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Enterprise Zones

INSIGHT: Opportunity Zones, An Innovative Investment Vehicle Created by the Tax Cuts and Jobs Act

James Brockway and Ashley Slisz of Withers Bergman discuss the opportunity funds created under the new tax act to direct resources to low income communities and how an investor can take advantage of them.

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On Dec. 22, 2017, the President signed into law legislation that represents the most sweeping tax reform in decades (the ''Act''), which generally takes effect on Jan. 1, 2018. The Act created a section in the tax code that allows taxpayers to take advantage of a new investment vehicle called ''opportunity funds.''

The purpose of this new investment vehicle is to help direct resources to low income communities, known as ''qualified opportunity zones,'' through a more market driven approach. Investing in opportunity funds can provide the following three tax incentives to investors: (1) deferral of income tax on capital gain, (2) possible reduction of the amount of gain realized through a basis adjustment, and (3) possible permanent exclusion of gain on the appreciation for the interest in a qualified opportunity fund. Furthermore, there is no cap on the amount of money that can be invested in qualified opportunity funds.

How to Receive Favorable Tax Treatment Under Code Section 1400Z If an investor realizes gain from the sale or exchange of a capital asset to an unrelated party, he has 180 days from the date of disposition to reinvest the gain amount with a cash investment into a qualified opportunity fund. A qualified opportunity fund (the ''fund'') is an investment vehicle that must hold at least 90 percent of its assets in ''qualified opportunity zone property,'' defined below. The investor receives either stock or an interest in the fund and the fund then must invest in qualified opportunity zone property.

If the investor holds the interest in the fund for at least five years, he receives a basis increase in the investment that equals 10 percent of the deferred gain that he invested in the fund. If the investor holds his interest in the fund for an additional two years (or, seven

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years total), he receives an additional increase in his basis that equals 5 percent of the deferred gain invested in the fund. If the investor is still holding the interest in the fund on Dec. 31, 2026, then, regardless of if he continues to hold the interest in the fund, he is required to recognize and pay taxes on the deferred gain on that day, subject to any increases in basis that he may have received for holding the property for five years or more.

If the investor continues to hold the interest in the fund after Dec. 31, 2026, for at least a total of 10 years, he receives a step up in basis in the interest so that his basis equals the fair market value; therefore, he is not taxed on any appreciation in his interest. In order to receive a 10 percent increase in basis, the investor must invest in a fund by 2021 and in order to receive an additional 5 percent increase in basis, the investor must make an investment in a fund by 2019.

Before getting into the finer details of each requirement necessary to receive the tax incentives, below is a numerical example.

Joe is a real estate developer and creates a partnership, Joe's Homes, that qualifies as a qualified opportunity fund under tax code Section 1400Z-2(d). Joe sells stock and realizes $100,000 in capital gain. On June 1 (within 180 days of the day Joe sold his stock), Joe invests $100,000 cash in Joe's Homes. This investment represents the capital gain. Since Joe invested the $100,000 of gain from the sale of stock into a fund, he does not recognize the gain immediately. After holding his interest in Joe's Homes for five years, Joe decides to sell his interest in the fund for $300,000. As a result of holding the interest for five years, Joe eliminates $10,000 in gain from his original investment.

Sale Price:	$300,000
Joe's deferred gain:	$100,000
Joe's Basis Increase:	$10,000
Gain recognized:	$290,000

Note that if Joe fails to hold his interest in Joe's Homes for five years, his basis is $0 and he realizes $300,000 in gain at the time of his sale of Joe's Homes.

If Joe continues to hold his interest in Joe's Homes for another two years before selling, eliminates an additional $5,000 in gain from his original investment.

Sale Price:	$300,000
Joe's deferred gain:	$100,000
Joe's Basis Increase:	$15,000
Gain recognized:	$285,000

If Joe is still holding his interest in Joe's Homes on Dec. 31, 2026, he recognizes $85,000 in gain on that date. However, if Joe continues to hold the property through June 1, 2028, his basis in the Joe's Homes interest equals the fair market value and any appreciation is not taxed. For example, if Joe sells his interest in Joe's Homes on June 2, 2028, for $450,000, he does not realize any gain despite the appreciation in his interest in Joe's Homes. Therefore, Joe has eliminated $365,000 gain from tax as a result of investing in Joe's Homes and holding his interest for 10 years.

Now that the basics of this new investment vehicle have been laid out, it is time to analyze the finer details that allow taxpayers to reap the benefits of this new investment vehicle.

What Is An Opportunity Zone The governor of each state and chief executive officer of U.S. territories and the District of Columbia, needed to nominate communities as qualified opportunity zones and submit the nominations to the Secretary of the Treasury by April 20, 2018. Rev. Proc. 2018-16. Areas can be nominated as qualified opportunity zones if the areas are low income communities as defined in tax code Section 45D(e). The Secretary of the Treasury has 30 days to certify an area as a qualified opportunity zone from the date it receives the nomination.

To date, the following states and territories have received approval from the Secretary of Treasury for the zones it nominated: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Georgia, Guam, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Northern Mariana Islands, Oklahoma, Ohio, Oregon, South Carolina, South Dakota, Tennessee, Texas, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming, American Samoa, Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. For an update of the complete list of qualified opportunity zones approved by the Secretary of Treasury see **Opportunity Zones Resources, CDFI Fund,** https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

Each certified qualified opportunity zone retains its designation for 10 years. In many cases, the opportunity zones are in areas with expected concentrated development over the next decade. Investments in the qualified opportunity zones are made through funds, as described below.

Qualified Opportunity Funds The investor must invest in a fund within 180 days after the sale or exchange of the capital asset. The fund can be a partnership, a corporation, or a limited liability company. The investor receives either stock or an interest in the fund. The fund must invest in qualified opportunity zone property, explained below. The fund must hold at least 90 percent of its assets in qualified opportunity zone property. The percentage of assets is measured ''on the last day of the first six-month period of the taxable year of the fund, and on the last day of the taxable year of the fund.'' Section 1400Z-2(d)(1).

If a fund fails to meet the 90 percent standard, it is subject to a penalty for each month it fails to meet the required threshold. The penalty is "(i) the amount equal to 90 percent of its aggregate assets, over (ii) the aggregate amount of qualified opportunity zone property held by the fund, multiplied by the underpayment rate established under section 6621(a)(2)" for each month the fund fails to meet the required threshold. Tax code Section 1400Z-2(f)(1).

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In the summer of 2018, the Internal Revenue Service will be issuing a form that will allow taxpayers to self-certify as a qualified opportunity fund. After the taxpayer completes the form, they must attach it to their **timely** filed income tax return for the tax year. See **Opportunity Zones Frequently Asked Questions, IRS (last updated Apr. 24, 2018), https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.**

Qualified Opportunity Zone Property As stated above, the fund must hold at least 90 percent of its assets in qualified opportunity zone property, which includes qualified opportunity zone stock, qualified opportunity zone partnership interests, or qualified opportunity zone business property. Each form of opportunity zone property must meet the specifications set forth below.

Stock: Qualified opportunity zone stock is any stock of a domestic corporation that was obtained by the fund after Dec. 31, 2017 from the corporation, either directly or through an underwriter, solely in exchange for cash. The corporation must be a qualified opportunity zone business, as defined below, when the stock is purchased. If the corporation is a new corporation then it must be organized for the purpose of being a qualified opportunity zone business. The corporation must qualify as a qualified opportunity zone business for a substantial duration of the fund's holding period.

Partnership Interest: A qualified opportunity zone partnership interest is any capital or profits interest in a domestic partnership that was acquired after Dec. 31, 2017, by the fund solely in exchange for cash. Similar to qualified opportunity zone stock of a corporation, the partnership must be a qualified opportunity zone business when the interest is purchased, or, in the case of a new partnership, it must be organized for the purpose of being a qualified opportunity zone business. Lastly, the partnership must qualify as a qualified opportunity zone business for a substantial duration of the fund's holding period.

A qualified opportunity zone business means a business that owns or leases substantially all of its tangible property in qualified opportunity zone business property. The business must also generate at least 50 percent of its total gross income from active business conduct with ''a substantial portion of the intangible property of such entity used in the active conduct of any such business,'' and ''less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity attributable to nonqualified financial property.'' Tax code Section 1400Z-2(d)(3)(i),(ii). Lastly, the business cannot be a ''private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.'' Tax code Section 1400Z-2(d)(3)(iii).

Business Property: Qualified opportunity zone business property is tangible property acquired after Dec. 31, 2017, that is used in a qualified opportunity zone trade or business and either the use of the property in the qualified opportunity zone originates with the fund or the fund substantially improves the property so long as ''during substantially all of the qualified opportunity fund's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone.'' Tax code Section 1400Z-2(d)(2)(D)(i). Property is considered substantially improved if ''during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the qualified opportunity fund.'' Tax code Section 1400Z-2(d)(2)(D)(ii). For example, if the original use of the property does not begin with the fund and the fund acquired the property for $75,000, then it is required to invest an additional $75,000 into the property in order for it to qualify as qualified opportunity zone business property. Note that there is no limitation preventing the fund from borrowing cash in order to purchase or improve the property.

How Real Estate Developers and Passive Investors Could Benefit From Opportunity Zones If you are a real estate developer then you can establish a fund in order to generate third party investment capital for your projects. Furthermore, you can use your fund to defer tax on the sale of your capital assets. In addition, by investing the gain in a qualified opportunity fund you will be paying less in taxes. To illustrate this point, if an investor puts cash generated from the sale of a capital asset into a fund for eight years, with a 15 percent basis increase and a 5 percent present value discount to value the deferral, the investor will pay only 57 percent of what he otherwise would pay in taxes.

In the case of a passive investor, the investment into the fund allows deferral of tax payments on recognized gains for up to eight years (the latest date being, Dec. 31, 2026) with an up to 15 percent gain reduction and the possibility of avoiding any income tax on the qualified opportunity zone investment if held for at least 10 years.

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