Qualified opportunity funds provide new tax incentives for investors

March 21, 2018

In brief

The 2017 tax reform reconciliation act (the Act), enacted December 22, 2017, includes a new tax incentive program, Internal Revenue Code Subchapter Z – Opportunity Zones, aiming to promote investments in certain economically distressed communities. Through the opportunity zone program, investors are able to inject capital into low-income communities and promote long term economic growth through a variety of investment vehicles. Investors may also receive significant tax benefits that include (i) tax deferral for capital gain invested in a qualified opportunity fund, (ii) elimination of up to 15% of the tax on the capital gain that is invested in the qualified opportunity fund, and (iii) potential elimination of tax when exiting a qualified opportunity fund investment.

Potential investors who might be interested in specific states for investment should note that governors have until March 21, 2018 to submit the notification of nomination for specific census tracts to be designated as a QO Zone to the Treasury Secretary, unless the state requests a 30-day extension. Some states, such as California, which has identified 798 tracts, have already submitted their proposals.

In detail

Background

Current and prior federal tax incentive programs for distressed communities include: empowerment zones (EZs), renewal communities (RCs), enterprise communities (ECs), and the New Market Tax Credit (NMTC). Starting with the EC and EZ tax incentives in 1993, the goals of these programs have been to alleviate poverty, reduce unemployment, and boost economic activity in targeted areas. The EC and RC programs have expired, but the NMTC was extended through 2019 as part of the Act and the EZ incentive was extended retroactively through 2017 as part of the Bipartisan Budget Act of 2018.

Highlights of the new opportunity zone tax incentives

Capital gains deferral

Subchapter Z provides incentives for investments in qualified opportunity zones (QO Zones) by means of temporary capital gain deferrals and ultimately permanent exclusion from gross income of capital gains, if certain requirements are met. Under the new law, any gain from the sale or exchange of property by a taxpayer to an unrelated person, that is invested in a qualified opportunity fund (QO Fund), as defined below, within 180 days of the sale of that property is excluded from gross income until the earlier of the date the investment in the QO Fund is sold or December 31, 2026.

Observation: The law requires only the gain to be reinvested into the QO Fund, not the total proceeds, which is different than other tax deferral tools such as like-kind exchanges. The gain deferred can be any gain (e.g., short-term, long-term, ordinary and Section 1231 gains) in connection with the disposition of property.

Observation: Assuming the taxpayer holds its investment in the QO Fund until December 31, 2026, the gain subject to tax is the lesser of the fair market value of the property at the time of the event or the original deferred gain. Taxpayers will need to value their interest in the QO Fund in order to capture the correct gain.

Observation: This incentive may be used as a complementary tool for investors who are also receiving NMTCs or Low-Income Housing Tax Credits.

Basis boosts

The taxpayer's basis in the QO Fund is initially zero but will be increased by 10% of the deferred gain if investment is held for 5 years and increased by an additional 5% if the investment is held for 7 years. Therefore, if a gain on the sale of property is reinvested in a QO Fund within the required timeframe, taxpayers may be able to decrease the taxable portion of the originally deferred gain by 15% (an overall basis step up of 15%) if investment is held up to 7 years.

Observation: Consideration should be given when modeling the impact of partnership losses on an investor's return in a QO Fund as an investor's basis is zero and the losses may be limited under Section 704(d).

Capital gain exclusion

For investments held for at least 10 years, the taxpayer will recognize no capital gain income on the appreciation of the asset from the time of the initial investment in the QO Zone through the sale of the investment.

Observation: Where the taxpayer invests both capital gain proceeds and cash from other sources into a QO Fund, the Act specifically states that the investment will be treated as two separate investments of which only the capital gain proceeds will be eligible for the 10 year capital gain exclusion (and basis boosts).

Qualified Opportunity Funds

Investors wishing to utilize the newly enacted opportunity zone program must invest their gain in a QO Fund. QO Funds can be structured as corporations or partnerships. In order to meet the criteria of a QO Fund, 90% of the assets held by the vehicle on the last day of the fund's taxable year (and the last day of the first six-month period of the fund's taxable year) must be qualified opportunity zone property (QOZ Property) within a QO Zone and the QO Fund must have acquired the property after December 31, 2017.

The Act requires that the Treasury Secretary establish guidance for the certification process of QO Funds.

Observation*:* We expect that the Community Development Financial Institutions Fund (CDFI Fund) will assist the Treasury Department in certifying the QO Funds. The CDFI Fund historically has assisted with the allocation credit process for the NMTC program. The CDFI Fund is currently supporting the Internal Revenue Service (IRS) with the QO Zone nomination and designation process.

Observation: A previous version of the bill would have permitted taxpayers to invest directly in QOZ Property rather than invest through a QO Fund. Presumably, the requirement of a QO Fund was added in the enacted version so the Treasury Department could certify through the QO Fund that the vehicle met the statutory requirements (rather than work directly with individual investors).

Observation: The IRS updated their 2017-18 Priority Guidance Plan in February 2018, specifically adding guidance on Opportunity Zones to the list of new guidance projects in connection with the Act.

Qualified Opportunity Zones

The Act authorizes the creation of QO Zones, which are defined as a population census tracts that are low income communities and specifically designated as QO Zones. For a census tract to be designated as a QO Zone, a low income community must be identified and nominated by the governor of the state (or territory) in which the community is located. The governor must notify the Treasury Secretary in writing, and in turn, the Treasury Secretary must certify the community as a QO Zone. Governors are required to provide particular consideration to areas that: (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) have demonstrated success in geographically targeted development programs such as NMTC, EZ, and RC; and (3) have recently experienced significant layoffs due to business closures or relocations.

The governor must submit the notification of nomination to the Treasury Secretary by March 21, 2018, however, there is a 30-day extension period available for the March 21 deadline. The number of communities that can be designated as QO Zones in a state is limited to 25% of the number of low income communities in the state but if the state has less than 100, it is permitted to designate 25 tracts as QO Zones.

Observation: Governors have the opportunity to designate areas that are not only in need of economic investment, but also areas that will continue to grow after initial investments have been made. The backbone of this program is the reliance on private investors introducing new capital into communities in need.

Observation: Some states have already completed the process of designating their QO Zones. A previous version of the bill provided that if a governor did not designate the areas within the required timeframe, the Treasury had authority to designate the zones directly. Because this language was removed from the final bill, governors may only have a one-time shot at designating the QO Zones or lose the incentive completely.

Observation: Investors and QO Fund sponsors should work with their local governments to nominate census tracts in areas they believe deserve consideration.

The Bipartisan Budget Act of 2018 declared all of Puerto Rico's low income communities to be QO Zones. It has been noted that more than 90% of Puerto Rico is considered low income.

Low income community

The Act refers to the NMTC for the definition of low income community, which is (1) any population census tract if the poverty rate for such tract is at least 20%, or (2) if the tract is not located in a metropolitan area, the median family income does not exceed 8% of the statewide median family income, or (3) if the tract is within a metropolitan area, the median family income for the tract does not exceed 8% of the greater statewide median family income or the metropolitan area median family income.

There is an exception in the Act for non-low income communities as defined as a population census tract that shares a border with a low income community, has been designated as a qualified opportunity zone, and the median family income of the tract does not exceed 125% of the median family income of the low income community the tract borders. The number of tracts designated under this exception may not exceed 5% of the total population census tracts designated as QO Zones.

Observation: Part of the Opportunity Zone framework, including the definition of low-income community, is leveraged from the NMTC program.

Qualified Opportunity Zone Property

The QO Fund must invest capital in QOZ Property. QOZ Property can be qualified opportunity zone stock (QOZ Stock), qualified opportunity zone partnership interest (QOZ Partnership Interest), or qualified opportunity zone business property (QOZ Business Property).

Qualified Opportunity Zone Stock

QOZ Stock is defined as any stock in a domestic corporation which meets the following requirements:

- the stock is acquired by the QO Fund after December 31, 2017, at its original issue (directly or through an underwriter) solely in exchange for cash;
- at the time the stock was issued, the corporation was a QOZ Business (defined below) or for a new corporation, it was formed for purposes of being a QOZ Business; and
- during substantially all the QO Fund's holding period of the stock, the corporation was a QOZ Business.

Qualified Opportunity Zone Partnership Interest

QOZ Partnership Interest is defined as any capital or profits interest which meets the following requirements:

- the interest is acquired by the QO Fund after December 31, 2017, from the partnership, solely in exchange for cash;
- at the time the interest was acquired, the partnership was a QOZ Business or for a new partnership, it was formed for purposes of being a QOZ Business; and
- during substantially all the QO Fund's holding period of the interest, the partnership was a QOZ Business.

Observation: A QO Fund cannot contribute an existing QOZ Business into a corporation in exchange for stock or into a partnership in exchange for interest. The law specifically states that the stock and partnership interest must solely be received for cash.

Observation: 'Substantially all' for purposes of the holding period is not defined within the law.

Qualified Opportunity Zone Business Property

QOZ Business Property is defined as tangible property used in a trade or business of the QO Fund and meets the following requirements:

- the property was acquired by the QO Fund by purchase (as defined in Section 179(d)(2), which requires the purchase to be from unrelated parties);
- the original use of the property in the QO Zone commences with the QO Fund or the QO Fund

substantially improves the property;

- during substantially all the QO Fund's holding period of the property, substantially all the use of the property was in a QO Zone.

Substantial improvement of a property is defined as occurring if during the 30-month period after the date of acquisition of the property, additions to the basis of the property in the hands of the QO Fund exceed the basis of the property at the beginning of the 30-month period.

Observation: The substantial improvement language allows real estate developers or investors to purchase used property and to rehabilitate/improve the property without having to meet the original use requirement.

Observation: QO Funds need a clear plan if acquiring tangible property, as the asset must either be newly placed in service or substantially improved. The intent is not to have investors buy buildings or land simply to be held for long term investment.

Qualified Opportunity Zone Business

As discussed above, one of the requirements of a QOZ Partnership Interest and QOZ Stock is that the partnership or corporation was a QOZ Business or formed for the purpose of becoming a QOZ Business. A QOZ Business is a trade or business that meets the following requirements:

- the QOZ Business Property was acquired by the QOZ Business by purchase (as defined in Section 179(d)(2), which limits the purchase to unrelated parties);
- the original use of the QOZ Business Property in the QO Zone commences with the QOZ Business or the QOZ Business substantially improves the property;
- during the QOZ Business's holding period of the QOZ Business Property, substantially all the use of the property was in a QO Zone.
- at least 50% of total gross income of the QOZ Business is derived from an active trade or business;
- a substantial portion of the intangible property is used in an active trade or business;
- less than 5% of the average of the aggregate unadjusted bases of the property of the entity is attributable to nonqualified financial property; and
- the business is not described in Section 144(c)(6)(B).

Observation: Nonqualified financial property generally means debt, stock, partnership interests, options, forward and future contracts, warrants, notional principal contracts, annuities and other similar property. It does explicitly exclude cash, cash equivalents, accounts receivable or debt instruments with a term of less than 18 months.

Observation: The Act and Section 144(c)(6)(B) excludes certain 'sin' businesses from the definition of a QOZ Business. These are golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks, other facilities used for gambling, or a store where the principal business is the sale of alcoholic beverages for consumption off premises.

Example of the mechanics of the incentive

Year 1	Year 1	Year 5	Year 7	Year 8 (December 31, 2026)	Year 10
Property is sold for a gain. (e.g. stock in a public company is sold resulting in proceeds $150 and a capital gain of $100.	Within 180 days, the $100 gain is reinvested in an OZ Fund.	Taxpayer receives a $10 step up in basis in connection with the original gain. (e.g. if the Taxpayer sold the interest in the OZ Fund after 5 years they would recognize a gain of no more than $90 not $100.	Taxpayer receives a $5 step up in basis in connection with the original gain. (e.g. if the Taxpayer sold the interest in the OZ Fund after 7 years they would recognize a gain of no more than $85 not $100.	Tax on deferred gain of $85 is due. (Assuming FMV of OZ Fund Interest is higher than the deferred gain.)	Taxpayer would not owe any tax related to post acquisition appreciation on interest of the OZ Fund if sold.

Qualified Opportunity Funds penalties for noncompliance

If the QO Fund fails to meet the 90% asset requirement it will be assessed a penalty for each month it fails to meet the requirement of an amount equal to the excess of 90% of its aggregate assets, over the aggregate amount if QOZ Property held by the fund multiplied by the underpayment rate under Section 6661(a)(2).

Observation: The Act indicates that the penalty may be waived if the failure is due to reasonable cause.

Observation: If the QO Fund is a partnership, the penalty is taken into account proportionally as part of each partner's distributive share.

Treasury reporting requirements

The Treasury Secretary is required to report to Congress on Opportunity Zones beginning five years after it was signed into law. The report is to include the number of QO Funds, the amount of assets held in each QO Fund, the composition of QO Funds investments by asset class, the percentage of QO Zones that have received QO Fund investment, and an assessment on the impact and outcomes of the investments including the impact on jobs, new businesses and poverty.

The takeaway

QO Funds are not only an opportunity for investors to promote growth within our nation's struggling communities, they also can provide tax savings to investors if structured properly. Taxpayers that have large gains should analyze reinvestment opportunities within designated QO Zones to see if the incentives available through this program could provide benefits.

Let's talk

For a deeper discussion on how Qualified Opportunity Funds may affect your business, please contact:

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