15 Most Asked Opportunity Zone Tax Questions

Q&A with Nick Gibbons,
CPA and Partner at Armanino

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Urban Catalyst is here to help investors make the most of their investments. We recently sat down with Nick Gibbons - CPA and Partner at Armanino – to get answers to some of the most frequently asked questions about Opportunity Zone taxes.

Discover the main tax benefits of Opportunity Zone investing, the reasoning behind the IRS' 180-day deadline to make an investment, how the depreciation recapture works and so much more.

Q: Let's start at the very beginning at the origin of the Opportunity Zone Tax Program, where did this come from and where is it within the IRS code?

A: The program was conceived by Sean Parker and his economic innovation group, which was tasked to figure out a way to bring all of this wealth as accumulated over time and be deployed into census tracts of areas that could really benefit. It was designed to be a win-win and an efficient way to make other areas of the country improve. It didn't become law until 2017 under the Trump administration.

It was brought to law by a bipartisan group – so you had senators Tim Scott and Cory Booker, as well as U.S. Representative Ron Kind. The program was signed into law within the Tax Cuts and Jobs Act of 2017. It resulted in a brand new code section within the internal revenue code and those code sections are 1400Z-1 and 1400Z-2.

Q: One of the questions we get a lot from our investors is, "Hey, we've heard about the tax benefits inherent in this new IRS tax code. What are those main tax benefits?"

A: I think the best way to explain this is through a simple example. Let's say you have a million dollars of stock appreciation. You're sitting on an unrealized capital gain. Say you want to take advantage of the 1400Z-2 and find a great fund like Urban Catalyst and invest that million dollars of stock (gain) into Urban Catalyst. Normally, that would be a taxable event. You would have to pay capital gains tax. But through the deferral, you do not have to pay that tax during the year that you're investing. It's important to distinguish and remember that you do pay tax on that initial capital gain that you're investing into a Qualified Opportunity Fund.

There's also a reduction of that tax; you would get 10% off of that taxable gain.

Finally, if that investment appreciates over 10 years, and then it's sold, you cash out of your appreciation –100% of that is federally tax-free and that's really the primary benefit of this whole program.

Q: These gains that are part of the Opportunity Zone Program have to be capital gains. What about ordinary income – why did the government choose capital gains for this program?

A: I think it goes back to Sean Parker's original thinking that there's all of this unrealized wealth that's just sitting there. How do we get some of that into areas that really benefit from that wealth? Think of it this way: you're moving some of that wealth into an area so that you can help people raise their ordinary income, but the initial investment only applies to a capital gain, so that's a sale of property, stock, cryptocurrency, a business – anything that's characterized as a capital gain. That's why it's capital gains and not ordinary income.

Q: Why does the IRS have a 180-day deadline to make an Opportunity Zone Investment?

A: Once you realize a gain, you cash out your gain. Now you're sitting on X amount of dollars you have access to. The IRS gives you 180 days to identify or create an Opportunity Zone Fund because it's a meaningful period of time. It's the same amount of time with Section 1031 gains, which is probably why they used the 180 day. But it has to be less than a year because if it's more, it's just a whole added year of deferral which is not part of this program. They want that wealth to actually be deployed

relatively soon into these census tracts.

Q: What happens with the taxes for an initial capital gain?

A: It gets deferred. So, on your 2020 tax return, you would tell the IRS, essentially, that you have X dollars of taxable gain, but then also report that you're investing in opportunities on programs so that it's just a negative. You pay zero for capital gains tax on your 2020 form, but the tax becomes due on your 2026 tax return. When the 2026 tax return is filed, that's when the tax is owed to the IRS.

Q: We often have investors who are very successful with short-term gains. Maybe they have taken advantage of the tumultuous market here in 2020, and they want to get off the rollercoaster, as we say. What happens if that gain is categorized as a short-term capital gain and not a long-term capital gain?

A: First of all, it does qualify. It's a capital gain. You can take that short-term capital gain and find a Qualified Opportunity Fund in which to invest. The only difference is the tax rate. When that tax becomes due in 2026, the tax rate will be the short-term gains tax rate in 2026. If it were today – say nothing changed in the tax code – you would pay your ordinary tax rate on that short-term capital gain.

Q: A lot of Opportunity Zone Funds are organized as Real Estate Investment Trust Vehicles (REIT), rather than as Opportunity Zone Partnerships. Urban Catalyst is a partnership. As a tax expert, what would you say is the difference for the investor in a partnership versus a REIT?

A: If you're investing in a REIT in an Opportunity Zone REIT, then you're not going to benefit from some of these partnership benefits because distributions will be taxable versus distributions in the partnership, which are tax-free. This is the most tax-efficient structure. The biggest difference or, really, the reason why we do not want to invest in Opportunity Zone REIT is because distributions from a REIT is ordinary income. It's taxed at ordinary income tax rates. You really don't want to set this up via REIT, in my opinion. You want to take advantage of the partnership structure.

Q: One of the things that happens in partnership funds is that in the initial years of the fund life cycle, there might be losses. Do you want to explain to potential investors a little bit about how those losses could potentially work?

A: Of course. In a partnership, the partners will receive their allocable share of the business activity. If the fund is generating losses, which most will at the beginning of the period, those will get passed on to the partners of the partnership. Let's say I have a million dollars and I invested into Urban Catalyst, and then by year two or three on what's called a Schedule K-1, I see that there are passive losses that's allocable to me of $25,000 (the amount of my ownership percentage of the QOF). I'll then be able to utilize that $25,000 loss to offset other passive gains as well carryforward (indefinitely) any amount that wasn't utilized.

Q: Depreciation is, obviously, extremely common in all types of real estate investments. Can you talk a little bit about depreciation and depreciation recapture in the context of an Opportunity Zone Fund?

A: One of the other benefits is depreciation. The final regs establish that once you sell your investment, you do not have to pay tax on that depreciation, which you normally would under what's called depreciation recapture. Normally you would actually have to pay back tax on that depreciation. That's an added benefit, thanks to this program. It was written in the final regulations. That was a real gift the IRS gave us.

Q: A very important part of the opportunities on strategy has to do with refinance distributions. Are those refinance distributions taxable? If not, why not? And how does this work?"

A: Yes, it's tax-free because of the basis. Distributions of

debt financing generate basis, and therefore are tax-free.

Q: A lot of our investors have other investments, of course, and they're getting multiple K-1s per year. When that tax comes due for their original Opportunity Zone Investment, what happens if they have other capital losses that they've incurred?

A: You can offset that deferred capital gain that's being recognized on your 2026 return. You can take those losses, harvest them in between the time you invested your gain and 2026, and offset the 2026 gain, which is the 2020 gain that you invested. It's another incremental benefit of this overall program, and with smart tax planning, you could reduce that tax bill even further.

Q: As we know, the IRS set the program up so that you get additional key tax benefit only after you've held your investment for 10 full years. Do we know exactly what the IRS' reasoning was on having that specific 10 year date?

A: It goes to the spirit of the program. If you look at the preamble, the final regs, or just the initial genesis of the program, it was to provide long-term benefit to these census tracts. Ten years is a good period of time. It's a good period of time that you can measure the benefits, the economic benefits and it really wants that commitment.

Q: All seven of the Urban Catalyst properties are in California. Our fund is based in the downtown San Jose Opportunity Zone and the majority of our investors are Californians. However, California is a non-conforming state to the OZ legislation so how does that work for our investors?

A: Well, how it would specifically work is on your Federal 1040. If you're an individual investor, you get to show the IRS that you're taking advantage of the Opportunity Zone Program and not have to pay federal capital gains tax. On your California form, you would have to pay the California capital gains tax on that because California is one of the three states that, unfortunately, do not conform.

Q: Based upon what you just said, it sounds like Californians are kind of stuck anyway, because we're a non-conforming state. However, we have investors from other states and there is a tax implication for them. Which part of their gain is potentially going to qualify for California taxes?

A: If you're an out-of-state investor investing in a California-based Qualified Opportunity Fund, you will not have to pay your state capital gains tax on that investment, assuming you're not in the few states that do not conform with 1400Z-2. Keep in mind that because the property you're investing in is in California, after that 10-year period, when it's sold, you would still have to pay capital gains tax on that.

Q: What tax forms do investors need to submit to let the federal government, the state government know that they've invested in a Qualified Opportunity Fund?

A: Let's talk about the individual investor. If I'm an investor in Urban Catalyst and invest a million dollar gain in 2020, on my 2020 tax return, I would also attach a Form 8997, which basically tells the IRS, "Hey, I'm taking advantage of the Opportunity Zone Program." This Form 8997 would be filed every year that my investment stays in an Opportunity Fund. How does the IRS know that Urban Catalyst has my money? Well, it's through this Form 8997 which is filed again every single year for the year(s) in which you invest and hold the QOF investment in any part of those years.

Also, on Form 8949 (for the first year in which you invest), you would report the capital gain investment, offset by a negative number that's equal to the invested capital gain which tells the IRS that you do not have pay tax on the invested gain.

Finally, there is also a Schedule Form K-1 (Form 1041) where the distributions are reported and then upload this information on your income tax return.

Have more questions?

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Nick is a Partner in Armanino's Tax practice with over 17 years of public and private accounting experience. He has significant, hands-on expertise in ASC 740 (FAS 109), corporate taxation, purchase accounting, opportunity zones consulting, cryptocurrency taxation and business development, and serves numerous industries, including technology, biotech and entertainment.

He graduated from Montana State University with Bachelor of Science in Business and Master of Professional Accountancy degrees. Nick is a Certified Public Accountant and a member of the American Institute of Certified Public Accountants and the California Society of CPAs.