Opportunity Zones and New Real Estate Opportunities.

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The Tax Cuts and Jobs Act of 2017 establishes a federal tax incentive for deferring and partially exempting capital gains for investments made into a "Qualified Opportunity Fund" which may own business property within "Qualified Opportunity Zones." In March, Governor Abbott designated 150 Opportunity Zones in the metro Houston area and 628 state-wide.

This new type of investment vehicle is designed to incentivize real estate investment in low-income communities. Unlike Enterprise Zones, which give you a tax incentive for buying land and opening a business in a zone, here you invest in a Qualified Opportunity Fund that is organized as a partnership or a corporation for the purpose of investing in real estate or certain other assets in the designated Opportunity Zones.

While the designated Opportunity Zones are supposed to be low-income communities as defined in the Internal Revenue Code, the designated areas include some prime areas for real estate investment, such as downtown Houston, parts of midtown, and much of east downtown, and many other potentially great places to park capital gains from a real estate sale. There are real tax incentives that give you 1) a deferred tax on your capital gains from the sale of real estate; 2) receive a stepped-up basis on those gains after some time, and 3) allow you to eventually take your appreciation tax-free from the sale of property held by your Qualified Opportunity Fund.

So how does this work?

Capital gains from the sale of an asset such as real estate can be reinvested within 180 days of the sale into a Qualified Opportunity Fund, which can be a corporation or a partnership organized for this purpose. The Qualified Opportunity Fund must maintain 90% of its assets in Qualified Opportunity Zone Property, which can be a few different things, but for real estate, means Qualified Opportunity Zone Business Property. The Business Property must be for a trade or business of the Qualified Opportunity Fund that either originates with the Fund or is substantially improved by the fund. This requires that improvements occur within 30 months after the date of acquisition and be in an amount at least to the adjusted basis of the property held by the Qualified Opportunity Fund.

Unlike a like-kind exchange, only the capital gains and not the original basis from the sale of an asset need to be reinvested in the Qualified Opportunity Fund.

Once the investment is made, taxes owed on the capital gains are deferred until the earlier of the date the investment is sold or exchanged, or December 31, 2026. For investments held for 5 years, there is a 10% step-up in the basis of the gains. For investments held for 7 years, there is a total of 15% step-up in the basis. Here's the potentially largest incentive: while the investment in a Qualified Opportunity Zone has no basis, if it is held for 10 years, the basis becomes equal to the fair market value at the time of sale, exempting all appreciation from the Qualified Opportunity Fund from taxation. That means you can pay some tax after year 7 and get the remaining money out of your real estate tax-free after year 10.

For example:

Year 1 – I sell a piece of real estate for $200. I originally paid $100. I keep my original $100 (unlike in a like-kind exchange), and I put my $100 gain into real estate in a Qualified Opportunity Zone through a Qualified Opportunity Fund within 180 days of sale. I defer taxes on the gain for now.

Year 5 – I now have a 10% basis in my original $100. If I sell now, I owe capital gains tax on $90.

Year 7 – I now have a 15% basis in my original $100. I owe capital gains tax on $85.

December 31, 2026 – I owe the IRS capital gains tax on $85.

Year 10 – I sell the real estate held by the Qualified Opportunity Fund for $300. I have already paid taxes to the IRS on $85 out of the original $100 after year 7. I now owe no tax at all on the remaining $200.

I want to take advantage of this. What do I do next?

First, call your CPA, or contact me and I'll put you in touch with one. There are certain requirements to establishing a Qualified Opportunity Fund. Also, because this is so new, make sure you get professional assistance. Second, start shopping. The US Treasury Department has an interactive mapping tool that will help you identify parcels within Qualified Opportunity Zones. I've included links to the mapping tool as well as an FAQ on the IRS's website below. Feel free to contact me and I will be happy to email the links to you. Third, plan for the future. Do you or your clients have property that needs to be sold and reinvested through a like-kind exchange? Consider keeping the basis and reinvesting the gain into a Qualified Opportunity Fund. You'll defer tax with a stepped-up basis, but you'll get your money out tax-free after 10 years.

Here is a link to the IRS's FAQ on the zones:

https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

Here is a link to the US Treasury Department's interactive mapping tool that'll help you check Opportunity Zones on a parcel basis:

https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml