Opportunity Zones Don't Offer One-Size-Fits-All Tax Benefits, 2018 Law360 317-115

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Summary

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A worker uses a digger at a construction site in an ***opportunity zone*** in Belleville, New Jersey. (AP)The ***opportunity zone*** fund, or OZF, became available after President Donald Trump signed (*2017 Law360 356-3*) the Tax Cuts and Jobs Act (97 PL 115) and is designed to help communities in need by investing unrealized capital gains into building and job creation projects in those low-income areas. When an investor sells an unrelated asset and reinvests those capital gains in a qualifying OZF, the taxpayer can defer tax on the gains until Dec. 31, 2026, and all taxes are forgiven on gains from investments held in ***opportunity*** funds for at least 10 years.

Daniel Hemel, an assistant professor at the University of Chicago Law School, said despite those benefits, there are already other ways to avoid capital gains tax on investments in areas such as startup businesses and real estate.

"The qualified ***opportunity zone*** provisions largely replicate those benefits, but add more onerous restrictions than taxpayers would face if they invested through other vehicles," he said. "To illustrate: If I want to invest in a small business organized as a C corporation, I can potentially use the qualified small business stock provisions Section 1202 (*26 U.S. Code § 1202*) and avoid capital gains tax if I sell the stock after a five-year holding period."

Section 1202 provides a partial exclusion of up to 50 percent of capital gains in the sale or exchange of qualifying small business stock sales by taxpayers held for at least five years, whereas under the ***opportunity zone*** program, if an investor holds a qualifying ***opportunity zone*** fund for five years, 10 percent of capital gains will be forgiven, and if it is held for seven years, the investor gets another 5 percent forgiven, for a total of 15 percent tax-free. All OZF-related capital gains are forgiven if it has been held for 10 years.

Hemel said the ***opportunity zone*** provision that requires holding onto the fund for at least 10 years is not only longer than the stock sales' five-year holding period, but also imposes limits on a business' ability to invest because it cannot expand its OZF investing activities beyond low-income communities. Investing in startups could be more advantageous because they are not geographically restricted, he said.

And while Hemel conceded OZFs could help taxpayers invest in areas that may be ineligible for qualified small business stock benefits - such as hotels and restaurants - he explained those entities are often organized as partnerships rather than C corporations, so most of that return will be ordinary income and not qualify as capital gain, which means there would be no OZF-related tax advantage.

David Miller, who is a partner at Proskauer Rose LLP, remains more optimistic about OZFs as investment vehicles because not only do they ***offer*** the chance to reinvest capital gains to help low-income areas, but they also provide a new investment option for those previously unrelated gains to be taxed at a lower rate.

"The benefit of ***opportunity*** funds are greatest for a taxpayer who has short-term capital gains because short-term capital gains are taxed at a higher rate than long-term capital gains," he said. The maximum individual income rate for short-term capital gains is 40.8 percent, far higher than the long-term capital gains rate of 23.8 percent. Moreover, the 23.8 percent rate decreases when combined with the scaled forgiveness of capital gains if the fund is held for five, seven or 10 years.

Plus, 100 percent of the OZF does not have to be invested in qualified ***opportunity zone*** property in low-income designated census tracks (*2018 Law360 171-44*) because of how some of the provisions' requirements work, Miller added.

He explained that ***opportunity zone*** funds are required to invest 90 percent of their assets in qualified ***opportunity*** "***zone*** property," and that includes a "***zone*** entity." Miller said recent guidance explained the ***zone*** entity (*2018 Law360 292-7*) has to invest 70 percent of its tangible property in "***zone*** business property," which means that only 63 percent, or 90 percent multiplied by 70 percent, of the OZF's assets have to be in ***zone*** business property or ***zone*** property.

Essentially, this means that while a taxpayer may be invested in an OZF, just 63 percent of those assets have to be invested in low-income areas, while 37 percent of the investments can be in other property that may not be related to low-income development, Miller said.

And even if an OZF investment does not grow in value during seven years, after which 15 percent of capital gains are forgiven, the investor essentially gets that 15 percent as a basis step-up with respect to her or his original investment, which is worth $6.12 for every $100 of short-term capital gains, he said. Furthermore, if the OZF investment during those seven years drops in value, the investor will still have the 15 percent step-up while being able to claim a capital loss on the sale of the OZF, Miller added.

Despite these OZF tax advantages, Hemel said another area ***offering*** different tax benefits is real estate, where taxpayers can already use the like-kind exchange provision under *Internal Revenue Code Section 1031* (*26 U.S. Code § 1031*), which allows a taxpayer to roll over real estate investments into new buildings without paying capital gains on the sale. Then a taxpayer can defer capital gains until death, after which a beneficiary gets the benefit of stepped-up basis.

The result in using a like-kind exchange is that taxpayer will not have to worry about being forced to invest in particular areas and this provision is not available for OZFs, he explained.

"For a top-bracket taxpayer with long-term capital gains to offset, a qualified ***opportunity zone*** investment will outperform an alternative investment in after-tax terms over 10 years if the rate of return inside the [qualified ***opportunity zone***] is within roughly 1.5 percentage points of the after-tax rate of return on the alternative investment," Hemel said. "For a taxpayer on the margin between an investment in a low-income community and somewhere else, this might make the difference. But the idea that it will lead to a flood of money into low-income communities strikes me as implausible."

Michelle D. Layser, a professor at the University of Illinois College of Law, said while Section 1031 has its own tax benefits that are dissimilar to OZFs, not all taxpayers can use like-kind exchanges. They allow investors to defer

capital gains taxes owed on a sale of real estate only if the money is reinvested in the same kind of real estate and taxes will be paid only when the real estate is sold. But she did concede that rolling over proceeds and continuously deferring capital gains is not uncommon, so those types of real estate investors would not necessarily need or want to use ***opportunity zone*** funds as an investment option.

"But not all taxpayers can use 1031," Layser said. "That rule is only available to taxpayers who have capital gains from selling real property held as an investment or for business use. The OZF rules are available for taxpayers who have capital gains from any sale. So it has the potential to sweep in a ton of taxpayers who can't use 1031."

Overall, Layser said she thought it was really hard to conclude whether OZFs are a good investment in terms of returns.

Derek Uldricks, president of Virtua Capital Management LLC, told Law360 he believes OZFs ***offer*** superior tax benefits because they provide tax forgiveness for capital gains held longer than 10 years, whereas Section 1031 only ***offers*** a delay of taxes, with the tax reduction coming once the asset is passed onto an investor's heirs.

"***Opportunity zone*** funds [also] ***offer*** greater flexibility because you can roll over capital gains from the sale of any asset into an ***opportunity zone*** fund. Only real estate assets held for productive use are eligible for a 1031 exchange," he said. "That means that capital gains from the sale of a fine art collection or a stock portfolio are eligible for an ***opportunity zone*** fund, but not a 1031."

Miller echoed that sentiment, saying Section 1031 provides a benefit for a taxpayer who has already invested in real estate and intends to stay invested in real estate. But many taxpayers who have unrealized capital gains may not already be invested in real estate to take advantage of that code provision, or they may own real estate but may no longer want to stay invested in that field.

"For those taxpayers, ***opportunity*** funds are unique because they allow deferral of capital gains that have already been realized," he said.

--Editing by Tim Ruel and Neil Cohen.

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