OPPORTUNITY ZONES: A NEW INCENTIVE FOR INVESTING IN LOW-INCOME COMMUNITIES

The Opportunity Zones program offers three tax incentives for investing in designated low-income communities through a qualified Opportunity Fund [1]:

Temporary Deferral

A temporary deferral of inclusion in taxable income for capital gains reinvested into an Opportunity Fund. The deferred gain must be recognized on the earlier of the date on which the opportunity zone investment is disposed or December 31, 2026.

Step-Up In Basis

A step-up in basis for capital gains reinvested in an Opportunity Fund. The basis is increased by 10% if the investment in the Opportunity Fund is held by the taxpayer for at least 5 years and by an additional 5% if held for at least 7 years, thereby excluding up to 15% of the original gain from taxation.

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 gains accrued after an investment in an Opportunity Fund.

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1. The private sector and other stakeholders are responsible for establishing Opportunity Funds. A qualified fund is a privately managed investment vehicle organized as a corporation or partnership for the specific purpose of investing in qualified Opportunity Zone property (the vehicle must hold at least 90 percent of its assets in such property). Opportunity Zones have been designated in all states and territories. Qualified Opportunity Zone property includes any qualified Opportunity Zone business stock, any qualified Opportunity Zone partnership interest, and any originally-used or substantially-improved tangible business property.

The new Opportunity Zones provision of the tax code is designed to incentivize patient capital investments in low-income communities nationwide. All of the underlying incentives relate to the tax treatment of capital gains, and all are tied to the longevity of an investor's stake in a qualified Opportunity Fund, providing the most upside to those who hold their investment for 10 years or more.

The figure above and table below illustrate how an investor's available after-tax funds compare under different scenarios. For example, after 10 years an investor will see an additional $44 for every $100 of capital gains realized in 2018 and reinvested into an Opportunity Fund compared to an equivalent investment in a more traditional stock portfolio generating the same annual appreciation. Table 1 and the examples that follow provide additional information on the tax liabilities and differences in the after-tax annual rates of return.

Figure 1. Incentives Offered by the Opportunity Zones Program

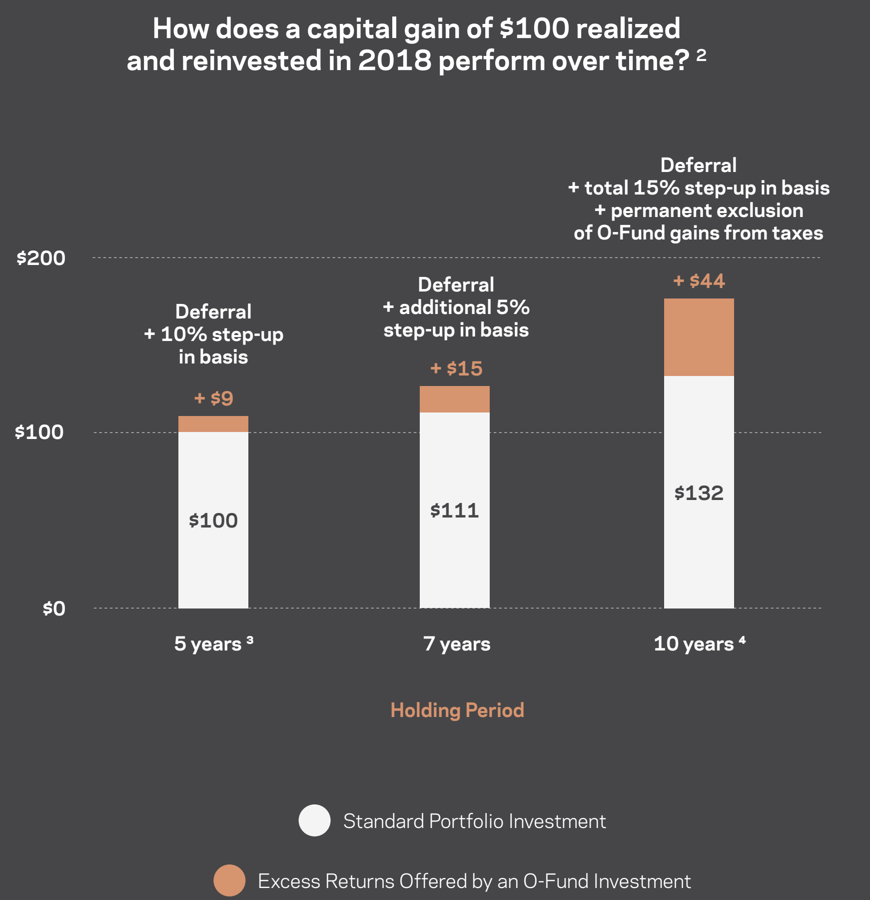

Table 1. How Investing in an Opportunity Fund Compares to a Traditional Stock Portfolio

Scenario: A Capital Gain of $100 is Realized and Reinvested in 2018 [2]

Holding Period	Appreciation Rate	Investment in a Stock Portfolio		Investment in an Opportunity Fund		Difference in After-Tax Annual Rate of Return
		Total Tax Liability	After-Tax Funds Available	Total Tax Liability	After-Tax Funds Available	
5 Years [3]	7%	$31	$100	$31	$109	1.9%
7 Years	7%	$35	$111	$35	$126	1.8%
10 years [4]	7%	$41	$132	$20	$176	3.0%

2. The model assumes a long-term federal capital gains tax rate of 23.8%, no state income tax, and annual appreciation of 7% in both the O-Fund and benchmark scenarios.

3. The model assumes that a capital gain is realized in 2018. In the benchmark scenario that gain is taxed, reducing the principle to $76, which becomes the new basis. It takes 5 years of appreciation for that investment to return to $100 in value.

4. The model assumes that the taxpayer will settle the deferred tax bill with money from outside the O-Fund in order to qualify for the benefits of the 10-year hold. The tax will actually be paid in year 2027 (included in tax year 2026's taxable income).

Example 1: Investor holds the O-Fund stake for 10 years

Susie has $100 of unrealized capital gains in her stock portfolio. She decides in 2018 to realize those gains and reinvest them into an O-Fund that invests in distressed areas of her home state, and she holds that investment for 10 years. Susie is able to defer the tax she owes on her original $100 of capital gains until 2026. Further, the basis is increased by 15% (effectively reducing her $100 of taxable capital gains to $85). Thus, she will owe $20 (23.8% of $85) of tax on her original capital gains when the bill finally comes due. In addition, since she holds her O-Fund investment for at least 10 years, she owes no capital gains tax on its appreciation. Assuming that her O-Fund investment grows 7% annually, the after-tax value of her original $100 investment in 2028 is $176. Susie has enjoyed a 5.8% effective annual return, compared to the 2.8% an equivalent non-O-Fund investment would have delivered.

Total taxes paid by 2028: ***$20***
After-tax value of investment in 2028: ***$176***
Effective after-tax annual return on the $100 capital gain realized in 2018: ***5.8%***

Example 2: Investor holds the O-Fund stake for 7 years

As in Example 1, in 2018 Susie rolls over $100 of realized capital gains into an O-Fund. She holds the investment for 7 years, selling in 2025. As in Example 1, she temporarily defers the tax she owes on her original capital gains and steps-up her basis by 15%, so that in 2025 she will owe $20 (23.8% of $85) of tax on her original capital gains. Unlike Example 1, however, Susie will owe capital gains tax on the appreciation of her O-Fund investment, since she holds the investment for less than 10 years. Assuming that her O-Fund investment grows 7% annually, in 2025 Susie will owe $15 (23.8% of $61) of tax on the O-Fund investment's capital gain. Susie did not take full advantage of the Opportunity Zone program but nevertheless received a 3.3% effective annual return thanks to the deferral and step-ups compared to the 1.5% an equivalent non-O-Fund investment would have delivered.

Total taxes paid by 2025: ***$35***
After-tax value of investment in 2025: ***$126***
Effective after-tax annual return on the $100 capital gain realized in 2018: ***3.3%***

Example 3: Investor holds the O-Fund stake for 5 years

As in Example 1, in 2018 Susie rolls over $100 of capital gains into an O-Fund. She holds the investment for 5 years, selling in 2023. As in Example 1, she can temporarily defer the tax she owes on her original capital gains, but her step-up in basis is only 10%, so that in 2023 she will owe $21 (23.8% of $90) of tax on her original capital gains. As in Example 2, Susie enjoys no exemption from capital gains tax on the appreciation of her O-Fund investment, since she holds the investment for less than 10 years. Assuming that her O-Fund investment grows 7% annually, in 2023 Susie will owe $10 (23.8% of $40) of tax on the O-Fund investment's capital gain. Susie did not take full advantage of the Opportunity Zone program but nevertheless received a 1.8% effective annual return on her initial capital gains thanks to the deferral and step-up compared to the -0.1% effective after-tax annual return an equivalent non-O-Fund investment would have delivered.

Total taxes paid by 2023: ***$31***
After-tax value of investment in 2023: ***$109***
Effective after-tax annual return on the $100 capital gain realized in 2018: ***1.8%***