Tax Reform Tidbit: Deferring Gain Using Qualified Opportunity Zones

By Aman Badyal

The recently enacted Tax Cuts and Jobs Act adds a new section 1400Z to the Internal Revenue Code. Section 1400Z provides taxpayers the opportunity to defer gain on the sale or exchange of an asset if such gain is reinvested in a Qualified Opportunity Zone Fund (a "QO Fund") within 180 days. Note that the entire proceeds from an asset sale need not be invested in a QO Fund; rather, only the portion of the proceeds that represent gain must be invested in a QO Fund.

The gain is deferred until the sooner of (i) the date the taxpayer sells its investment in the QO Fund or (ii) December 31, 2026. If the taxpayer holds its QO Fund investment for five years, the amount of gain that will ultimately be recognized is reduced by 10% of the amount invested in the QO Fund; and if the investment is held for seven years, the amount of gain is reduced by an additional 5%. If the taxpayer maintains its investment in the QO Fund through December 31, 2026, the taxpayer can further reduce the amount of taxable deferred gain by showing a reduction in the value of the QO Fund. We believe taxpayers will be able to apply recognized valuation discounts to determine the value of their QO Fund interest.

Additionally, if the taxpayer holds its QO Fund interest for 10 years, they will recognize no taxable gain when they sell that investment.

In order to be a QO Fund, an entity must be organized for the purpose of investing in Qualified Opportunity Zone Property and 90% or more of its total assets must be Qualified Opportunity Zone Property. In lieu of defining the various applicable terms of art applicable to Qualified Opportunity Zone Property, suffice it to say, the QO Fund must invest in new, or must substantially improve, tangible property, including commercial real estate (e.g., offices buildings, apartment complexes, etc.) and equipment located in qualified opportunity zones. These investments can be direct or through other corporations or partnerships that are located in qualified opportunity zones. Each U.S. state has or will identify its own qualified opportunity zones.

Illustration

Taxpayer sells property for $1,000,000 on June 1, 2018 and realizes a $400,000 gain. Within 180 days, taxpayer invests the $400,000 gain in a QO Fund. Taxpayer does not include the $400,000 of realized gain in his 2018 gross income and has no current tax liability. Taxpayer holds the QO Fund investment for 10 years. On June 1, 2023, the five-year anniversary of the investment, taxpayer's basis in the QO Fund increases from $0 to $40,000. On June 1, 2025, the seven-year anniversary of the investment, taxpayer's basis increases from $40,000 to $60,000. On December 31, 2026, taxpayer must recognize a portion of the deferred gain equal to the lesser of (i) $340,000 (i.e., $400,000 minus $60,000) or (ii) the excess of the fair market value of the QO Fund interest over $60,000. Taxpayer sells the QO Fund interest on June 2, 2028 for $2,000,000 and pays no additional tax on the gain. Therefore, in the aggregate, the taxpayer enjoys $1,660,000 of tax-free gain.

Our View

We have identified several areas located in qualified opportunity zones that we believe will be attractive to investors. Therefore, it appears this tax incentive will provide taxpayers with a significant opportunity to defer gains. The incentive will be particularly impactful considering section 1031 like-kind exchanges are now only available to real estate transactions. As icing on the cake, taxpayers may be able to pledge or otherwise borrow against their QO Fund interests, which would allow them to quickly monetize a portion of their investment tax-free.

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