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To: Firm Clients and Contacts

From: Niesar & Vestal LLP

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Re: **Are You in the Zone for Opportunities?**

One of the new provisions in the December 2017 tax act was the creation of Qualified Opportunity Zones ("QOZ"). A QOZ is a population census tract that is a low-income community or a tract adjacent to a low-income tract that has been so designated by the Governor of a state. Each state has a minimum of 25 QOZs and a maximum of 25% of its low-income census tracts. QOZs have already been designated and can be found in an interactive map at https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml. There are over 3000 such zones. See, IRS Notice 2018-48.

QOZs allow an investor to invest gain, however derived, into a fund which owns a business or property in such a zone and to defer recognizing such gain until the earlier of the disposition of the QOZ investment or December 31, 2026. If the QOZ investment is held for 5 years, then 10% of the gain will become added basis to the original investment. If held an additional 2 years, another 5% of the gain will be added to the original basis. Finally, if the QOZ investment is held for 10 years, the basis in the QOZ investment is stepped-up to its then-fair market value. That means that you can sell stock, invest the gain in a QOZ business or real estate for 10 years and sell it in 2029, and only pay taxes on 85% of the original gain in 2026. The catch here is that the gain from the initial sale of assets must be recognized by December 31, 2026. But that does not belie the advantage of gain deferral and partial gain exclusion. Eliminating 15% of the original gain and assuming the time value of money at a 5% discount, there will be over a 40% tax savings, if held for 8 years.

So how does this differ from Section 1031 exchanges? Currently, 1031 exchanges can only be used for real estate. With a QOZ, an investment may be made in a fund where 90% of the assets [both real and tangible personal property] are within the QOZ. As such, there is more flexibility with QOZs. Also, the source of the reinvested gain is not limited to real estate: it can come from the sale of a business; securities; or both tangible and intangible personal property.

Section 1031 exchanges require replacement property to be equal or greater in value to avoid gain recognition. With a QOZ, only the realized gain need be invested. As such, the investor may choose to recover his/her basis in the original investment for personal use or to invest in a different manner. [If more than the gain is invested, the non-gain portion is treated as a separate investment to which the usual rules apply].

Section 1031 exchanges require that replacement property be identified within 45 days and be acquired within 180 days of disposition or the original property. With QOZs there is no identification requirement, but there is the same 180 day requirement to reinvest.

Although 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 are excluded from qualifying as an eligible investment; there are plenty of other types of businesses and properties that will deliver this tax benefit.

The replacement assets must be new to the fund and acquired after 2017. They must also be new to the opportunity zone in the hands of the fund. That means that buying an existing business or real estate in a QOZ will not work. However, if substantial improvements are made to a property, that will qualify. Such improvements must be greater than the fund's basis in the property and be incurred within any 30 month period. That means that either new construction or a substantial rehabilitation of real estate will work to qualify.

Any investment must make economic sense. The QOZ helps tilt the decision tree to encourage investments in low income areas. California has not yet and may never adopt this new law, but the federal tax benefits are still available.

For an example, let's consider Thomas. Thomas worked as a project manager/software developer at AZ corp. He was well compensated and had amassed $500k in company stock with only a $10k basis. Thomas decided to start his own software company. If he sold his stock he would have $490k in gain, with about $100k in federal taxes owing as a result.

Thomas decides to create an Opportunity Zone Fund for his new business. East Palo Alto has a designated Opportunity Zone that is reasonably close to both his home and where his potential workforce resides. Thomas attracts other investors into a new LLC, NEWCO., which is taxed as a partnership. NEWCO purchases a small building to house the operation for $500k and upgrades the building's HVAC, electric and plumbing and seismically retrofits it as well, at a cost of $600k. NEWCO also buys new computers, software and furniture. To obtain his interest in the LLC, on September 1, 2018, Tomas sells his AZ stock and invests the $490k gain in NEWCO for a 51% interest.

As a result, Thomas does not recognize the income from the sale of stock. His $10k basis is returned to him to pay for his living expenses while NEWCO starts up.

NEWCO initially has a loss for the first two years and then Thomas' software takes off and NEWCO becomes profitable. Because Thomas only invested his gain into NEWCO, he has no basis in his LLC interest. As such, Thomas is unable to deduct his share of NEWCO's losses, but they are suspended until NEWCO begins to make money

On September 2, 2023, Thomas' investment in NEWCO passes five years. His basis in the sold stock automatically increases by 10% of his original gain, or $49k. On September 2, 2025, his basis increases another 5%, $24.5k. On December 31, 2026, even though Thomas still owns his interest in NEWCO, he is required to recognize his gain from the 2018 sale of stock. However, because of the increase in basis, only 85% of the gain is recognized, $416.5k. Thomas then owes $83.3k in federal taxes and must either use other resources or a loan to pay it. Thus, Thomas pays less tax and has deferred paying that tax for 8 years.

On September 2, 2028, Thomas' basis in NEWCO is stepped up to its then-fair market value. Thomas immediately sells NEWCO to AZ corp for $1B and pays no federal taxes on his share of the proceeds. Overall, a tax advantage to Thomas.

Should you have any questions, please contact Alan R. Seher, Niesar & Vestal LLP, aseher@nvlawllp.com.