Morgan Stanley

Qualified Opportunity Zones – A New Investment Possibility

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When the Tax Cuts and Jobs Act (TCJA) was signed into law on December 22, 2017 (P.L. 115-97), it opened the possibility for tax-incentivized investments into economically-distressed communities, designated as Qualified Opportunity Zones (QOZ), in every state and territory. Taxpayers with unrealized capital gains may be able to sell or dispose of their appreciated assets and re-deploy the gains into these QOZs to achieve substantial short and long-term tax benefits. Below, we detail how taxpayers can participate in and benefit from this new investment opportunity. There are still several questions that remain unanswered related to the application of these rules. Morgan Stanley does not provide tax advice. Taxpayers should consult their own tax advisors regarding the application of these rules to their particular circumstances.

What are Qualified Opportunity Zones?

QOZs are low income census tracts in each state and territory that have been certified as such (after a nomination process by the Governor or executive of the state/territory) by the U.S. Department of the Treasury. QOZs were created by the TCJA to encourage long-term investments in underserved communities across the country. There are roughly 8,700 such Opportunity Zones within the United States and its territories.[1]

What are Qualified Opportunity Funds?

In order to take advantage of the tax benefits described below, a taxpayer must invest in a Qualified Opportunity Fund (QOF). QOFs are privately managed investment vehicles, organized as corporations or partnerships, which are required to invest/hold at least 90% of their assets in QOZ property.[2] For taxpayers (entities or individuals) that incur capital gains from the sale or exchange of property with an unrelated person, the QOZ program allows the taxpayer to elect to roll those gains into a QOF and achieve certain tax benefits as long as the requirements discussed below are met.

The Tax Benefits of Investing in a QOF

To encourage long-term investment into QOFs, the law establishes several tax benefits for investors who wish to re-deploy built-up capital gains. The tax benefits include: (1) deferral and partial exclusion of tax on realized capital gains that are reinvested into a QOF, and (2) exclusion of tax on the gain that the QOF itself may achieve over a 10 year or longer investment period.

The breakdown of tax benefits available to investors is as follows:

I. <u>Initial Deferral of Capital Gains Tax</u>

For a taxpayer choosing to invest realized capital gains into a QOF, the immediate benefit is the ability to elect to temporarily defer taxation on those reinvested gains. The election to defer capital gains tax is subject to the following rules:

- The taxpayer must invest the gain(s) in a QOF within 180 days from the date of the sale or exchange that gave rise to such gain;
- The taxpayer's ability to defer taxation on the reinvested gain(s) lasts until the <u>earlier of</u>:
  - The date the taxpayer disposes of the investment in the QOF,

or

  - December 31, 2026

Note that the process for making this deferral election is not clear from the statute. Guidance from the Treasury Department will be necessary to clarify how this election is made.

Example 1: On September 1, 2018, a taxpayer sells property to an unrelated person and realizes a gain of $20 million on the sale. Within 180 days of the sale, the taxpayer invests the entire $20 million of gain in a QOF. The taxpayer makes an election under Section 1400Z-2 of the Internal Revenue Code. The $20 million will not be included in the gross income of the taxpayer for the 2018 tax year. Subject to the rules regarding permanent reduction in capital gains liability, discussed in II below, the $20 million will be included in the gross income of the taxpayer on the earlier of i) the date that the taxpayer disposes of its interest in the QOF or ii) December 31, 2026.

II. <u>Reduction in Capital Gains Tax Liability</u>

Beyond the immediate benefit of capital gains deferral, long-term investors in QOFs may also see a portion of that deferred gain excluded entirely from taxation when eventually realized. Here's how it works:

- A taxpayer that invests realized capital gains into a QOF (the "original gain") starts out with zero tax basis in that investment, assuming the amount invested in the QOF came entirely from the capital gains that are being deferred;
- If the taxpayer maintains that investment in the QOF for 5 years, the basis is increased by 10% of the original gain, effectively allowing for 10% of the reinvested capital gains to be eliminated from taxation;
- If the taxpayer maintains that investment in the QOF for 7 years, the basis is increased by an additional 5% of the original gain, effectively allowing for a total of 15% of the taxpayer's reinvested capital gains to be eliminated from taxation.

Example 2: Assume the same facts as Example 1. The taxpayer's initial basis in its investment in the QOF will be zero. If the taxpayer holds the investment in the QOF for 5 years (until September 1, 2023), the taxpayer's basis will step up to $2 million. In addition, if the taxpayer holds the investment in the QOF for 7 years (until September 1, 2025), the taxpayer's basis will step up to $3 million. On the earlier of when the taxpayer eventually disposes of its investment in the QOF or December 31, 2026, the taxpayer will be required to pay tax on $17 million (or $18 million if disposed of after September 1, 2023 but before September 1, 2025), rather than $20 million in capital gains.

Remember, with the deferral of tax on reinvested capital gains set to expire, at the latest, on December 31, 2026, to take full

advantage of ability to exclude up to 15% of the reinvested gain from taxation, the reinvestment of capital gains into the QOF must occur by the end of 2019.

III. Exclude Gains within the QOF from Tax

As a further inducement to reinvest capital gains into a QOF, taxpayers that maintain their investment in the QOF for at least 10 years will be entitled to permanently exclude from taxation the appreciation of the QOF itself. Once the investment is maintained in the QOF for the 10 year period, the taxpayer will be allowed to step-up the basis for tax purposes of his/her investment to its fair market value on the date of disposition, and by doing so would avoid tax liability on the appreciated value of the taxpayer's initial investment in the QOF.

Example 3: Assume the same facts as Examples 1 and 2. On December 1, 2028, the value of the taxpayer's investment in the QOF has a fair market value of $40 million, and the taxpayer sells the QOF investment for its fair market value. The basis on the date of the sale steps up to $40 million dollars. Therefore, when the taxpayer sells the QOF for $40 million, the taxpayer will not pay tax on the $20 million appreciation of the investment because the taxpayer held the investment for at least 10 years.

TO RECAP: If you have a long range time horizon, you can invest realized capital gains into a QOF within 180 days of the sale or disposition of the appreciated asset and, depending upon the length of time you maintain that QOF investment you can:

1. Defer taxation on those reinvested capital gains (in the QOF) until the earlier of the date you dispose of the investment in the QOF, or December 31, 2026;
2. Permanently exclude from taxation up to 15% of the original gain that is reinvested in the QOF; and
3. Exclude from taxation any appreciation from performance of the QOF itself.

As a recap of Examples 1-3: on September 1, 2018 a taxpayer sells property to an unrelated person and realizes a gain of $20 million on the sale. Within 180 days of the sale, the taxpayer invests the entire $20 million of gain in a QOF. The taxpayer makes an election under Section 1400Z-2 of the Internal Revenue Code. The taxpayer sells its interest in the QOF on December 1, 2028 for $40 million:

- The $20 million original gain will not be included in the gross income of the taxpayer until December 31, 2026 (since the taxpayer still held the QOF on that date);
- On December 31, 2026, the taxpayer will be required to pay tax on $17 million of the original gain, rather than $20 million in capital gains;
- When the taxpayer sells the QOF for $40 million, after holding for 10 years, the taxpayer will not pay tax on the $20 million appreciation of the QOF investment.

What's Next?

The Treasury Department is expected to release Guidance in the coming weeks/months to clarify questions surrounding the implementation and operation of the QOZ program. Treasury's guidance will be important in understanding the QOZ program since a number of questions affecting the ability of investors to take full advantage of the tax benefits offered through the investment of capital gains into QOFs remain unanswered. Morgan Stanley does not provide tax advice. Given the ambiguities in the law, taxpayers should consult their own tax advisors regarding the application of these rules to their particular circumstances.

Morgan Stanley Wealth Management is exploring various alternative investment strategies for the Firm's qualified clients to participate in Qualified Opportunity Funds.

1. All QOZs lose this designation on December 31, 2028. It is unclear without further guidance from Treasury how this will affect the tax benefits described below, especially related to investments held past December 31, 2028.
2. Qualified Opportunity Zone Property is property that includes interests in stock of a corporation, capital or profits interests in a partnership or tangible property, each of which must be involved in a qualified opportunity zone business.

Investing in the Qualified Opportunity Funds (QOF) entails the risk of market volatility and possible loss of capital. The value of all types of securities, may increase or decrease over varying periods.
Alternative investments often are speculative and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for eligible, long-term investors who are willing to forgo liquidity and put capital at risk for an indefinite period of time. They may be highly illiquid and can engage in leverage and other speculative practices that may increase the volatility and risk of loss. Alternative Investments typically have higher fees than traditional investments. Investors should carefully review and consider potential risks before investing.

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