

Business Alert – Qualified Opportunity Zones and Investment in Qualified Opportunity Zone Funds

July 30, 2018

Contained within the recently enacted Tax Cuts and Jobs Act of 2017 (Act) is a new program designed to encourage economic investment in low-income communities, designated in the Act as “qualified opportunity zones,” by providing tax incentives to investors who do so (Opportunity Zone Program).

In many respects, the Opportunity Zone Program is similar to the New Markets Tax Credit (NMTC) program (both programs utilize similar concepts and definitions); however, rather than incentivizing investment by way of the issuance of tax credits, the Opportunity Zone Program incentivizes investment by (1) potentially deferring otherwise taxable gain, (2) potentially reducing deferred taxable gain, and (3) potentially excluding future gain arising out of appreciation in the value of the investment. It should be possible to utilize both programs in a qualifying project (i.e., the programs may be “twinned”).

What is a Qualified Opportunity Zone?

Generally, a qualified opportunity zone (Opportunity Zone) is a population census tract that is a low-income community designated by the governor of each state, and which has a poverty rate of at least 20%, and

1. If the tract is within a metropolitan area, the median family income for the tract does not exceed 80% of the greater of statewide median family income or the metropolitan area median family income; or
2. If the tract is located outside of a metropolitan area, has a median family income that does not exceed 80% of statewide median family income.

The governor of each state had until mid-April of this year to identify up to 25% of its state’s low-income, high poverty census tracts and submit them to the Department of the Treasury (Treasury) for certification as Opportunity Zones. As of last month, the Treasury had certified over 8,700 Opportunity Zones across the country.

How Does the Opportunity Zone Program Work?

By reinvesting gains from the sale or exchange of property with an unrelated third-party within 180-days of the date of the transaction, a taxpayer can defer realization of a portion of the resulting gain by reinvesting all, or a portion, of it into a “qualified opportunity fund” (Opportunity Fund), which is a corporation or partnership that

invests at least 90% of its assets in a qualified opportunity zone property (Opportunity Zone Property). If the 90% threshold is not met, the Opportunity Fund would be subject to a penalty. It is important to note that funds invested in the Opportunity Fund that are in excess of gains will not qualify for special tax treatment under the Opportunity Zone Program.

3 Types of Qualified Opportunity Zone Property

Qualified Opportunity Zone Stock.

Original issue stock in a domestic corporation acquired by the Opportunity Fund from the corporation after December 31, 2017, solely in exchange for cash, provided that: (a) at the time the stock is issued, the corporation was an Opportunity Zone Business (see definition below) (or, in the case of a new corporation, was being organized for that purpose), and (b) the corporation continues to be an Opportunity Zone Business during substantially all of the period the Opportunity Fund holds the stock.

Qualified Opportunity Zone Partnership Interest.

Any capital or profits interest in a domestic partnership acquired by the Opportunity Fund from the partnership after December 31, 2017, solely in exchange for cash, provided that (a) at the time the interest was acquired, the partnership was an Opportunity Zone Business (or, in the case of a new partnership, was being organized for that purpose), and (b) the partnership continues to be an Opportunity Zone Business during substantially all of the period the Opportunity Fund holds the interest.

Qualified Opportunity Zone Business Property.

Tangible property used in a trade or business of the Opportunity Fund that was purchased by the Opportunity Fund after December 31, 2017, provided that (a) the original use of the property in the Opportunity Zone begins with the Opportunity Fund or the Opportunity Fund substantially improves the property, and (b) substantially all of the use of the property was in an Opportunity Zone during substantially all of the period the Opportunity Fund holds the property.

Qualified Opportunity Zone Business

A qualified opportunity zone business (Opportunity Zone Business) is, generally, an active trade or business in which substantially all of the tangible property owned or leased by the taxpayer (through the Opportunity Fund) is qualified opportunity zone business property.

Qualified opportunity zone business do not include:

- Golf courses
- Country clubs
- Massage parlors
- Hot tub facilities

- Suntan facilities
- Racetracks or other facilities used for gambling
- Any store the principal business of which is the sale of alcoholic beverages for consumption off premises

What Are the Tax Incentives For Investing in an Opportunity Zone?

A taxpayer who reinvests otherwise taxable gain from the sale or exchange of an asset into an Opportunity Fund will have the ability to defer recognition of the gain in an amount that is the lesser of:

(A) the amount of deferred gain, or

(B) the fair market value of the investment in the Opportunity Fund over the taxpayer's basis in the investment in the Opportunity Fund (the Act considers the taxpayer's basis in its investment to be zero) on the date the investment is sold, or December 31, 2026, whichever is earlier.

The Opportunity Zone Program is structured so that the longer the investment is held in the Opportunity Fund, the greater the tax benefits provided to the taxpayer.

Short-Term Deferral of Portion of Taxable Gain

Investment Held for Less Than Five Years

If the investment in the Opportunity Fund is held for less than five years, then 100% of the deferred gain will be recognized (i.e., included in gross income).

Example Taxpayer sells stock, resulting in an otherwise taxable gain of \$500,000, and, within 180 days thereafter, invests the entire gain in an Opportunity Fund. Taxpayer then sells its interest in the Opportunity Fund less than five years later for \$595,000. In this example, the calculation is as follows:

- Investment (deferred gain): \$ 500,000
- Sale Price: \$ 595,000
- Basis in Investment: \$ 0
- Recognized Gain: \$ 595,000

Here, 100% of the deferred gain, together with the appreciation on the investment, will be recognized.

Investment Held for Five Years

If the investment in the Opportunity Fund is held for at least five years, then the basis of the investment will be increased by 10% of the deferred gain.

Example

Taxpayer sells an apartment complex, resulting in a taxable gain of \$1,500,000, and, within 180 days thereafter, invests the entire gain in an Opportunity Fund. Taxpayer holds the investment in the Opportunity Fund for at least five years (but less than seven) and sells its interest for \$2,500,000 prior to December 31, 2026. In this example, the calculation is as follows:

- Investment (deferred gain): \$ 1,500,000
- Sale Price: \$ 2,500,000
- 10% Increase in Investment Basis: (\$ 150,000)
- Recognized Gain: \$ 2,350,000

Here, only 90% of the initial deferred gain, together with the appreciation on the investment, will be recognized.

Investment Held for Seven Years

If the investment in the Opportunity Fund is held for at least seven years (but less than ten years), then the basis of the investment will be increased by an additional 5% of the deferred gain (i.e., a total of 15%: 10% + 5%).

Example

Taxpayer sells an apartment complex, resulting in a taxable gain of \$1,500,000, and, within 180 days thereafter, invests the entire gain in an Opportunity Fund. Taxpayer holds the investment in the Opportunity Fund for at least seven years and sells its interest for \$2,800,000 prior to December 31, 2026. In this example, the calculation is as follows:

- Investment (deferred gain): \$ 1,500,000
- Sale Price: \$ 2,800,000
- 10% Increase in Investment Basis: (\$ 150,000)
- 5% Increase in Investment Basis: (\$ 75,000)
- Recognized Gain: \$ 2,575,000

Here, only 85% of the initial deferred gain (10% + 5%), together with the appreciation on the investment, will be recognized.

Importance of December 31, 2026

Regardless of the period that a taxpayer holds its investment in an Opportunity Fund, it must recognize its deferred gain on December 31, 2026, even if it continues to hold it in the Opportunity Fund thereafter.

Potential Elimination of Post-Investment Gain

If the investment in the Opportunity Fund is held for at least ten years, then, in addition to having potentially received a 15% stepped-up basis, the taxpayer will also be entitled to permanently exclude the gain on the fair market value of the investment when the investment is sold or exchanged.

Example

Taxpayer sells an apartment complex, resulting in a taxable gain of \$1,500,000, and, within 180 days thereafter, invests the entire gain in an Opportunity Fund. Taxpayer holds the investment in the Opportunity Fund for 12 years, at which time it sells its interest for \$3,750,000. In this example, the calculation is as follows:

- Investment (deferred gain): \$ 1,500,000
- Sale Price: \$ 3,750,000
- Post-Investment Gain: \$ 2,250,000

Because the taxpayer held its investment in the Opportunity Fund for at least ten years, its entire post-investment gain of \$2,250,000 is permanently excluded from gross income.

Still Awaiting Issuance of Regulations and Guidance from Treasury

As of the date of publication, Treasury has not yet issued regulations or useful guidance necessary to implement the Opportunity Zone Program. For example, Treasury will need to issue them to address issues such as:

- How to roll-over gain from existing investments into an Opportunity Fund.
- The process pursuant to which Treasury will certify Opportunity Funds (presently, taxpayers may self-certify an Opportunity Fund by filling-out and submitting a form to Treasury; however, as of this date, Treasury has not released the form).
- What will qualify as a “substantial improvement” of Opportunity Zone business property.
- What happens if an Opportunity Zone loses its designation as an Opportunity Zone while the investment is being held in an Opportunity Fund.

Special Situation Where Opportunity Fund Invests in Real Property to be Re-Developed

The Opportunity Zone Program requires that an Opportunity Fund hold at least 90% of its assets in Opportunity Zone Property. The test to determine whether the Opportunity Fund meets this requirement is determined by averaging the percentage of Opportunity Zone Property held in the Opportunity Fund, measured on the last day of the first 6-month period of the Opportunity Fund’s taxable year and, again, on the last day of the Opportunity Fund’s taxable year. In a situation in which an Opportunity Fund will substantially improve an existing property, it is quite possible that more than 10% of its assets will be cash or cash equivalents, which do not qualify as Opportunity Zone Property, for more than 6 to 12 months while construction is being conducted. If so, the Opportunity Fund could be subject to a penalty for failing to hold at least 90% of its assets in Opportunity Zone Property for those time periods. Hopefully, Treasury will address this potential issue.

Opportunity Zones (Nationally and in Specific States)

- **National** – A national list (by state) of all approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones, may be viewed at <https://www.cdfifund.gov/opportunity-zones>.
- Alabama has 158 approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones, which may be viewed at <https://adeca.alabama.gov/Divisions/OpportunityZones/Pages/Opportunity-Zones.aspx>.
- California has 879 approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones, which may be viewed at http://dof.ca.gov/Forecasting/Demographics/opportunity_zones/.
- Florida has 426 approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones, which may be viewed at <http://www.floridajobs.org/business-growth-and-partnerships/for-businesses-and-entrepreneurs/business-resource/opportunity-zones>.
- Louisiana has 150 approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones, which may be viewed at <https://www.opportunitylouisiana.com/business-incentives/opportunity-zones>.
- Mississippi has 99 approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones.
- New York has 514 approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones, which may be viewed at <https://esd.ny.gov/opportunity-zones>.
- Ohio has 320 approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones, which may be viewed at <https://development.ohio.gov/wps/portal/gov/development/>.
- Tennessee has 176 approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones, which may be viewed at <https://www.tn.gov/ecd/opportunity-zones.html>.
- Texas has 527 approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones, which may be viewed at <https://gov.texas.gov/news/post/governor-abbott-submits-opportunity-zone-designations-to-the-u.s.-treasury-department>.
- Washington, DC has 25 approved and designated low-income, high poverty census tracts that have been designated as Opportunity Zones, which may be viewed at <https://dmped.dc.gov/page/opportunity-zones-washington-dc>.

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