William Blair



# New tax breaks target investing in struggling communities

A new program established under the sweeping Tax Cuts and Jobs Act of 2017 is drawing the attention of investors as well as city and state officials across the country. The initiative creates *opportunity zones* which offer significant tax breaks to individuals and companies who invest in these selected urban and rural areas that meet income or poverty thresholds.

## A key attraction

Investing in these zones allows investors to defer and reduce capital gains from other investments. The program also offers the potential for a full tax break on subsequent investment gains.

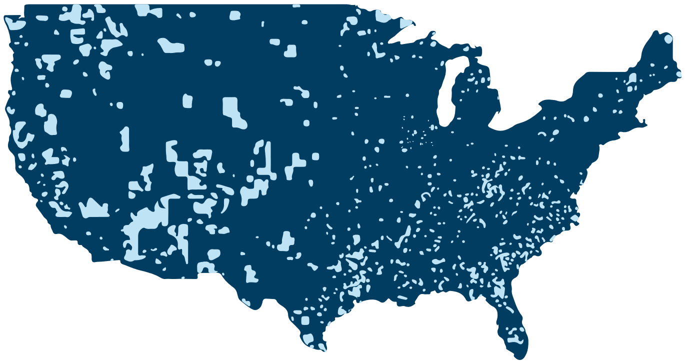
That innovation is a significant one for both communities and investors.

The law recognizes transformative steps are needed to revitalize rural communities and some urban pockets that have seen little to no economic revitalization following the 2008 financial crisis—a contrast to popular metropolitan areas that have attracted significant private investment over the past decade.

The tax law allows opportunity zones to be designated by the governors of each state from a pool of low-income, high-poverty areas identified by Census data and certified by the U.S. Treasury.

**Opportunity Zones**

More than 8,700 opportunity zones have been designated across the country, primarily in urban areas. For example, in Illinois there are 327 zones, with more than 130 in Chicago, mostly in the South and West sides of the city.



Taxpayers can invest directly in opportunity zones or in "qualified opportunity funds" that seed businesses and real estate developments in those areas. An opportunity fund is an investment vehicle organized as a corporation or a partnership that holds at least 90% of its assets in qualified opportunity zone areas.

Opportunity fund investors reinvest their capital gains from other investments—money made on the sale of an asset such as a business, real estate or appreciated stock—in the fund. It would be a long-term investment, with the largest tax benefits available to those who remain invested for at least 10 years.

## A triple tax advantage possible

### A temporary deferral on capital gains

Initially, taxpayers may defer taxation on their capital gains by reinvesting into an opportunity zone or fund within a defined period of time.

### A step-up in basis

After 5 years, there is a 10% exclusion of the initial capital gains tax obligation (i.e., a 10% basis step-up). After 7 years, the 10% benefit adds another 5% (i.e., a total 15% basis step-up). And, if the investment is held until December 31, 2026, the deferred capital gains tax on the remaining 85% would be due by April 2027.

### Permanent exclusion

After 10 years, there is no capital gains tax due on the investment's appreciation beyond the original reinvested capital into an opportunity zone area or a qualified opportunity fund (i.e., capital gains tax paid only on 85% of the initial reinvested gains). This is a rarity relative to typical private equity and real estate investing.

## Case study

In 2019, suppose Mr. Smith realized $1,000,000 in capital gains after selling stock he has held for several years. Assuming a 20% capital gains tax rate, he would owe $200,000 for tax year 2019. Instead, he decides to defer that tax by reinvesting the entire $1,000,000 in a qualified opportunity zone investment.

If he holds the investment for 5 years, 10% of the 2019 capital gains tax obligation ($20,000) is excluded from tax. After 7 years, the exclusion grows to 15% of the 2019 capital gains tax ($30,000).

By April 2027, he must pay 85% of the 2019 capital gains tax liability due ($170,000). If he continues to hold his opportunity zone investment for at least 10 years, all capital gains tax on the investment's appreciation is eliminated.

### Summary of Potential Tax Benefits

| | Non-OZ Investment | Qualified OZ Investment |
|---|---|---|
| Capital gain | $1,000,000 | $1,000,000 |
| Capital gains tax *(less)* | ($200,000) | $0 |
| After tax investment | $800,000 | $1,000,000 |
| 10-year value (assuming 10% annual investment appreciation) | $2,074,994 | $2,593,742 |
| Capital gains tax on 85% initial OZ investment for tax year 2026 (assuming 20% capital gains $850,000 x 0.20) *(less)* | $0 | ($170,000) |
| Capital gains tax (20%) on 10-year investments *(less)* | ($254,999) | $0 |
| Total 10-year value after taxes | $1,819,995 | $2,423,742 |
| Total net gain after 10 years on initial $1 million investment | $819,995 | $1,423,742 |

## Where do investment options in opportunity zones stand as of early 2019?

The Department of Treasury is finalizing its guidance in early 2019 to clarify the new law's rules regarding capital gains deferrals, investments in the zones, and other questions left open by the Tax Cuts and Jobs Act of 2017. Firms are now assessing their investment offerings relevant to each zone in each state.

William Blair is planning to offer qualified clients the option to invest in opportunity zone funds in 2019. We are carefully reviewing Internal Revenue Service guidance and a variety of opportunity fund options that will best meet clients' financial goals. For more information, contact your William Blair representative. For more details, visit:

**williamblair.com/opportunity-zones**

### Opportunity Zone Timeline

| 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | April 2027 | 2028 | 2029 |
|---|---|---|---|---|---|---|---|---|---|---|
| Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 |
| Roll over gain into OZ investment (defer taxable gain) | | | | | Tax on original capital gain is reduced by 10% | | Tax on original capital gain is reduced by additional 5% (15% total) | Pay taxes on original deferred capital gain (less 15% reduction) | | All capital gain taxes are now eliminated on the OZ fund investment |

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