

OPPORTUNITY ZONES: AN UPDATE ON THE LAND OF OZ

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Tax free. These two words rarely go together but, when they do, one thing is certain...people get excited. For the last 13 months, we have been researching, dissecting, educating and consulting on the latest opportunity to put these two words together. Enacted as part of the Tax Cuts and Jobs Act of 2017, Opportunity Zones have generated a lot of excitement around the country. I've traveled the state doing presentations and consulting on this program. We have presented to bankers, lawyers, economic development groups, municipalities, start-ups, high-net-worth individuals and so many more. One thing remains consistent across all these meetings and presentations. Everybody is excited about the potential of this program.

Four main incentives exist for Opportunity Zone investors:

- **First**, you can defer tax on your original capital gain until 12/31/2026.
- **Second**, you can permanently exclude 10% of your original capital gain from tax after the investment is held for five years.
- **Third**, the exclusion of your original capital gain increases to 15% after the investment is held for seven years.
- **Lastly**, but certainly not least, all post investment gains are permanently tax free once the investment is held for 10 years.

This last incentive is the one that people consistently question whether this is too good to be true. It requires long-term investing, but the potential benefit is unmatched in the tax world. The potential to enjoy unlimited gains permanently tax free is driving capital to these Opportunity Zones.

To put that in perspective and see how this could work, let's look at an example. Imagine you start a company with \$100,000 of capital gains that you reinvested this year and sold that company at least 10 years from now for \$5 million. At the highest tax rate on capital gains (20% Federal, 5% AL) you would normally pay \$25,000 in tax on that

original gain of \$100,000. Additionally, you would pay another \$1,225,000 in tax upon your exit after ten years. While this is a great return that many of us would be happy to enjoy, you would still be paying \$1,250,000 in taxes over the 10-year period. Not exactly a check anybody would be happy handing over to the IRS. Now imagine you do the exact same thing, except the company is in an Opportunity Zone and you comply with all rules and regulations of this new program. The tax on your original gain today is deferred for seven years, you pay \$21,250 of tax on your original gain with your 2026 tax return, and your \$4.9 million gain after year ten is tax free forever. Again, we see those two words that are generating so much excitement, and now you see why.

So where do we stand on this program currently? Some deals have been made, some are in the works, and many are still waiting for additional guidance from the IRS. For a program with so much promise and support, the rollout has been bumpy to say the least. Passed in December 2017, it took almost six months just for all zones across the country to be known and designated. We discussed early on about how great the incentives are but without knowing where the zones were located, nobody could take advantage of them. Even after we knew the location of the zones, the Code governing this program had as many holes as swiss cheese. This left many wondering if they could qualify and comply with the rules that would eventually govern their investment. It took 10 months for the first round of regulations to be proposed, but even then, the IRS admitted they did not address many questions. They just wanted to answer what they could at that time so some of these deals could get off the sidelines. Initially, we were told additional guidance would come by the end of 2018, but that came and passed with no word from the IRS. Although it is unclear whether the government shut down is delaying the release of additional guidance, it certainly isn't expediting the process.

Some areas of the new law are clearer than others. For instance, we received some clarity on many of the questions regarding investment in real estate but questions surrounding investments in operating businesses are still extensive. This is where the greatest potential of the program lies. Don't get me wrong, a good real estate deal can enjoy some incredible benefits from an Opportunity Zone investment. In the real estate world, this is like combining a 1031 like-kind exchange with a Roth IRA and injecting it with steroids. With that said, the truly explosive potential of this program lies with investments in start-ups and operating businesses thanks to the multiples that are associated with their future sale. Some investors are moving forward with an Opportunity Zone investment; moving forward knowing that some uncertainty exists but realizing at the same time, the potential is too good to pass up or ignore. However, many are still waiting on the sidelines. They are waiting for certainty that their investment will enjoy the many benefits the program offers, waiting to turn their good investment into an outstanding investment. As advisors, we are waiting as well — waiting to digest additional regulations and advise clients on their impact, waiting for clarity around a program of so much promise and potential, waiting to see if the government will answer the many questions that exist and take the handcuffs off a promising program that has the potential to transform communities across the country.

Please contact your BMSS professional if you would like to learn more about opportunities in your area or if you have any questions.