How Collectors Can Utilize the Opportunity Zone Program

Investors See a Potential Replacement for Like-Kind Exchanges

By Sidney Kess and Michael Kelley

For many investors in art, coins, or fine wine, their investments are their passion. The pride of ownership and the beauty they bring into the lives of collectors is undeniable. This joy can turn into tax pain, however, when it comes time to sell. The capital gains tax on collectibles is considerably higher than almost any other investment.

Collectibles shoulder a 28% capital gains rate, as compared to 20% for most other investments made by high-income taxpayers. In 2013, the net investment income tax (NIIT) added a 3.8% charge on top of most capital gains for high earners, leaving many art, wine, and precious metals enthusiasts facing a rate of 31.8%. To make matters worse, the Tax Cuts and Jobs Act of 2017 (TCJA) discontinued Internal Revenue Code (IRC) section 1031 exchanges for collectibles and precious metals.

This new reality could be stifling to the art and collectibles world. There is a fear that the lock-in effect will slow the circulation of works that otherwise would have been sold, keeping them sitting in storage, waiting for a friendlier tax regime. There is also a flight risk, as many pieces may be loaned to museums overseas or otherwise moved abroad.

Fortunately, the TCJA did offer a potential alternative to collectors by creating the Opportunity Zone (OZ) program. This program eases the capital gains tax burden through deferral and partial elimination of the capital gains tax, while wiping out any capital gains liability on the subsequent investment through December 2047.

How the OZ Program Works

The OZ program is designed to encourage investors with capital gains liability to put these funds to use by making long-term investments in communities that need capital investment. OZs were born as a rare bipartisan provision and late addition to the TCJA. Gains on the sale of any property, such as collectibles, can be postponed by reinvesting it in a Qualified Opportunity Zone Fund (QOZF) within 180 days. There is no dollar limit on how much gain can be deferred.

The OZ program offers three benefits:

- The previously realized capital gains tax liability is deferred until December 2026.
- The realized capital gain is reduced via a step-up of 10% after five years and another 5% after seven years.
- After 10 years, any capital gains liability from the OZ project can be forgiven via a step-up election though December 31, 2047.

The first two benefits are designed to mitigate the pain of realizing the original capital gain. It is the third, however, that has the most potential to affect after-tax returns in the long run. The *Exhibit* illustrates that OZs offer after-tax return outperformance in every scenario. As the returns show, the OZ program is designed to reward qualifying investments that are economically successful and long term.

A qualifying investment must be made through a QOZF. The QOZF can be structured as a corporation or partnership (or as a limited liability company treated as a corporation or partnership for federal tax purposes) designed to invest in QOZ property. The QOZF must put at least 90% of its assets into QOZ property.

QOZFs will typically hold only a single investment because of cashflow timing rules. The investment itself can be in a broad range of businesses or real estate development. The common theme of a qualifying asset, however, is that the taxpayer cannot just buy something and sit on it; one must bring new investment into the QOZ. For example, a piece of property would have to be improved by investing at least as much as the original purchase price within 30 months.

There is a short list of forbidden businesses, such as liquor stores, massage parlors, and golf courses. Interestingly, marijuana businesses are not on the forbidden list.

OZs are not all created equal, so it is important to find areas that can truly flourish with capital investment. All OZs have high unemployment rates and low-income populations, often chosen because they possess great potential. There are 8,700 QOZs covering all 50 states; Washington, D.C.; and five U.S. territories, including the entire island of Puerto Rico.

Existing Guidance

Additional OZ implementation guidelines from the Treasury Department are still forthcoming, but the most recently released proposed regulations (REG-115420-18, 10/19/18) helped to flesh out some of the rules for QOZFs. For example, the previous draft of the guidelines said that a qualifying investment needed to have "substantially all" of its qualified tangible asset in the OZ; the update defined "substantially all" with a more measurable "70%." This allows QOZFs to invest with confidence in projects and businesses that are heavy with tangible assets that do not move. It is still uncertain, however, how a business with intangible assets, like a software company, will be treated. There is also a need for guidance for companies with tangible assets that move, such as a trucking firm. Is it enough that the trucking firm is based in an OZ, even though its trucks operate all across the United States? The answer is unclear.

Checklist for Obtaining Qualified Opportunity Zone Benefits

- ☐ Do I fully understand the criteria for eligibility of personal and or business gains?
- ☐ Do I fully understand my qualifying business and property investment options?
- ☐ Can I invest in a suitable Qualified Opportunity Zone Fund within the 180-day window from the recognition of the gain?
- ☐ Are there additional Opportunity Zone benefits offered by my state or local government?
- ☐ Do I fully understand the timing guidelines once an investment has been made?
- ☐ Am I a long-term investor who can benefit from the Opportunity Zone program?

Exhibit
After-tax Return from Opportunity Zones

Holding Period	Appreciation Rate	Standard After-tax Funds Available	Opportunity Zone After-tax Funds Available	Difference in After-tax Annual Return
5 Years	8%	$93	$107	2.8%
7 Years	8%	$105	$127	2.8%
10 Years	8%	$128	$182	3.7%
10 Years	15%	$226	$363	5.3%

Advantages and Potential

The OZ program has the potential to direct a tremendous amount of capital, as the tax savings are substantial and there is currently an estimated $6 trillion in unrealized U.S. capital gains liability, split between U.S. households ($3.8 trillion) and corporations ($2.3 trillion). Unlike other government-directed programs, there is no need to apply for a limited pool of tax credits; taxpayers who follow the guidelines will receive the benefit without limit. In addition, each time the Treasury has had the chance to make the program more restrictive or more bureaucratic, it has resisted.

Qualified and nonqualified equity investments can be mixed, but only qualified investments will receive the OZ benefits. Use of debt is also not a problem; any capital gain in the OZ asset, whether leveraged or unleveraged, can be fully offset via the step-up election.

The program is also stackable with other tax incentives. Many commercial real estate projects that qualify for low-income housing tax credits, historic tax credits, or new markets tax credits will also qualify for OZ benefits. Solar farms are also a good fit. OZ business partnerships may also be eligible for the 20% qualified business income deduction.

Those who already own property in a QOZF, however, are somewhat out of luck; to qualify for OZ benefits, the property must have been purchased from an unrelated party after December 2017. They can, however, sell their property to a QOZF, pocket their principal, and reinvest their capital gain in the same fund. As long as their ownership of the fund stays below 20%, it will still be considered an unrelated transaction. They are also free to invest all or part of their gain in any other QOZF.

A New Gold Rush?

Interest in the potential of the OZ program to be the next must-have financial tool has grown rapidly, but completed deals remain few and far between. This should change, as the Treasury is expected to clarify the OZ implementation guidelines this month. Some state and local governments are also planning their own tax incentives to bolster property and land development in their OZs.

There should be a sense of urgency among investors, because OZ benefits are temporary by design. The provision was written with hard dates, so the deferral benefit grows shorter every day. By the end of 2019, the deferral period ending in December 2026 will not leave enough time to enjoy the 5% step-up benefit, and by the end of 2021, the 10% step-up will also be unobtainable.

The second half of 2019 could see a new type of gold rush, as investors seek deals that can deliver both strong performance and qualify for OZ tax incentives. High earners with collectibles capital gain liability have every reason to be at the front of the line. ❑

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