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Opportunity Zones: A New Program Incentivizing Private Real Estate Investment in Designated Areas

by Chad J. Richman and Mariana D. Molina

A FREEBORN & PETERS LLP CLIENT ALERT

ABOUT THIS CLIENT ALERT:

Investors should be aware of new tax benefits of investing in certain geographical areas.

The Tax Cuts and Jobs Act enacted on December 22, 2017 unveiled new tax incentives designed to encourage long-term private investment in certain designated areas throughout the United States.

The "Opportunity Zones" program (the "Program"), codified in Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code, allows investors to receive three significant tax benefits in exchange for investing in funds ("QO Funds")[1] newly created to invest at least 90% of their assets in businesses and real estate within low-income communities designated as Qualified Opportunity Zones ("QO Zones"). As of May 21, 2018, the U.S. Department of Treasury has confirmed QO Zone designations for all but four states.[2] The Program's tax benefits are generally set forth as follows:

- First, investors may defer gain from the sale of property by reinvesting (within 180 days) amounts otherwise subject to capital gains liability in QO Funds. The gain will be deferred until the earlier of: (a) the date on which the investment in the QO Fund is sold, or (b) December 31, 2026.

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[1] The IRS and Treasury will provide further details and legal guidance on the formation and certification of QO Funds in the upcoming months, but it is anticipated that these funds will be self-certifiable partnerships or corporations.

- Second, investors receive a modest step-up in basis for investments held in QO Funds beyond 5 years (10% step-up) and 7 years (additional 5% step-up), thereby eliminating up to 15% of the original gain from taxation.

- Third, after 10 years, the investor may elect the basis of the QO Fund investment to equal the fair market value of the investment on the date that it is sold, such that **no tax** will be due on the appreciation of the investment in the QO Fund.

From the investor perspective, the question is basic: are the tax benefits of investing in a QO Zone (indirectly through a QO Fund) worth the yield forgone by not investing in non-QO Zones or more proven investment strategies. As the Program progresses, the impact on properties within QO Zones will become evident. Speculative investment is likely to increase within QO Zones in the near term since property values within QO Zones may marginally escalate immediately following their designation. Exit strategies for existing investors in these areas should be carefully considered.

[2] The following four states' submissions are pending: Florida, Nevada, Pennsylvania and Utah.

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ABOUT THE AUTHORS

Chad J. Richman
Partner

Chicago Office
(312) 360-6491

crichman@freeborn.com

Chad is a Partner in the Real Estate Practice Group, and has significant experience in a broad range of real estate, finance, transactional, and general business matters.

Mariana D. Molina
Attorney

Chicago Office
(312) 360-6347

mmolina@freeborn.com

Mariana's main area of practice is in commercial real estate and development, with a focus on the acquisition, leasing, financing, and disposition of various types of commercial properties.

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CHICAGO
311 South Wacker Drive
Suite 3000
Chicago, IL 60606
(312) 360-6000
(312) 360-6520 fax

NEW YORK
230 Park Avenue
Suite 630
New York, NY 10169
(212) 218-8760
(212) 218-8761 fax

SPRINGFIELD
217 East Monroe Street
Suite 202
Springfield, IL 62701
(217) 535-1060
(217) 535-1069 fax

RICHMOND
411 East Franklin Street
Suite 200
Richmond, VA 23219
(804) 644-1300
(804) 644-1354 fax

TAMPA
1 Tampa City Center
201 North Franklin Street
Suite 3550
Tampa, FL 33602
(813) 488-2920

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