Insights: Alerts

Opportunity Zone Program Offers A New, Tax-Efficient Vehicle For Investors And Developers

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Background

On December 22, 2017, President Donald Trump signed into law the Tax Cuts and Jobs Act (the "Act"), which contained a potentially lucrative tax incentive program (the "Opportunity Zone Program") to encourage long-term investments in low-income communities designated as "opportunity zones" by the Secretary of the Treasury. [1] The Opportunity Zone Program offers developers, including start-up companies developing new technologies in the energy, chemical, and infrastructure industries, an exciting, new opportunity to attract private placement funds into business operations and projects constructed in such opportunity zones. Under the Act, the Opportunity Zone Program allows investors to:

- Defer recognition of capital gains until December 31, 2026 if those gains are used to acquire equity interests in qualified opportunity funds ("QOFs") (discussed below) within 180 days of the date on which the gain is recognized by the investor without regard to the Opportunity Zone Program;
- Exclude from taxable gross income up to 15% of the deferred capital gains (if certain holding periods are met); and
- Exclude from taxable gross income any post-investment gains from the disposition of such investments if the investments are held for at least 10 years.

On October 19, 2018, the Department of Treasury and the Internal Revenue Service issued initial proposed regulations and guidance for the Opportunity Zone Program. The proposed regulations clarify, among other things, the types of gains that are eligible for deferral, the requirements for QOFs, and the application of these rules to partnerships.

Definitions

A. *Eligible Taxpayers*

   Eligible taxpayers under the Opportunity Zone Program include any taxpayer that may recognize gains for the purposes of Federal income tax accounting, including but not limited to individuals, C corporations (including "regulated investment companies" and "real estate investment trusts"), S corporations and partnerships (including LLCs taxed as partnerships).

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In the case of a partnership or LLC taxed as a partnership electing deferral under the Opportunity Zone Program, the deferred gain is not included in the distributive shares of the partners under section 702 of the Internal Revenue Code of 1986, as amended (the "Code"). To the extent the partnership does not elect to defer eligible gains, each partner is eligible to elect deferral with respect to their distributive share of such partnership eligible gain, provided the gain did not arise from a sale or exchange with a person related to that partner.

B. *Eligible Gains*

Generally, only capital gains that would otherwise be recognized for Federal income tax purposes before January 1, 2027 are eligible for deferral under the Opportunity Zone Program. This generally includes Section 1231 gains that are characterized as capital gains, as well as certain capital gains distributions from real estate investment trusts or regulated investment companies. Gains arising from a sale or exchange of property between "related persons" are not eligible. Whether parties are related persons is determined by applying the attribution rules of Section 267(b) and 707(b)(1) substituting 20% for 50%.

C. *Qualified Opportunity Funds*

A QOF is any investment vehicle organized as a domestic corporation or partnership for the purpose of investing in qualified opportunity zone property that holds at least 90% of its assets in qualified opportunity zone property (the "90% Test"). [2] The proposed regulations provide for a self-certification process for qualifying as a QOF, and pre-existing entities may be used as a QOF (or as a subsidiary operating entity of a QOF).

- The 90% Test is determined by averaging the percentage of qualified opportunity zone property held by the QOF as of:
    - The last day of the first 6-month period of the taxable year of the QOF; and
    - The last day of the taxable year of the QOF.
- For the purpose of the 90% Test, QOFs are required to use asset values reported on the QOF's applicable financial statement[3] for the taxable year, or if the QOF does not have an applicable financial statement, the cost of its assets. Cash may be counted towards the 90% Test (for up to 31 months) if certain requirements set forth in the proposed regulations are met.

D. *Qualified Opportunity Zone Property*

Qualified opportunity zone property includes, (i) "Qualified Opportunity Zone Stock"; (ii) "Qualified Opportunity Zone Partnership Interest"; and (iii) "Qualified Opportunity Zone Business Property" each of which is discussed below.

1. "Qualified Opportunity Zone Stock" is stock in a domestic corporation if:
    - The stock was acquired by a QOF after December 31, 2017 at its original issue from the corporation solely in exchange for cash;
    - At the time such stock was issued, such corporation was a qualified opportunity zone business

  (“Qualified Zone Business”), described below; and
- During substantially all of the QOF's holding period for such stock, the corporation qualified as a Qualified Zone Business.

2. “Qualified Opportunity Zone Partnership Interest” is a capital or profits interest in a domestic partnership (or LLC taxed as a partnership) if:
    - The partnership interest is acquired by the QOF after December 31, 2017 from the partnership solely in exchange for cash;
    - At the time such interest was acquired, such partnership was a Qualified Zone Business; and
    - During substantially all of the QOF's holding period for such interest, such partnership qualified as a Qualified Zone Business.

3. “Qualified Opportunity Zone Business Property” is tangible property used in a trade or business of the QOF, if:
    - Such tangible property is acquired by the QOF after December 31, 2017 by purchase;
    - The original use of such tangible property in the qualified opportunity zone commences with the QOF or the QOF substantially improves the property; and
        - A property is substantially improved by a QOF if, during any 30-month period beginning after the date of acquisition, additions to basis with respect to the property by the QOF exceed the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF.
        - If a QOF purchases a building on land that is wholly within a qualified opportunity zone, substantial improvement of such building does not require the QOF to separately improve the land upon which the building is located.
    - During substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone.

E. *Qualified Opportunity Zone Business (Qualified Zone Business)*

A qualified opportunity zone business is a qualifying trade or business:[4]

1. In which substantially all (more than 70%) of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property, determined by substituting “qualified opportunity zone business” for “qualified opportunity fund” in the definition of qualified opportunity zone business property;
2. At least 50% of the total gross income of such trade or business is derived from the active conduct of such trade business;
3. A substantial portion of the intangible property of such trade or business is used in the active conduct of such trade or business; and
4. Less than 5% of the average of the aggregate unadjusted bases of the property of such trade or business is attributable to nonqualified financial property. Nonqualified financial property generally includes, stock,

debt, partnership interests, options, futures, forward contracts, notional principal contracts and other similar property.

Tax Treatment of Deferral

Capital gains that are deferred and invested pursuant to the Opportunity Zone Program are included in income on the earlier of (i) the date on which the investment in the QOF is sold or exchanged, or (ii) December 31, 2026. The amount included in gross income as of such date is equal to the excess of (i) the lesser of (A) the amount of eligible gain excluded and invested in the QOF; or (B) the fair market value of the interest in the QOF attributable to the deferral of eligible gains, over the taxpayer's adjusted basis in the qualifying QOF investment (adjusted as discussed below). An investor's initial basis in an investment in a QOF is zero. Unless investors dispose of their interests in a QOF prior to December 31, 2026, all deferred gains will be required to be recognized in the taxable year that includes December 31, 2026 (subject to the basis adjustment rules discussed below).

Example:

Taxpayer A has $100 of eligible capital gains and elects to defer it pursuant to the Opportunity Zone Program on January 1, 2023. The $100 is properly invested in a QOF with a basis of zero. On December 31, 2026, Taxpayer A has not changed his position with respect to the investment, which is now worth $120. Taxpayer A must include $100 ($100 gain excluded – $0 basis) in income on December 31, 2026.

If on December 31, 2026, Taxpayer A has not changed his position with respect to the investment, but the investment is now worth $80, Taxpayer A would include $80 ($80 fair market value - $0 basis) in income.

Basis Adjustment for Investments

For purposes of determining the amount of gain recognized upon a disposition of the investor's interest in the QOF prior to December 31, 2026 (or automatically at December 31, 2026), the Opportunity Zone Program provides for an increase in basis in the investment if it is held for five or seven years. If the investment is held for at least 5 years, the basis of the investor's interest in the QOF is increased by an amount equal to 10% of the gain deferred. If the investment is held for at least 7 years, the basis of the investor's interest in the QOF is increased an additional 5% of the gain deferred.

If an investor in a QOF holds the interest for at least 10 years, the taxpayer may elect to increase the basis of his investment to its fair market value on the date such investment is sold or exchanged. This allows for the investor to permanently exclude from gross income all post-investment gains upon a disposition of the interest in the QOF. The following are several examples illustrating the application of these rules:

Example 1: Eligible Gains Reinvested in a QOF in 2019

Taxpayer A has $100 of eligible capital gains and elects to defer it pursuant to the Opportunity Zone Program in

2019. The $100 is properly invested in a QOF with a basis of zero. On December 31, 2026, Taxpayer A has not changed his position and has held the investment for at least 7 years. Accordingly, Taxpayer A is permitted to adjust his basis in the QOF by 15% of the amount of the deferred gain or $15. The investment is now worth $120. Taxpayer A must include $85 ($100 deferred gain - $15 basis) in income on December 31, 2026. Taxpayer A's basis in the investment is increased as of December 31, 2026 by $85 to $100.

Example 2: Eligible Gains Reinvested in a QOF in 2021

Same facts as Example 1, except Taxpayer A elects to defer the eligible gain pursuant to the Opportunity Zone Program in 2021. As of December 31, 2026, Taxpayer A is permitted to adjust his basis in the QOF by 10% of the amount of the deferred gain or $10. Taxpayer A must include $90 ($100 deferred gain - $10 basis) in income on December 31, 2026. Taxpayer A's basis in the investment increased by $90 to $100.

In each of the examples 1 & 2 above, if Taxpayer A holds the investment for at least 10 years before Taxpayer A sells the investment at its fair market value of $200 and elects a step-up in basis in accordance with 26 USC 1400Z-2(c), then Taxpayer A's basis in the investment is stepped up to the amount realized ($200), and no gain is included in Taxpayer A's income from this transaction.

Implications for Investors and Developers

The Opportunity Zone Program offers many potential benefits for taxpayers; however, each taxpayer should analyze their own situation to determine how to best utilize the program. For example, due to the time period limitation on the deferral in the Opportunity Zone Program, an exchange under section 1031 of the Code may be preferable for investors in real estate as it allows the taxpayer to potentially defer gains until the death of the taxpayer (when heirs may elect for a stepped up basis in the assets). Additionally, in eligible energy projects, partially utilizing tax-equity in lieu of deferring capital gains under the Opportunity Zone Program may prove to be an attractive tradeoff for investors. In such case, the benefits from the tax free treatment of post-investment gains would likely outweigh those from the step-ups in basis available after the 5 and 7 year holding periods.

Further Resources

For further in-depth analysis regarding the Opportunity Zone Program and the proposed regulations and guidance, please see Opportunity Zones White Paper. A second set of proposed regulations is expected to be released near the end of 2018.

Footnotes

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[1] Notice 2018-48, 2018-28 IRB 9, lists the population census tracts the Secretary of the Treasury has designated as qualified opportunity zones.

[2] Includes entities organized in the U.S. or U.S. possessions (with further restrictions on entities organized in

U.S. possessions).

[3] "Applicable Financial Statements" are generally those that are required to be filed with the Securities and Exchange Commission. See, Treas. Reg. § 1.475(a)-4(h).

[4] Certain trades or businesses are not eligible to qualify for the Opportunity Zone Program. These businesses include, private or public golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks and other gambling facilities, and liquor stores.

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