Opportunity Zones: What is All the Fuss About?

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When the Tax Cuts and Jobs Act was being negotiated and considered by Congress at the end of 2017, most practitioners, developers, and business owners were trying to assess its impacts on the mortgage interest limitation, the cap on the state and local tax deduction, 1031 exchanges, immediate expensing of business assets, and other key issues. In that flurry of negotiation and analysis, a powerful federal tax incentive was added to the law that could lead to a vast transfer of wealth while also funding the revitalization of some of the country’s most distressed areas. That new powerful tool is the Opportunity Zone program.

The basic goal of the Opportunity Zone program is to unlock unrealized capital gains being held by companies and individuals and direct that capital towards businesses and projects in certain distressed areas. This is accomplished by incentivizing prospective investors to sell appreciated property and reinvest the gains into qualified Opportunity Zone projects through offering attractive tax incentives—three tax incentives to be precise.

Any investor that sells any property, including real estate, stock, bonds, partnership or LLC interests, and reinvests the gain from the sale into a Qualified Opportunity Fund will be eligible for the following tax benefits:

- The deferral of paying tax on the gain invested in the Qualified Opportunity Fund until the earlier of: **December 31, 2026** or the date when the investor sells or disposes of its interest in the Fund;

- The deferred gain to be recognized is subject to a **10 percent reduction** if the investor holds its interest in the Qualified Opportunity Fund for at least 5 years (i.e., **invested on or prior to December 31, 2021**) and a **15 percent reduction** if the investor holds the Fund interest for at least 7 years (i.e., **invested on or prior to December 31, 2019**); and

- Finally, the investor pays **zero** tax on the appreciation of his/her interest in a Qualified Opportunity Fund if the investor holds its interest in the Fund for at least 10 years before selling or disposing of it.

The significant tax savings associated with this program coupled with a lack of other tax-deferral options and the typical investor’s desire to diversify portfolios over-weighted in the stock market, suggest that there will be an influx of new capital in the market for a host of different investments.

Here’s how to take advantage of this new tax incentive. To begin, it is useful to understand a few key terms:

- **A Qualified Opportunity Fund** is defined to mean any corporation or partnership organized for the purpose of investing in Qualified Opportunity Zone Property.
Ninety percent of a Fund’s assets must be invested in Qualified Opportunity Zone Property.

- **Qualified Opportunity Zone Property** is defined to include tangible property and buildings owned directly by a Fund and used in a trade or business of the Qualified Opportunity Fund provided that the property is acquired after December 31, 2017 and either: (1) the first use of the property is in the Opportunity Zone or (2) there must be a “substantial improvement” of the property. Qualified Opportunity Zone Property also includes stock or a partnership interest in a Qualified Opportunity Zone Business if the stock or partnership interest is acquired after December 31, 2017. A qualified business is a business entity based in an Opportunity Zone with “substantially all” of its tangible business property qualifying as eligible property using the same rules and limitations discussed above regarding a Fund’s direct ownership of Opportunity Zone property.

- **Substantial improvement** is defined to mean enough capital improvements undertaken on the property over any 30-month period following acquisition that will result in an increase to the tax basis of the property equal to the adjusted basis of the property at the time of acquisition.

It should be noted that an eligible Opportunity Zone business cannot include a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. Finally, although not specific in the statute, we expect the regulations to prohibit leasing qualified property to such “sin” businesses listed in the preceding sentence, similar to the rules associated with the New Market Tax Credit program.

Now that you understand the basics of the program, the next key step will be identifying Opportunity Zones. There are a host of mapping tools available online, including a very user-friendly mapping tool here: https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml. Each state’s zones were selected by the state’s respective governor and certified by Treasury. There are Opportunity Zones across all 50 states, Puerto Rico, the U.S. Virgin Islands, and Guam. Zone designations remain in place for 10 years unless Congress renews them.

Who can take advantage of this program? The answer is almost any person or business with appreciated assets can participate as an investor. Accordingly, fund managers will now have a new tax-efficient vehicle in their arsenal for raising capital and selecting targeted real estate, business and infrastructure assets for investment. In addition, almost any business or project located in an Opportunity Zone may tap into this new source of equity investment. That includes developers seeking bridge financing to get to the point of receiving construction financing; the only caveat is that the financing would come in the form of an equity investment in the project by a Qualified Opportunity Fund.

Importantly, investors need not invest in a third-party fund to realize the tax benefits associated with the program if they have identified an attractive new investment. An investor with his or her own capital gain could organize and fund its own Qualified Opportunity Fund to realize the tax
benefits while funding a new project in an Opportunity Zone. The benefits can also be indirectly realized by a tenant of a landlord/developer that is constructing a new facility, in that the tenant build-out or expansion of the premises and purchase of new equipment could also potentially be an investable project for an Opportunity Fund.

Finally, the Opportunity Zone program can potentially be used in tandem with other federal and state or local tax incentives, such as New Market Tax Credits, Low-Income Housing Tax Credits, and Rehabilitation/Historic Tax Credits. Collectively, these tax incentives can enhance a sponsor or developer’s capital stack to complete a project.

The possibilities with this program are truly endless in terms of the types of projects that can be funded through the Opportunity Zone program. Any real estate professional, whether involved in development, finance, brokering, investment sales or leasing, should become familiar with the program as soon as possible because many Opportunity Funds are expected to enter the market this fall and winter in search of projects to capitalize.

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