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Wealth Planning Update

Qualified Opportunity Zones: What Investors Should Know

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In this Wealth Planning Update:

- » *The 2017 Tax Cuts and Jobs Act established the Qualified Opportunity Zone program to provide a tax incentive for private, long-term investment in economically distressed communities.*
- » *Investors in these programs are given an opportunity to defer and potentially reduce tax on recognized capital gains.*
- » *If you are facing significant tax payments as a result of capital gains, investing in a Qualified Opportunity Zone Fund may be worth exploring.*

What is an Opportunity Zone?

An Opportunity Zone is a community nominated by the state and certified by the Treasury Department as qualifying for this program. As of June 14, 2018, the department certified zones in all 50 states, Washington, D.C., and U.S. territories.[1]

Approximately 8,700 Opportunity Zones nationwide

A list can be found at https://www.cdfifund.gov/pages/opportunity-zones.aspx

How does this program work?

To defer a gain, a taxpayer has 180 days from the date of the sale or exchange of appreciated property to invest the realized gain (typically a capital gain) into a Qualified Opportunity Zone Fund. The fund then invests in Qualified Opportunity Zone Property.

The taxpayer may invest the return of principal as well as the recognized capital gain, but only the portion of the investment attributable to the capital gain will be eligible for the exemption from tax on further appreciation of the Opportunity Zone Investment, as explained below. The Opportunity Zone program allows for the sale of any appreciated assets, such as stock with a reinvestment of the gain into an Opportunity Zone Fund. There is no requirement to invest in a like-kind property to defer the gain.

Note that Qualified Opportunity Zone Funds are not available to clients of Wells Fargo and this information is solely for educational purposes.

[1] According to the Internal Revenue Service, an Opportunity Zone is an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Secretary of the U.S. Treasury via his delegation authority to the Internal Revenue Service.

Qualified Opportunity Zone Fund

A Qualified Opportunity Zone Fund is any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property.

Similar to other investments, an investment in an Opportunity Zone Fund may increase or decrease in value over the holding period. In addition, income may be paid on this investment. Given that the purpose of the program is to improve particular areas, it is expected that the fund will continue to invest in the improvement of the property. Cash flow may occur once the property improvements are complete and the property is leased or sold to third parties.

As this investment will be a new option and the IRS and Treasury are still working on the specifics of how this fund will work over time, and as a result it is difficult to assess the level of risk associated with this type of fund. The risks may potentially include market loss, liquidity risk, and business risk to name just a few. Because this investment may not be appropriate for all investors, consult with your tax advisor before pursuing such an investment to determine if this fits with your risk profile and diversification of your investments.

Qualified Opportunity Zone Property

Qualified Opportunity Zone Property is used to refer to property that is qualified opportunity zone stock, a qualified opportunity zone partnership interest or a qualified opportunity zone business property acquired after December 31, 2017, used in a trade or business conducted in a Qualified Opportunity Zone or ownership interest in an entity (stock and partnership interests) operating with such tangible property.

Conceptually, the Opportunity Zone Fund must bring property new to the entity to be used in the Opportunity Zone. A fund that simply acquires property already being used in the zone will not qualify without substantial improvement. Substantial improvement requires improvements equal to the Opportunity Zone Fund’s initial investment into the existing property over a 30-month period.

For instance, if an Opportunity Zone Fund acquires existing real property in an Opportunity Zone for $1 million, the fund has 30 months to invest an additional $1 million for improvements to that property in order to qualify for this program. Improvements in a Qualified Opportunity Zone do not include golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, race tracks or other facilities used for gambling, or liquor stores.

Tax deferral and savings

An Opportunity Zone Fund investment provides potential tax savings in three ways:

Tax deferral through 2026

A taxpayer may elect to defer the tax on some or all of a capital gain if, during the 180 day period beginning at the date of sale/exchange, they invest in a qualified opportunity fund. Any taxable gain invested in an Opportunity Zone Fund is not recognized until December 31, 2026, (due with the filing of the 2026 return in 2027) or until the interest in the fund is sold or exchanged, whichever occurs first. In addition, the deferred gain can be further reduced as described below.

No tax on 10% or up to 15% of deferred gains

A taxpayer who defers gains through an Opportunity Zone Fund investment receives a 10% step-up in tax basis after five years and additional 5% step-up after seven years. Note that to take full advantage of the 15% step-up in tax basis, the taxpayer must invest by December 31, 2019. When the tax is triggered at the end of 2026, the taxpayer will have held the investment in the fund for seven years, thereby qualifying for the 15% increase in tax basis.

No tax on appreciation

Remaining in the qualified opportunity fund for at least ten years results in the cost basis of the property being equal to the fair market value on the date of sale/exchange (potential to lower cost basis but does not eliminate the gain recognition event on 12/31/2026).

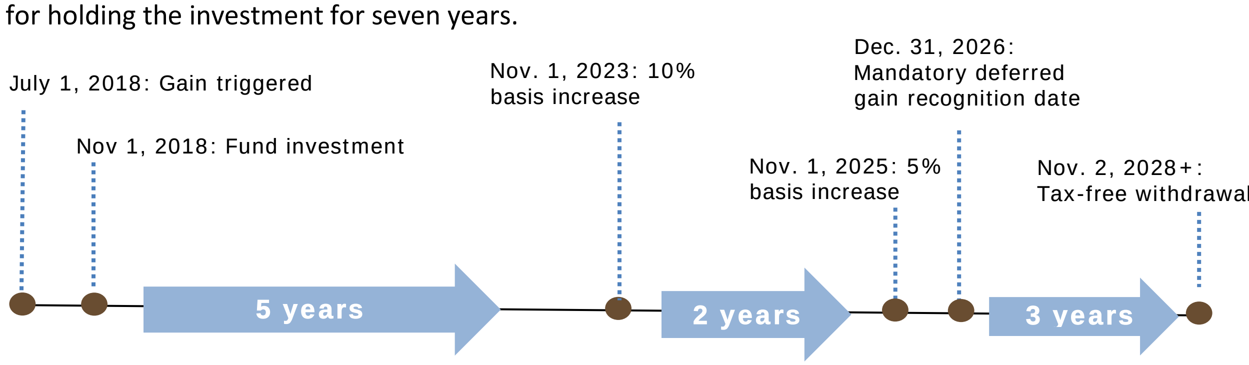
1. **Tax deferral through 2026**

The gain deferral applies to any investment gain (for example, sale of appreciated stock or a business). It is important to note that the tax cannot be deferred indefinitely – only until 2026. The tax savings, however, may still be significant. Qualifying for deferral does not require an intermediary, and the taxpayer has 180 days from a sale to invest the gains into an Opportunity Zone Fund.

Example*:* In January 2018, a taxpayer sells a zero-basis business for $10 million, resulting in a $10 million capital gain. The taxpayer invests the entire amount in a Qualified Opportunity Zone Fund within 180 days. None of the sale proceeds are taxable in 2018. At current federal capital gains rates, this allows the taxpayer to keep over $2 million that would otherwise have been taxed as capital gain (based on the current IRS rate of 20%) and paid in the 2018 tax year and instead invest it in the Qualified Opportunity Zone Fund. Assuming even a conservative rate of return on that $2 million, it could provide a significant return to the taxpayer over the length of the investment.

2. **No tax on 10% or up to 15% of deferred gains**

Example: Given the same situation as the previous example, after five years, the taxpayer is given a $1 million basis in the fund (10% of the original capital gain deferred). After seven years, the taxpayer is given another $500,000 of basis in the fund (5% of the original capital gain deferred). After seven years, hypothetically the taxpayer sells the $10 million investment and would pay tax on only $8,500,000 of the gain. At current federal capital gains rates, that's a savings of over $300,000 simply for holding the investment for seven years.



What if there is a loss in value in the Qualified Opportunity Fund?

The taxpayer is still eligible for the increase in basis for holding the investment for five or seven years. The taxpayer's recognized gain for 2026 (or the year of divesting from the fund) will be the lesser of the original deferred gain or the fair market value of the fund interest reduced by the taxpayer's adjusted basis in the fund, if any. Because of the complicated nature of these investments and the fact that the rules are still under review, consult with your tax advisor before committing any funds.

Example: Again given the same situation, after seven years, the Opportunity Zone Property is sold at a loss. Let's presume the taxpayer realizes $8 million from the Opportunity Zone Fund (80% of the original investment). Since the taxpayer held the investment for seven years, the taxpayer receives a 15% increase in basis, or $1,500,000. The gain realized would be $6,500,000 ($8,000,000 - $1,500,000).

3. **Potentially no tax on appreciation**

Example: In 2018, a taxpayer makes a $10 million investment in a Qualified Opportunity Zone Fund. In 2029, the taxpayer sells the investment for $15 million. The $5 million in appreciation is not taxable. At current federal capital gains rates, that's a savings of over $1 million. The taxpayer will, however, have phantom income (taxable income without corresponding sale) on the original $10 million investment in 2027 for the 2026 tax year since the investment in the fund was held beyond December 31, 2026, when the deferred gain on the original investment must be recognized.

Next steps

Over the next few months, the Treasury Department and the Internal Revenue Service will be providing further details, including additional legal guidance, on this new investment. If you have questions about your wealth plan, reach out to a Wells Fargo Relationship Manager.

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