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Wealth Planning Update

Qualified Opportunity Zones: What Investors Should Know

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Key takeaways:

- The 2017 Tax Cuts and Jobs Act established the Qualified Opportunity Zone program to provide a tax incentive for private, long-term investment in economically distressed communities.
- Investors in these programs are given an opportunity to defer and potentially reduce tax on recognized capital gains.
- Over nearly 24 months, the Internal Revenue Service issued several batches of proposed regulations, received feedback from the public, and issued final regulations providing more precise guidance on the use and operation of Qualified Opportunity Funds.

What this may mean for you:

- If you are facing significant tax payments as a result of capital gains, investing in a Qualified Opportunity Zone Fund may be worth exploring, provided you invest within a prescribed amount of time.

What is an Opportunity Zone?

An Opportunity Zone is a community nominated by the state and certified by the Treasury Department as qualifying for this program. The Treasury Department has certified zones

Approximately 8,700 Opportunity Zones nationwide

in all 50 states, Washington, D.C., and U.S. territories.[1]

A list can be found at the U.S. Department of the Treasury, Community Development Financial Institutions Fund.

How does this program work?

To defer a capital gain (including "net" §1231 gains), a taxpayer has 180 days from the date of the sale or exchange of appreciated property to invest the realized capital gain dollars into a Qualified Opportunity Zone Fund. The fund then invests in Qualified Opportunity Zone Property.

The taxpayer may invest the return of principal as well as the recognized capital gain, but only the portion of the investment attributable to the capital gain will be eligible for the exemption from tax on further appreciation of the Opportunity Zone Investment, as explained below. The Opportunity Zone program allows for the sale of any appreciated assets, such as stock, with a reinvestment of the gain into an Opportunity Zone Fund. There is no requirement to invest in a like-kind property to defer the gain.

Note that a taxpayer who receives a reported capital gain from a flow-through entity, such as a partnership, S-corporation, or a trust/estate, has 180 days from the end of the calendar year to make an investment in a Qualified Opportunity Zone Fund, regardless of how early in the calendar year the entity itself realized its gain. For example, if a partnership entity realized a capital gain in March, each partner's 180-day triggering date will be December 31 of the same year and each partner will have until approximately June 28 of the following year to make their Qualified Opportunity Zone investment.

Qualified Opportunity Zone Fund

A Qualified Opportunity Zone Fund is any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property.

Similar to other investments, an investment in an Opportunity Zone Fund may increase or decrease in value over the holding period. In addition, income may be paid on this investment. Given that the purpose of the program is to improve particular areas, it is expected that the fund will continue to invest in the improvement of the property in which it is invested. Cash flow may occur once the property improvements are complete and the property is leased or sold to third parties.

Since Qualified Opportunity Zone Funds are new income tax planning tools and are new investment options for taxpayers, these investments may involve risk. Like many other types of investments, the risks may potentially include market loss, liquidity risk, and business risk to name just a few. Because this investment may not be appropriate for all investors, consult with your tax advisor before pursuing such an investment to determine if this fits with your risk profile and diversification of your investments.

Qualified Opportunity Zone Property

Qualified Opportunity Zone Property is used to refer to property that is qualified opportunity zone stock, a qualified opportunity zone partnership interest or a qualified opportunity zone business property acquired after December 31, 2017, used in a trade or business conducted in a Qualified Opportunity Zone or ownership interest in an entity (stock and partnership interests) operating with such tangible property.

Conceptually, the Opportunity Zone Fund must bring property new to the entity to be used in the Opportunity Zone. A fund that simply acquires property already being used in the zone will not qualify without substantial improvement. Substantial improvement requires improvements equal to the Opportunity Zone Fund's initial investment into the existing property over a 30-month period.

For instance, if an Opportunity Zone Fund acquires existing real property in an Opportunity Zone for $1 million, the fund has 30 months to invest an additional $1 million for improvements to that property in order to qualify for this program. Certain businesses such as golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities,

[1] According to the Internal Revenue Service, an Opportunity Zone is an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Secretary of the U.S. Treasury via his/her delegation authority to the Internal Revenue Service.

race tracks or other facilities used for gambling, or liquor stores are prohibited for Opportunity Zone Fund investments.

Tax deferral and savings

An Opportunity Zone Fund investment provides potential tax savings in three ways:

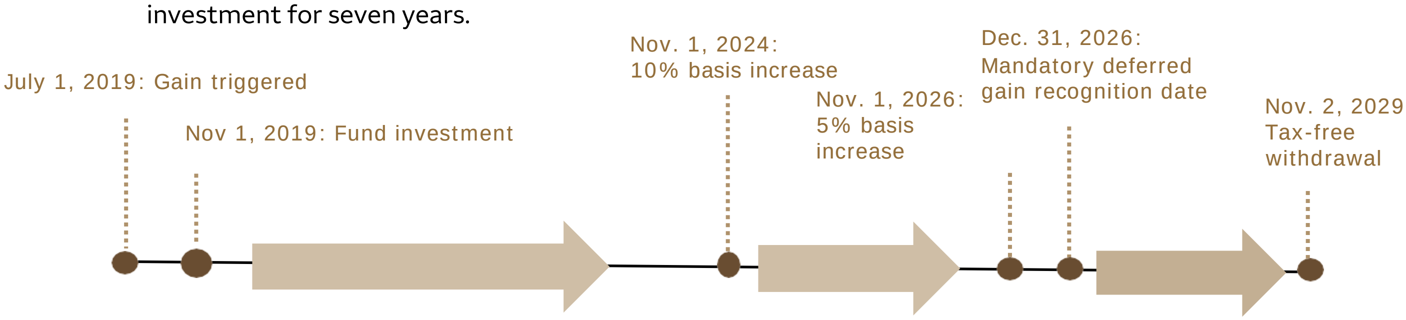
Tax deferral through 2026	A taxpayer may elect to defer the tax on some or all of a capital gain if, during the 180 day period beginning at the date of sale/exchange, they invest in a qualified opportunity fund. Any taxable gain invested in an Opportunity Zone Fund is not recognized until December 31, 2026, (due with the filing of the 2026 return in 2027) or until the interest in the fund is sold or exchanged, whichever occurs first. In addition, the deferred gain can be further reduced as described below.
Step up in tax basis of 10% or up to 15% of deferred gains	A taxpayer who defers gains through an Opportunity Zone Fund investment receives a 10% step-up in tax basis after five years and additional 5% step-up after seven years. Note that to take full advantage of the 15% step-up in tax basis, the taxpayer must have invested by December 31, 2019. When the tax is triggered at the end of 2026, the taxpayer will have held the investment in the fund for seven years, thereby qualifying for the 15% increase in tax basis.
No tax on appreciation	Remaining in the qualified opportunity fund for at least ten years results in the cost basis of the property being equal to the fair market value on the date of sale/exchange (potential to lower cost basis but does not eliminate the gain recognition event on 12/31/2026).

1. **Tax deferral through 2026**
   The gain deferral applies to any investment gain (for example, sale of appreciated stock or a business). It is important to note that the tax cannot be deferred indefinitely – only until 2026. The tax savings, however, may still be significant. Qualifying for deferral does not require an intermediary, and the taxpayer has 180 days from a sale to invest the gains into an Opportunity Zone Fund.

   Example 1: In July 2019, a taxpayer sells a zero-basis business for $10 million, resulting in a $10 million capital gain. The taxpayer invests the entire amount in a Qualified Opportunity Zone Fund within 180 days. None of the sale proceeds are taxable in 2019. At current federal capital gains rates, this allows the taxpayer to keep over $2 million that would otherwise have been taxed as capital gain (based on the current IRS rate of 20%) and paid in the 2019 tax year and instead invest it in the Qualified Opportunity Zone Fund. Assuming even a conservative rate of return on that $2 million, it could provide a significant return to the taxpayer over the length of the investment.

2. **No tax on 10% or up to 15% of deferred gains**

   Example 2: Given the same situation as the previous example, after five years, the taxpayer is given a $1 million basis in the fund (10% of the original capital gain deferred). After seven years, the taxpayer is given another $500,000 of basis in the fund (5% of the original capital gain deferred). After seven years, hypothetically the taxpayer sells the $10 million investment and would pay tax on only $8,500,000 of the gain. At current federal capital gains rates, that's a savings of over $300,000 simply for holding the investment for seven years.



3. **Investing in a QOZ after 2019**

   As stated above, the combined application of the "5-year, 10% basis increase" and the "7-year, 5% basis increase" necessitate that a taxpayer's gain be triggered and a subsequent QOZ investment all must occur prior to the end of 2019. However, the "5-year, 10% basis increase" is still available for taxpayers through December 31, 2021.

   Example 3: Assume similar facts as above, in Example 1 and Example 2, except the dates have been changed: July 2020, a taxpayer sells a zero-basis business for $10 million, resulting in a $10 million capital gain. The taxpayer invests the entire amount in a Qualified Opportunity Zone Fund within 180 days, on November 1, 2020. None of the sale proceeds are taxable in 2020. On November 1, 2025, the taxpayer receives a 10% adjustment to their cost basis in the QOZ investment, amounting to $1 million. On December 31, 2026, the taxpayer must recognize the deferred gain on the sale of the investment, and their cost basis for determining the total gain is $1 million. Assuming the overall value of the QOZ investment has not decreased, then the taxpayer will pay the capital gain on $9 million (i.e.: $10 million 2020 gain, reduced by 5-year 10% basis adjustment of $1 million) and the taxpayer must reflect that gain on their 2026 federal income tax return, to be filed in 2027. With the dates changed, the taxpayer misses the additional 5% basis adjustment since the 7-year anniversary is not attainable before the December 31, 2026, gain recognition date.

   What if there is a loss in value in the Qualified Opportunity Fund?

   The taxpayer is still eligible for the increase in basis for holding the investment for five or seven years. The taxpayer's recognized gain for 2026 (or the year of divesting from the fund) will be the lesser of the original deferred gain or the fair market value of the fund interest reduced by the taxpayer's adjusted basis in the fund, if any. Because of the complicated nature of these investments and the complicated rules that are associated with it, please consult with your tax advisor before committing any funds.

   Example 4: Again given the same situation, after seven years, the Opportunity Zone Property is sold at a loss. Let's presume the taxpayer realizes $8 million from the Opportunity Zone Fund (80% of the original investment). Since the taxpayer held the investment for seven years, the taxpayer receives a 15% increase in basis, or $1,500,000. The gain realized would be $6,500,000 ($8,000,000 - $1,500,000)**.**

4. **Potentially no tax on appreciation**

   Example 5: In 2019, a taxpayer makes a $10 million investment in a Qualified Opportunity Zone Fund. In 2030, the taxpayer sells the investment for $15 million. The $5 million in appreciation is not taxable. At current federal capital gains rates, that's a savings of over $1 million. The taxpayer will, however, have phantom income (taxable income without corresponding sale) on the original $10 million investment in 2027 for the 2026 tax year since the investment in the fund was held beyond December 31, 2026, when the deferred gain on the original investment must be recognized.

Conclusion

Wells Fargo Bank will be publishing companion article(s) which will provide a more in-depth analysis of the operation of Qualified Opportunity Zone funds and how taxpayers may navigate this new topic.

Since the introduction of this new law at the end of 2017, the Internal Revenue Service has issued "Treasury Regulations" which help taxpayers and their professional advisors better understand some of the detailed nuances of this program, and these regulations have settled some of the uneasy questions that surrounded the program in its early stages. Taxpayers should definitely seek the advice their professional legal and tax counselors when considering a Qualified Opportunity Zone Investment.

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