M. Shannon Martin
Partner
Dayton
937.224.1841
smartin@bricker.com

Opportunity Zones

August 13, 2018

Capitalizing on the new Opportunity Zone program spurs economic development in distressed communities through federal income tax incentives.

The program

The recent federal tax reform bill included provisions creating a new program through which a taxpayer can defer income tax on capital gains. The Opportunity Zone program allows a taxpayer to reinvest proceeds from the sale of an eligible business or property into an Opportunity Fund. This Opportunity Fund, in turn, will invest in one or more businesses or properties located within qualified Opportunity Zones. Qualified Opportunity Zones are low-income areas that have been specifically designated by the state and federal government.

By investing in an Opportunity Zone through an Opportunity Fund, a taxpayer can take advantage of up to three benefits, depending on the length of the investment.

1. Temporary deferral

   A taxpayer can defer any tax owed on capital gains by investing the realized gain in an Opportunity Zone. The tax liability is deferred until December 31, 2026, or at such earlier time that the taxpayer disposes of the Opportunity Zone investment.

2. Reduction in gain realized through basis adjustment

   For capital gains that are reinvested into an Opportunity Zone, the basis of the investment will increase by 10 percent if the taxpayer holds the investment for at least 5 years and by an additional five percent if the investment is held by the taxpayer for at least seven years. Therefore, a taxpayer can raise the basis of an investment in an Opportunity Zone by 15 percent of the amount of the initial investment by holding the investment in the Opportunity Zone for at least seven years.

3. Exclusion for capital gains on the Opportunity Zone investment

   If an investor holds the Opportunity Zone investment for at least 10 years, then the basis of the investment is its fair market value as of the date on which the investment is disposed. Therefore, a taxpayer will generally not be taxed on the gain realized from the disposition of the Opportunity Zone investment after 10 years.

A taxpayer must invest in an Opportunity Fund within 180 days of the disposition of the existing property to be eligible for the tax benefits under the program.

The zones

Nationwide, over 8,000 Opportunity Zones have been qualified as being eligible to participate in the program, 320 of which are located in Ohio. Ohio's Development Services Agency and the economic development professions in communities with designated Opportunity Zones are poised to assist investors with identifying potential opportunities in these local Opportunity Zones. A static map of the 320 qualified Ohio Opportunity Zone tracts is below. For a complete list and interactive map, please visit these CDFI Fund and Ohio Development Services Agency sites.

The funds

To enjoy the tax benefits under the program, a taxpayer's investment in an Opportunity Zone must take place via an Opportunity Fund. An Opportunity Fund is an entity organized to acquire and hold for investment purposes equity interests in businesses or properties located in Opportunity Zones. While the IRS is expected to issue additional guidance regarding Opportunity Funds, it is anticipated that the regulations will be relatively limited. The IRS has already indicated that any entity will be able to self-certify as being an Opportunity Fund without approval or action by the IRS and that the self-certification process will merely involve a yet-to-be-released form attached to the taxpayer's tax return.

Unlike the types of institutional investors that typically invest in low-income or distressed communities (e.g., investors seeking tax credits through low-income housing tax credit projects or community reinvestment area tax credits), Opportunity Zone investors are most likely to be high-net-worth individuals and investment oriented companies, such as life insurance companies, managed investment funds and mutual funds, that regularly realize significant capital gains. Consequently, Opportunity Funds will seek to balance risk and return and to structure investments in ways that meet the goals of the original taxpayers invested in the Opportunity Fund (i.e., to achieve temporary deferral, step up in basis or the permanent exclusion with a longer term investment under the program). Many mission-driven institutions are taking a lead in establishing impact-oriented Opportunity Funds to attract investors with specific fields of interest, such as development of affordable housing, investment in small business ventures that align with the community's goals, renewable energy development and health care delivery.

Since the law imposes no cap on the size of a given Opportunity Fund, it is expected that large-scale Opportunity Funds will be competing in the market for investors seeking to benefit from the program. However, the flexibility afforded by the self-certification process means that any taxpayer with appreciated assets can benefit by establishing an Opportunity Fund in order to invest in an Opportunity Zone. For example, local businesses may seek to redeploy equity in appreciated assets in order to reinvest in a local Opportunity Zone. Local economic development professionals and business advisors need to have the tools in place to help investors leverage such opportunities.

The investments

Attracting investments from Opportunity Funds will be critical for developers and economic development professionals looking to promote economic and community development in distressed Opportunity Zone communities. Even as we await more guidance on the creation and deployment of Opportunity Funds, communities are working hard to make their Opportunity Zones attractive to investment. Strategies include aligning existing and proposed projects with other sources of capital to reduce potential risk profiles, pairing Opportunity Fund investment with other local and state incentives and programs, and deploying wrap-around resources such as workforce development to support projects and retain mission-driven goals for the community.