fund investment when the investor sells its interest (including any depreciation recapture). For example, should the investor in the example above sell its interest in an OZ Fund in 2032 for $3 million, the investor can elect to permanently exclude the $2 million of appreciation in the value of the interest above the investor’s $1 million investment.