Approaching Deadlines for Opportunity Zone Investments

The Opportunity Zone program offers a unique opportunity to reduce tax bills while investing in underserved communities, but several key deadlines are fast approaching

The Opportunity Zone (OZ) program was created as part of the 2017 Tax Cuts and Jobs Act and is designed to spur investment and economic development in underserved communities selected by state governors in a nationwide process. Over 8,700 census tracts were designated to receive tax-advantaged investment based on median income criteria and other local considerations. To attract private investment, vehicles investing in OZs, called Qualified Opportunity Zone Funds (QOFs), are given special tax treatment in the form of capital gains deferral and eventual tax forgiveness after holding their investment for a minimum of 10 years. Similar to a 1031 exchange, investors in a QOF first defer their capital gains tax on an asset sale by investing in a QOF within 180-days of gain realization.

Qualified gains can originate from a wide variety of assets such as stocks, bonds and options, real estate, private equity, commodities, private business sales or even art or bitcoin. Due to the COVID-19 pandemic, the 180-day window of eligibility has been temporarily extended until December 31, 2020 for any sales made after October 4, 2019. This means that December 31, 2020 is the deadline for utilizing eligible gains realized during the 2020 tax year - a roller coaster year that has seen both a stock market collapse in the early stages of the Covid-19 pandemic, and a subsequent record-breaking recovery.

DEFER

The payment of capital gains tax on almost any asset sale

REDUCE

Tax on deferred gains by 10% after 5 years

ELIMINATE

Tax on gains in the new QOZ investments after 10 years

STATE TAXES AND INCENTIVES

Deferral and Forgiveness of Capital Gains Tax in Most States (excl. CA, NC, MA, MS)

State and municipal development incentives

The tax is deferred until December 31, 2026 when it comes due for the 2026 tax year. However, 10% of the gain is excluded from taxation as long as the investment has been held for at least 5 years. December 31, 2021 is therefore the deadline to lock in this 10% reduction benefit of a QOZ Fund. More meaningfully, if the QOF investment is held for at least 10 years, the basis on the investment is adjusted up to fair-market-value, and no capital gains taxes are owed on QOF investment gains. For highly-taxed activities, such as real estate development, the 10-year tax forgiveness represents a very significant boost to annualized investment returns, representing as much as 4% additional IRR for residents of high-tax states like New York.

This is one of the primary benefits of a QOZ investment versus a 1031 exchange. While a 1031 exchange offers a method for long-term capital gains deferral, it does not offer the opportunity to ‘step off the hamster wheel’ and receive complete tax forgiveness (after the required 10-year hold). Another key benefit of QOZ Funds over 1031 exchanges is the diversity of assets where the capital gains can originate from. In a 1031 exchange, the sale that generates the original capital gain must be of “like-kind” to the property that is purchased in exchange. For a QOZ, the capital gain can come from the sale of a much wider range of investments as outlined above. In the current market environment, many users of 1031 exchanges are finding it challenging to locate appropriate like-kind assets at attractive value, and QOFs have emerged as an option for real estate investors to shelter their realized gains.