WISCONSIN REALTORS® ASSOCIATION

LEGAL UPDATE

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A MONTHLY GUIDE TO WISCONSIN REAL ESTATE LAW & POLICY

Qualified Opportunity Zones

The Tax Cuts and Jobs Act of 2017 included a new powerful economic development tax incentive program called Qualified Opportunity Zones, designed to encourage long-term private capital investment in America's low-income communities. Investment and development in distressed communities is encouraged by extending tax benefits to investors.

Investors and local policymakers across the country are excited to tap into over $6 trillion dollars of unrealized capital gains to support redevelopment projects and new businesses in the 8,700 eligible Opportunity Zones. At the same time, there is concern among local policymakers and community groups who are afraid this tax incentive will have adverse effects including gentrification and displacement.

The goal is to give tax incentives for new investment in low-income communities or distressed areas. Under this program, investments in Opportunity Zones must be made via an Opportunity Fund. Ninety percent of the assets held by an Opportunity Fund must be Qualified Opportunity Zone Property within a Qualified Opportunity Zone.

This *Legal Update* overviews the new Opportunity Zones and the tax benefits investors can enjoy.

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Opportunity Zones

Opportunity Zones are designed to spur economic development by providing tax benefits to investors. The new Qualified Opportunity Zone (QOZ) program is a national investment program that seeks to connect private capital to low-income communities.

The QOZ program presents multiple opportunities for real estate professionals. On the front end, it provides a way for investors to invest capital gains without paying the tax on those gains immediately, which may encourage them to sell real estate assets they might otherwise hold on to in order to avoid taxes. On the back end, the Opportunity Funds created to invest in the zones will be looking for business property to invest in, which in many cases will include real property and/or involve development opportunities for real estate.

The QOZ tax policies provide for the deferral or exclusion of capital gains taxes on investments that are sold if the proceeds are reinvested into low-income or economically disadvantaged communities or neighborhoods that have been officially designated as QOZs. Opponents are concerned the QOZ program will encourage gentrification of neighborhoods as opposed to creating economic opportunities for current residents. They argue there are not enough government parameters and rules as to what is developed (e.g., affordable housing or requirements that jobs be created), which they fear may lead to fraud and abuse of the program.

What are Opportunity Zones?

A Qualified Opportunity Zone (QOZ) is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment.

How were Opportunity Zones selected?

QOZs are 8,700 low-income communities across U.S. states and territories nominated by the governors of those states and certified by the United States Department of Treasury (USDT) in June 2018.

What are some of the characteristics of Opportunity Zones?

The majority of the designated Opportunity Zones are low-density, drivable suburban areas. The selected zones have an average poverty rate of nearly 31 percent, well above the 20-percent eligibility threshold, and an average median family income of only 59 percent of its area median, compared to the 80-percent eligibility threshold. The average QOZ's housing stock has a median age of 50 years, more than 10 years older than the U.S. median, a sign that many of these neighborhoods urgently need reinvestment. Seventy-one percent of QOZs meet the USDT's definition of "severely distressed." The average designated tract has a poverty rate nearly double the national average. More than one-fifth of all Opportunity Zones have poverty rates of 40 percent or higher, which is true of only around 5 percent of communities nationwide.

Where are the Opportunity Zones?

The designated QOZs can be seen listed by state and census tract number, and a map is also available at www.cdfifund.gov/pages/opportunity-zones.aspx.

> ⓘ **MORE INFO**
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> Lists of designated QOZs can be found at www.cdfifund.gov/Pages/Opportunity-Zones.aspx, and www.irs.gov/pub/irs-drop/n-18-48.pdf and a map of designated QOZs is at www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml.

> ⓘ **MORE INFO**
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> To assist in deciphering census tract numbers, census tract reference maps for Wisconsin are available at www.census.gov/geo/maps-data/maps/2010ref/st55_tract.html. You can find the 11-digit census tract numbers for a specific address, also known as GEOIDs, using the U.S. Census Bureau's Geocoder at https://geocoding.geo.census.gov/geocoder. After entering the street address, select ACS2015_Current in the Vintage drop-down menu and click Find. In the Census Tracts section, you'll find the number after GEOID.

> ⓘ **MORE INFO**
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> The city of Milwaukee is an ideal location to maximize the benefits of QOZs that are found from the far northwest side to an area near Mitchell International Airport. Real estate projects in the 30th Street Industrial Corridor/Century City business park, the Menomonee Valley, Riverworks industrial area, Harbor District, the near south side, and adjacent to the Park East corridor all qualify for QOZ investment. See the interactive map at https://city.milwaukee.gov/DCD/CityRealEstate/OpportunityZones#.XJOumShKjcs.

Qualified Opportunity Zone Funds

Opportunity Zones are designed to incentivize new equity investments in low-income communities. The goal is to draw capital to areas where investment has lagged since the Great Recession by allowing investors to avoid some taxes when they fund projects. The tax incentives relate to the tax treatment of capital gains and are tied to the longevity of an investor's investment in a Qualified Opportunity Zone. Investments in QOZs must be made via an Opportunity Zone Fund.

What are Qualified Opportunity Zone Funds?

A Qualified Opportunity Zone Fund (Opportunity Fund) is an investment vehicle that is set up as either a partnership or corporation for investing in eligible property that is located in a QOZ. There are no statutory limits on who may form Opportunity Funds, but there are other requirements:

- May be a partnership or corporation organized for the purpose of investing in QOZ property;
- An LLC that chooses to be treated either as a partnership or corporation for federal tax purposes can also organize as an Opportunity Fund;
- Must hold at least 90 percent of its assets in QOZ property, which can be stock, partnership interests and/or other tangible property used in a trade or business, e.g., real estate, within a QOZ; and
- Must be certified according to IRS and Treasury regulations.

The Treasury Department's proposed rules released in October 2018 state that Opportunity Funds will be able to self-certify via a Qualified Opportunity Fund form filed with federal income tax returns (Form 8996).

Is there a list of Opportunity Zones in which an Opportunity Fund can invest?

Yes, the list of designated Qualified Opportunity Zones in which an Opportunity Fund may invest to meet its investment requirements can be found at www.irs.gov/pub/irs-drop/n-18-48.pdf.

How does an Opportunity Fund certify that it has met the "90% Assets" Requirement?

Opportunity Funds are self-certifying via an IRS Form (Form 8996) that is submitted with federal income tax filings. The 90% asset requirement will be assessed by the asset values reported on the Opportunity Fund's applicable financial statements for the year.

What are the QOZ Business Property Requirements?

QOZ Property can be stock, partnership interests or tangible property used in a trade or business within a QOZ, such as real estate. The original use of the property in a QOZ must begin with the QOZ business, or the QOZ business must substantially improve the property. Substantially improved means the investment in improvement during the 30-month period after acquisition is at least as much as was paid for the used asset. The proposed rules provide that the basis of the land need not be counted for purposes of determining whether real property has been substantially improved, thus significantly reducing the required investment amounts.

A QOZ Business is a business where substantially all tangible property is QOZ business property. Substantially all means at least 70% of the tangible property owned or leased is in a QOZ.

There is a "working capital safe harbor" for Opportunity Fund investments in QOZ businesses that acquire, construct or rehabilitate tangible business property, including real property and other tangible property used in a business operating in a QOZ. Cash and cash equivalents qualify as business property for at least 30 months after new capital is raised.

Does an investor need to live in a QOZ to take advantage of the tax benefits?

No, you can get the tax benefits even if you don't live, work or have a business in a QOZ. All one needs to do is invest a recognized gain in an Opportunity Fund and elect to defer the tax on that gain.

Qualified Opportunity Zone Tax Benefits

Investors are able to defer and reduce taxes up to 15 percent on capital gains realized from asset sales, if these capital gains are reinvested into Opportunity Funds within 180 days of the sale to an unrelated party. In addition, the taxation on the capital appreciation eventually realized on the Opportunity Fund's performance may be forgiven if the Fund investment is held for at least 10 years.

What are the tax benefits?

Investments in Opportunity Funds may be capital gains from a previous sale made within 180 days and/or non-gain funds. When both gains and non-gains funds are invested, they are treated as separate investments and receive different tax treatments by the federal government.

There are three core tax incentives for capital gains investments:

- **Temporary deferral:** A temporary deferral of inclusion in taxable income for capital gains reinvested into an Opportunity Fund until the earlier of the date on which the investment in an Opportunity Fund is sold or exchanged, or December 31, 2026.
- **Step-up in basis:** A step-up in basis for the deferred capital gains reinvested in an Opportunity Fund that effectively results in forgiveness of a proportional amount of the gain. The basis is increased by 10 percent if the investment in the Opportunity Fund is held by the taxpayer for at least five years, and by an additional 5 percent if held for at least seven years, thereby excluding up to 15 percent of the original deferred gain from taxation. In other words, if the QOF investment is held for longer than five years, there is a 10-percent exclusion of the deferred gain, and if held for more than seven years, the 10 percent becomes 15 percent.
- **Permanent exclusion:** A permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in an Opportunity Fund if the investment is held for at least 10 years. This exclusion only applies to post-investment gains accrued on investments made through an Opportunity Fund. There is no permanent exclusion possible for the initially deferred gain.

Gains made in connection with investments that were not capital gains initially are not eligible for these tax benefits.

ⓘ **MORE INFO**

For a thorough overview and analysis of the benefits of Opportunity Zones investment, see Economic Innovation Group EIG's Opportunity Zones Fact Sheet at https://eig.org/wp-content/uploads/2018/02/Opportunity-Zones-Fact-Sheet.pdf and the Opportunity Zones primer from The Advice Lab in J.P. Morgan's Private Bank, which walks through the tax benefits and qualifying investments, at https://am.jpmorgan.com/blob-pbstudio/1383570235572/83456/washington_watch_spotlight_opportunity_zones.pdf.

Investment Example

Ozzie Opportunistic owns land he purchased many years ago for $10,000. In 2018 he sells it for $60,000 and within 180 days he reinvests the proceeds into an Opportunity Fund. The following are the possible tax benefits Ozzie might enjoy, depending on how long the capital tax gain remains invested in the Opportunity Fund:

1. Ozzie can defer paying tax on the $50,000 gain until the earlier of the date he sells his interest in the Opportunity Fund or the last day of 2026.
2. If Ozzie holds his $50,000 investment in the Opportunity Fund for at least five years, 10 percent of the gain ($5,000) will escape tax when he sells his interest.
3. If Ozzie holds his investment for at least seven years, 15 percent of the gain ($7,500) will escape tax when he sells his interest.
4. Assume Ozzie's interest in Opportunity Fund that started as $50,000 was worth $70,000 after 10 years. Under the regular tax rules, he would realize a $20,000 capital gain on value since the date of the investment, but investing in the Opportunity Fund allows the entire appreciation to escape taxation.

Opportunity Zone Questions and Answers

I am a real estate professional. What does this mean for my business?

The QOZ program presents multiple opportunities for real estate professionals. On the front end, it provides a way for investors to invest capital gains without paying the tax on those gains immediately, which may encourage them to sell real estate assets they might otherwise hold on to in order to avoid taxes. On the back end, the Opportunity Funds created to invest in the QOZs will be looking for business property to invest in, which in many cases will include real property and/or involve development opportunities for real estate.

A party sold some stock for a gain in 2018 and, during the 180-day period beginning on the date of the sale, he invested the amount of the gain in an Opportunity Fund. Can he defer paying tax on that gain?

Yes, he may elect to defer the tax on the amount of the gain invested in an Opportunity Fund. If he only invests part of the gain in an Opportunity Fund, he can elect to defer tax on only the part of the gain that was invested.

How does an investor elect to defer his gain on the 2018 sale of the stock?

The investor may make an election to defer the gain, in whole or in part, when filing his 2018 federal income tax return. That is, he may make the election on the return on which the tax on that gain would be due if it was not deferred.

The investor sold some stock on December 15, 2018, and, during the required 180-day period, he invested the amount of the gain in an Opportunity Fund. Can he elect to defer tax on that gain?

Yes, he would make the election on his 2018 return by attaching Form 8949 (www.irs.gov/forms-pubs/about-form-8949) reporting information about the sale of the stock. Instructions on how to use that form to elect deferral of the gain are available along with the form.

How can an investor get more information about Opportunity Zones?

Over the next few months, the Treasury Department and the Internal Revenue Service (IRS) will be providing further details, including additional legal guidance, on this new tax benefit. More information will be available at Treasury.gov and IRS.gov.

Is this program permanent?

No, QOZ designations will expire at the end of 2028 and investments made in 2019 and in following years will still be eligible for a step-up in basis through the end of 2047. This is a temporary program, set to fully sunset on December 31, 2047.

Are all the final rules in place?

No, The Treasury Department and the IRS are conducting notice-and-comment rulemaking to finalize regulations for the program.

White House Opportunity and Revitalization Council

Other efforts are being made to help promote the success of QOZs. On December 12, 2018, the President established the White House Opportunity and Revitalization Council, chaired by Secretary of Housing and Urban Development Ben Carson and comprised of 13 federal agencies. In order to further facilitate investment in QOZs, reforms will be studied and enacted to streamline existing regulations, protect taxpayers by optimizing use of federal resources, stimulate economic opportunity and mobility, encourage entrepreneurship, expand quality educational opportunities, develop and rehabilitate quality housing stock, promote workforce development, and promote safety and prevent crime in urban and economically distressed communities. The Council is to engage with state, local and tribal governments to find ways to better use public funds to revitalize urban and economically distressed communities.

ⓘ **MORE INFO**

See the Executive Order on Establishing the White House Opportunity and Revitalization Council at www.whitehouse.gov/presidential-actions/executive-order-establishing-white-house-opportunity-revitalization-council.

LOCUS National Opportunity Zone Ranking Report

LOCUS, Latin for “place,” is a national coalition of real estate developers and investors who advocate for sustainable, equitable, walkable development in America’s metropolitan areas. LOCUS brings together real estate developers and investors from across the country to change policy at the local, state and federal level and to build neighborhoods that are more economically, socially and environmentally sustainable for America’s future.

The LOCUS National Opportunity Zone Ranking Report ranks each of the designated Opportunity Zones based on its Smart Growth Potential (SGP) and its Social Equity + Vulnerability Index score (SEVI). Communities of color and low-income neighborhoods want greater investment that preserves and strengthens current residents, business and cultures, instilling value in people rather than displacing them. The Opportunity Zone designation can offer an opportunity for communities to develop their vision for investments and implement protective policies to keep people in place while enhancing and offering access to new streams of capital and investment. In addition to providing data for investors to determine how to prioritize Opportunity Zone investments, this report provides policymakers and local groups with a framework to manage and ensure equitable, inclusive development in Opportunity Zones.

ⓘ **MORE INFO**

Explore the report and learn more about Opportunity Zones at https://smartgrowthamerica.org/program/locus/opportunity-zones.

IRS Opportunity Zone Hearing

On February 14, 2019, the IRS held a public hearing on QOZs, seeking input regarding the first round of proposed rulemaking for the program, released in October 2018. Commentary came from state economic development groups; technology, small business and community reinvestment coalitions; economic think tanks; and several investment funds. Some common themes emerged:

- Requirements for Qualified Opportunity Zone businesses: under the proposed rules a QOZ business must be at least 70 percent within a QOZ to qualify, and at least 50 percent of gross income receipts must be from business within a QOZ. Concerns were raised about businesses that conduct e-commerce or manufacturing, which may struggle to meet that standard.
- Flexibility for Opportunity Funds to reinvest interim gains without penalty: investment funds thrive on flexibility and diversity, and locking funds into their investments, including any gains they make, for at least 10 years runs counter to that. It was suggested the IRS should allow Opportunity Funds to reinvest gains within a reasonable time into other QOZ Businesses without triggering a taxable event.
- Data reporting requirements: clear data-reporting requirements for Opportunity Funds and QOZ businesses were requested to

provide a transparent mechanism for tracking the program's effectiveness, help funds and investors make well-informed decisions and prevent fraud and abuse.

- Protections and incentives for affordable housing were requested as most of the census tracts designated as QOZs qualify as severely distressed communities.
- IRS clarification was requested regarding exactly how the QOZ program and its tax benefits will work with other tax benefits meant to encourage development, such as the New Market Tax Credit and the Low-Income Housing Tax Credit.
- In the proposed rules, the IRS states a property is substantially improved if investments into it are worth at least the cost of the property, not including the basis of the land. Witnesses asked if this could be aggregated between multiple properties in a QOZ invested in by a single Opportunity Fund, and also requested more flexibility for the timeperiod in which a property can be "substantially improved" (now 30 months).

Another round of regulations should be forthcoming.

Resources

- NAR Background: Qualified Opportunity Zones (Fall 2018) General questions and links to additional resources, including a list of designated QOZs, a map of QOZs and proposed rules by the Treasury: www.nar.realtor/taxes/background-qualified-opportunity-zones
- IRS FAQ on Opportunity Zones (January 2019) These FAQs (and answers) help to explain opportunity zones and give links to the IRS notices and resources for opportunity zones: www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions
- NAR Issue Summary: https://narfocus.com/billdatabase/clientfiles/172/issue_pdfs/375.pdf
- QOZ two-page handout with a brief overview of the program and its guidelines, perfect for sharing with members and others: https://narfocus.com/billdatabase/clientfiles/172/26/3236.pdf
- Webinar: Capitalizing on Opportunity Zones and Section 199A: NAR representatives discuss how these two new developments will affect the commercial real estate industry: www.nar.realtor/webinars/capitalizing-on-opportunity-zones-and-section-199a
- List of designated QOZs: www.cdfifund.gov/Pages/Opportunity-Zones.aspx
- Map of designated QOZs: www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml
- Treasury Proposed Rules on Opportunity Zones: www.irs.gov/pub/irs-drop/reg-115420-18.pdf
- WHEDA Opportunity Zone Webinar: www.youtube.com/watch?v=1IMwhn8KDKE&feature=youtu.be
- "Get Up to Speed on O-Zones," March-April 2019 *REALTOR® Magazine*: https://magazine.realtor/commercial/feature/article/2019/02/get-up-to-speed-on-o-zones

CONTACT INFORMATION

Wisconsin REALTORS® Association
4801 Forest Run Road, Suite 201
Madison, WI 53704
608-241-2047
800-279-1972

LEGAL HOTLINE

Ph: 608-242-2296
Fax: 608-242-2279
Web: www.wra.org

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