

## Opportunity Zones: Opportunities for Whom?

On December 22, 2017, Congress enacted the Tax Cuts and Jobs Act of 2017 (the “Tax Act”). The law created a new incentive to encourage long-term investment in the nation’s low-income areas. If a taxpayer invests eligible capital in certain distressed communities, as designated by the federal government, they can then defer the recognition of capital gains for several years.

This incentive is designed to spur economic development and job creation in these particular undercapitalized areas of the country. Since the Tax Act was signed into law, the US Treasury Department has designated over 8,700 such areas, known as “opportunity zones.”

The vehicle through which a taxpayer can invest in an opportunity zone is called a qualified opportunity fund. Qualified opportunity funds must be organized (as a corporation or a partnership) for the purpose of investing in qualified opportunity zone property.<sup>2</sup>

A corporation, partnership, or an individual with capital gains can invest in an opportunity fund. This can be accomplished either by transferring an existing asset into a fund,<sup>3</sup> or by transferring cash in an amount equal to the gain arising from a sale or exchange within the 180-day period beginning on the date of the sale or exchange.<sup>4</sup>

### Tax Benefits of Investing in Opportunity Zones

A central tax benefit of investing in an opportunity fund is that, assuming certain criteria are met, any tax on any prior capital gains is deferred until the earlier of the date on which the investment is sold or exchanged, or December 31, 2026.<sup>5</sup> Additionally, a taxpayer can enjoy the benefits of step-ups to the basis on the original investment, resulting in the taxpayer’s capital gain tax liability being reduced by ten percent.

This occurs if the investment is held longer than five years prior to December 31, 2026, and fifteen percent if it is held longer than seven years prior to that date.<sup>6</sup> Even more enticing, investments in opportunity funds that are held for at least ten years enable a taxpayer to have his or her basis adjusted to the



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establish advantageous positions in order to maximize the potential tax benefits available. However, as in so many other areas affected by the Tax Act, anxious investors were uncertain about how best to proceed. The statute’s brief text offered very little in the way of direction and there was a total absence of any accompanying guidance.

For example, one portion of the Tax Act states that “qualified opportunity zone business property” means, in part, property, “the original use of [which] commences with the qualified opportunity fund [...]”.<sup>8</sup> However, that is the only instance in which the phrase “original use” appears, and taxpayers were left to guess as to its meaning in this context and hope that they had guessed correctly.

Since then, the IRS has issued two sets of guidance and proposed regulations. The first came on October 19, 2018<sup>9</sup>—almost a full year after the passage of the Act—and the second on April 17, 2019.<sup>10</sup> These materials clarify many of the open questions created by the statute’s wording, including that almost all capital gains qualify for deferral.

fair market value of the investment as of the date of its ultimate sale or exchange. With this adjustment, the tax on the gain from the initial investment can thereby be avoided altogether.<sup>7</sup>

### Current State of Investment

Not surprisingly, with the passage of the Tax Act came an eagerness to form opportunity funds and

Furthermore, in the case of a partnership, either the individual partners or the partnership itself may elect deferral. Investment vehicles, as provided for in the guidance and proposed regulations, are permitted to self-identify as opportunity funds by simply filing Form 8996, Qualified Opportunity Fund. Additionally, as a general rule, property qualifies as “original use” property if it is tangible property, placed into service in an opportunity zone, that has not yet been depreciated by a taxpayer other than the relevant opportunity fund.

### Opportunity Zones Going Forward

The reasoning behind the creation of opportunity zones and opportunity funds is straightforward: by attracting private investment, as opposed to spending taxpayer dollars, the government can stimulate economic growth and development in low-income neighborhoods without spending government monies. The authors of the legislation have noted that over the last several years, economic growth in the United States has been heavily concentrated in large metropolitan areas.<sup>11</sup>

Smaller metropolitan as well as rural areas have either lagged behind or, in some cases, experienced economic decline.<sup>12</sup> These communities are in dire need of economic stimulus in order to regenerate economic activity. Meanwhile, affluent investors continue to grow their portfolios. The opportunity zone incentive represents an attempt to braid these disparate realities into an “everybody wins” scenario.

One study estimates that at the end of 2017, there was, between individual taxpayers and corporations, over \$6 trillion in unrealized capital gains, i.e. capital potentially eligible for investment in opportunity funds.<sup>13</sup> If even a small fraction of this pool can be converted into long-term investments in opportunity funds, that would represent a major injection of capital into depressed neighborhoods where previously none had existed at all.

However, even if significant capital is invested into opportunity funds, with investors receiving the attendant tax benefits and the opportunity zones receiving an influx of capital, will the

Tax Act achieve its stated purposes? The question of whether or not the incentive provided by the statute have been a “success” will turn on how one gauges its effectiveness.

One item to bear in mind is that there will be a not insignificant cost associated with the taxes that are being deferred. The Joint Committee on Taxation estimates that this cost could be in the range of \$1.6 billion between 2018 and 2027.<sup>14</sup> In considering the success of the incentive at issue, this cost should be weighed against the measurable outcomes realized by the increase in economic activity.

Additionally, some have pointed to some potential unintended consequences resulting from opportunity zone investments. Among them could be an increase in housing prices due to the influx of capital and the creation of new jobs. Such an occurrence would not only diminish the intended impact of the incentive provided by the Tax Act, but it may also exacer-

bate the actual problem the legislation sought to address in the first place.

On the other hand, proponents point to the flexible nature of the incentive, particularly the ability of investors to pool resources through opportunity funds in order to deploy them according to the needs of specific communities. This flexibility may, if properly exercised, lessen any unintended consequences.

Only time will tell whether opportunity zones are revitalized by this incentive, or whether it will just amount to providing tax breaks for investors with no corresponding benefit to the intended beneficiaries.

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1. IRS Notice 2018-48, IRS Notice 2019-42.
2. IRC § 1400Z-2(d)(1).
3. Proposed Reg. § 1400Z2(a)-1(b)(9).
4. IRC § 1400Z-2(a)(1).

5. IRC § 1400Z-2(b).
6. IRC § 1400Z-2(b)(2).
7. IRC § 1400Z-2(c).
8. IRC § 1400Z-2(d)(1)(D)(i)(II)
9. 83 FR 54279.
10. 84 FR 18652.

11. See, e.g., Senator Cory A. Booker, “Statement for Hearing Before the Joint Economic Committee Implementation of the Opportunity Zones Program,” May 17, 2018, available at <https://bit.ly/2XwH7bi>.

12. Id.

13. Economic Innovation Group, “Opportunity Zones: Tapping into a \$6 Trillion Market.” March 21, 2018.

14. Joint Committee on Taxation, “Estimated Budget Effects of the Conference Agreement for H.R. 1, The “Tax Cuts and Jobs Act,”” JCX-67-17, Dec. 18, 2017, available at <https://bit.ly/2s0oEIt>.