

Location, Location, Location: A Primer on Qualified Opportunity Zones

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Practice Area: Business and Corporate Law & Tax & Real Estate

Under the Tax Cuts and Jobs Act of 2017, new rules were established that allow taxpayers to defer capital gain from the sale of assets to unrelated persons by investing in a Qualified Opportunity Zone. Qualified Opportunity Zones are mostly high-poverty, low-income census tracts in which the federal and state governments wish to encourage investments. The governors of each state and U.S. territory submitted candidate Qualified Opportunity Zones, and the U.S. Treasury Department certified those Qualified Opportunity Zones as of July 1, 2018. In Wisconsin, for example, there are 120 Qualified Opportunity Zones.

Taxpayers can defer the gain portion of the amount realized on a sale and take back the basis portion as tax-free cash by investing the gain through a Qualified Opportunity Fund which makes an investment in a Qualified Opportunity Zone. The deferral includes both long-term and short-term capital gains from the sale of any property (not just sales of real estate), including marketable securities and closely held business interests. A Qualified Opportunity Fund is any tax corporation or tax partnership that self-certifies with the Internal Revenue Service. The investments can be in the form of either cash or property; however, property investments only get capital gain deferral to the extent of basis rather than fair market value.

Taxpayers have a 180-day time limit to reinvest into a Qualified Opportunity Fund. For individual and C corporation taxpayers, the 180-day time limit starts on the date the capital gain is recognized. For taxpayers receiving capital gains from pass-through entities (e.g. tax partnerships, S corporations, trusts, etc.), the taxpayers may elect to start the 180-day time limit on either the date the capital gain is recognized or the last day of the taxable year. For instances in which a taxpayer has a net 1231 gain, the 180-day time limit starts on the last day of the taxable year.

The deferred capital gain that is the initial investment in a Qualified Opportunity Fund is taxable to the taxpayer upon the earlier of the sale of the Qualified Opportunity Fund interest or December 31, 2026. Additionally, the deferred capital gain that represents the initial investment in a Qualified Opportunity Fund is taxable upon a pre-2027 inclusion event which generally includes any disposition that results in a reduction of the taxpayer's beneficial interest in a Qualified Opportunity Fund.

The beneficial tax treatment for the deferred capital gain depends on the holding period.

- If the taxpayer holds the Qualified Opportunity Fund interest for less than 5 years, then 100% of the deferred capital is taxed as a long-term capital gain (including any portion of the deferred capital gain that was initial short-term capital gain).
- If the taxpayer holds the Qualified Opportunity Fund interest for 5 years or more but less than 7 years, then 10% of the deferred capital gain is forgiven and the remainder of the deferred capital is taxed as a long-term capital gain (including any portion of the deferred capital gain that was initial short-term capital gain). In order to receive this treatment, a taxpayer needs to make an investment in a Qualified Opportunity Fund prior to December 31, 2021.
- If the taxpayer holds the Qualified Opportunity Fund interest for 7 years or more but less than 10 years, then 15% of the deferred capital gain is forgiven and the remainder of the deferred capital is taxed as a long-term capital gain (including any portion of the deferred capital gain that was initial short-term capital gain). In order to receive this treatment, a taxpayer needs to make an investment in a Qualified Opportunity Fund prior to December 31, 2019.
- If the taxpayer holds the Qualified Opportunity Fund interest for 10 years or more, then 15% of the deferred capital gain and all capital appreciation is forgiven and the remainder of the deferred capital is taxed as a long-term capital gain (including any portion of the deferred capital gain that was initial short-term capital gain).

If you have a recognized 1231 gain as of December 31, 2018 for a calendar taxpayer or if you received a capital gain in 2018 from a pass through entity that is a calendar taxpayer, you have until June 28, 2019 to invest in a Qualified Opportunity Zone to defer and potentially reduce that gain.

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