"Tax Tips: Opportunity Zone program offers investors deferred gain tax benefits"

Carl Grassi for Crain's Cleveland Business

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The Opportunity Zone Program included in the federal tax-reform law passed last year is designed to spur investment in low-income areas. Done properly, investments in designated areas, known as Opportunity Zones, allow both gain deferral and gain exclusion. Imagine a supercharged like-kind exchange, where you can defer income without a like-kind requirement, take cash off the table between investments and even exclude gain upon exit.

How the program works

Proposed Treasury regulations issued last month, which explain the new program with flexible rules, have stirred up interest in investing in the 8,700 designated Opportunity Zones, including 320 in Ohio.

While the Opportunity Zone Program is quite complex, the path toward its tax benefits can be summed up as follows:

- The investor must realize eligible capital gain income, meaning almost any capital gain income subject to a few exceptions;
- Within 180 days, the investor must reinvest the capital gain in an "Opportunity Fund"; and
- The Opportunity Fund must invest more than 90% of its assets in Qualified Opportunity Zone Property ("qualified property") within an Opportunity Zone, either through operating a Qualified Opportunity Zone Business ("qualified business") itself or investing in a subsidiary that operates a qualified business.

Tax benefits

Let's use an example to explore the benefits of the Opportunity Zone Program. Suppose you had a $300,000 basis in corporate stock that you sold for $1 million in cash. You can defer the $700,000 capital gain by reinvesting the gain into an Opportunity Fund. You don't need to recognize the gain on the sale of the stock until you dispose of your Opportunity Fund investment or Dec. 31, 2026, whichever occurs first.

In addition to tax deferral, the Opportunity Zone Program also allows investors to exclude some portion of the gain altogether. Returning to our example, 10% of the deferred $700,000 gain would be excluded from income if the Opportunity Zone investment is held for five years. If the investment is held for seven years, another 5% would be excluded, for a total of 15%. That could mean excluding $105,000 in capital gain income in our example and deferring income recognition on the non-excluded amount until the end of 2026. These holding periods need to be satisfied by the end of 2026, so the 10% or 15% exclusions require investment in the next couple of years.

Beyond these benefits, any appreciation on the Opportunity Fund investment over the deferred gain amount is tax free if you hold the investment for at least 10 years. Obviously, if the investment performs well over those 10 years, this will be a very significant savings.

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