Lesser-known change in Trump tax cuts is a consequential tax-avoidance opportunity

As a CPA who survived last year's difficult tax season due to implementing the expansive changes that were enacted by the Tax Cuts and Jobs Act (TCGA), I have taken a step back and revisited some of the less-publicized and -known provisions of the new tax law.

One such provision is the incredible tax advantages offered to taxpayers interested in investing in qualified "Opportunity Zones." Opportunity zones provide tax incentives to investors willing to take realized gains on sale of assets and provide capital to some of America's most impoverished communities.

Opportunity zones are economically distressed areas designated by the governors of each state and U.S. territories. The objective is to provide tax incentives that will bring private domestic capital to improve housing, commercial enterprises such as hotels, restaurants, manufacturing facilities and agricultural developments to these communities. To qualify, the distressed area must have a poverty rate of 20% or higher, or a median household income that is less than 80% of the surrounding area. To date, approximately 8,700 areas have been designated by governors and approved by the Secretary of the U.S. Treasury.

Unlike previous development incentives such as "Enterprise Zones" and "New Market" tax credits, which capped tax benefits and placed restrictions on the industries and regions that would qualify, the opportunity zones investment and business opportunities are broad. Businesses such as country clubs, liquor stores, casinos and massage parlors are not allowed; however, just about any other business opportunity would be eligible.

Investors and developers, however, must do more than invest in crumbling and dilapidated properties. To qualify for the tax incentives, investors must make substantial improvements and upgrades to existing buildings of at least equal to the cost of the initial purchase. The improvement must be made within a 30-month period. The substantial improvement is only on the cost allocated to the building, not the amount allocated to the cost of the land. These incentives can lay the groundwork for significant economic boom; with real estate projects come new office buildings, industrial districts, restaurants and affordable housing.

The qualified taxpayer must either invest in an existing qualified opportunity fund (QOF) or establish their own QOF. It may be more practical for a large investor to set up their own QOF; however, it may be more cost-effective to invest into an already established QOF for a small investor. The QOF may be set up as a corporation or a partnership and does not need to be located in an opportunity zone, but it must be established in the U.S.

The corporation or partnership established as a QOF must file IRS Form 8996, self-certifying with its tax return for each year the entity intends to operate as a QOF. In the first tax year, the entity must specify the first month in which they are to be considered a QOF, which is important due to the fact that any funds invested before that time are not eligible for the deferral. The QOFs must hold at least 90% of their assets in qualified opportunity zone property.

A qualified taxpayer is any person or entity that may recognize a capital gain for purpose of federal income tax. This will include individuals, C and S corporations, real estate investment trusts, partnerships, trusts and estates. The provision of the new tax law allows the qualified taxpayers to elect to temporally defer tax on all or a portion of their realized capital gains from pre-2027 sales of non-opportunity zones property until Dec. 31, 2026.

The realized capital gain from the sale of 1231 property does qualify as an eligible gain; however, any depreciation recapture under section 1245 or 1250 does not qualify for the deferral. The sale may not be made to a related party. The funds from the capital gain property must be reinvested into a qualified opportunity fund that invests in qualified opportunity zones within 180 days beginning on the date of sale of the asset.

The initial sale that produces the capital gain may be from the sale of any type of property that will produce a taxable capital gain, including the sale of real estate, stocks and business interests. Tax deferral using a 1031 exchange has been available in tax law for many years for deferring tax on like-kind exchange of real property. (Personal property is no longer eligible.) However, for the sale of stock or business interests, until now there has not been a tax-deferring vehicle for this type of gain.

The assumption is: Investors are sitting on large capital gains with low-basis investments. The goal is to incentivize these investors to sell appreciated assets which will, in turn, release domestic capital that has been sitting on the sidelines. The designations of the opportunity zones provide investors the ability to place their money into investments where they would not typically invest, thus improving their communities.

The taxpayer election is made on IRS Form 8949 and IRC section 1400Z allows for the taxpayer to elect to defer the gain portion of the sale only. The taxpayer may retain the original cost basis of the original property without tax consequence. This is different from a

1031 exchange, in which all proceeds must be reinvested to maintain tax-deferred treatment. Remember, this is only a deferral of tax; if the investment is held until 2026, the taxpayer will be required to pay a portion of the tax on the realized gain. Taxpayers should consider holding out a portion of the nontaxable principal for the eventual payment of the tax, which will be due even if the taxpayer does not sell their investment in the fund.

There are special rules for partnerships, S Corporations, estates and trusts that the entity may elect to realize the eligible gain at the entity level or may pass the gain through to its partners, who then must make their own decision about to reinvest the deferred proceeds. When the entity does not elect to defer the gain but to pass out the gain to the partners, the 180-day period begins on the last day of the entity's tax year in which the gain is allocated.

The taxpayer can take advantage of a partial step up in basis the longer the investment in the QOF is held. The basis in the opportunity zone fund investment starts at zero. If the investment is held for five years, the taxpayer may recognize 10% of the original gain as its new basis.

For example, a taxpayer sold stock for $100,000 with a basis of $40,000. Thus, the realized capital gain would be $60,000 and would be available to be tax-deferred into an opportunity zone. The basis in the opportunity zone investment in year one is zero. If the investment is held for five years, the taxpayer can step up the basis 10% or $6,000 ($60,000 deferred gain x 10%).

But there's more: If the investment is held for 10 years, there is a permanent exclusion of capital gains on the appreciation from the sale or exchange of an investment in the QOF. This can be looked at much like a Roth IRA, where any appreciation, after the tax is paid in 2026, is tax-free. Please note that this is federal law and you will need to consult your tax adviser as to whether your state complies.

In my research, I was pleasantly surprised to find that this was bipartisan legislation whose core members were an unlikely group of conservatives, liberals, capitalists and philanthropists who have successfully created one of the most consequential tax-avoidance opportunities in American history. All with the goal of improving underperforming American cities and neighborhoods by using private capital instead of a redistribution of wealth, we can end up creating jobs and opportunity.