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OPPORTUNITY ZONES KNOCKS UNDER NEW TAX ACT

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An Opportunity to Fund Economically Depressed Areas and An Opportunity for Investors to Shelter Unrealized Capital Gains from Other Investments

The Tax Cuts and Jobs Act of 2017 enacted December 22, 2017 and included in the Internal Revenue Code as Section 1400Z includes a new tax incentive requiring an investment in a qualified opportunity zone. The opportunity zone provisions allow a temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund. The investments in opportunity funds are intended to encourage investments that will be used to start businesses, develop abandoned properties or provide low-income housing in low-income, economically distressed communities.

The basis for the opportunity zone program are as follows:

1. An opportunity fund is formed and certified by the U.S. Department of Treasury.
2. An investor with a recently realized capital gain has 180 days from the underlying sale or exchange to elect to invest all or part of the gain in the opportunity fund and in addition to the investment is able to defer the capital gain from inclusion the investor's income.
3. The opportunity fund uses the investment to acquire "qualified opportunity zone property," which is the opportunity fund's interest in the underlying business or property in the low-income community.
4. The investor holds the interest for as long as the investor desires or as agreed to with the opportunity fund.
5. In the event the investor sells or exchanges the interest in the opportunity fund before December 31, 2026, the investor will recognize the deferred capital gain. If the holding period is at least five years, the investor gets a basis allocation that will offset some of the original capital gain. The basis allocation increases if the holding period is at least seven years.
6. In any event, the investor's capital gain deferral period ends on December 31, 2026 and even if the investment is still outstanding at the time, the deferred capital gain must be recognized on the investor's 2026 tax return.
7. In the event the investor holds the interest in the opportunity fund for at least 10 years, the investor is entitled to a step-up in basis to the investment's fair market value at that time so that any appreciation in the value of the investment can be excluded from income.

"UNTIL THE REGULATIONS ARE ISSUED, THERE IS AN OPEN QUESTION AS TO HOW THE OPPORTUNITY FUND WILL BE CERTIFIED AND ON WHAT BASIS."
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The opportunity zone provisions provide an incentive to potential investors in opportunity funds by allowing for (a) temporary deferral of capital gain recognition, (b) a possible step-up in the basis in the opportunity fund, and (c) possible permanent exclusion of capital gain from the opportunity fund investment if the holding period is at least 10 years.

Until the regulations are issued, there is an open question as to how the opportunity fund will be certified and on what basis. An opportunity fund can be organized as a corporation or a partnership for the purpose of investing in a fund that holds at least 90% of its assets in qualified property. Whether the opportunity fund holds at least 90% of its assets in qualified property is determined by the percentage of qualified property held in the opportunity fund measured (a) on the last day of the first six-month period of the opportunity fund's taxable year, and (b) on the last day of the opportunity fund's taxable year.

Qualified property includes qualified opportunity zone stock, qualified opportunity zone partnership interests, or qualified opportunity zone business property. Qualified opportunity zone stock is stock in a domestic corporation acquired by the opportunity fund after December 31, 2017, at its original issue, solely in exchange for cash. When the stock is issued, the corporation must be a qualified opportunity zone business and must remain a qualified business for substantially all of the opportunity fund's holding period of such stock.

A qualified opportunity zone partnership interest is a domestic partnership interest acquired by the opportunity fund after December 31, 2017, solely in exchange for cash. When the partnership interest is issued, the partnership must be a qualified business and remain one during substantially all of the opportunity fund's holding period of such interest.

Qualified opportunity zone business property means tangible property used in a trade or business of an opportunity fund if such property (i) was acquired by purchase after December 31, 2017, (ii) the original use of such property in the opportunity zone commences with the opportunity fund or the opportunity fund substantially improves the property, and (iii) substantially all of the use of such property was in an opportunity zone during substantially all of the opportunity fund's holding period for the property. Qualified business property will be treated as substantially improved by a opportunity fund only if during the 30 month period beginning after the date of acquisition, the additions to the basis of such property in the hands of the opportunity fund exceed the adjusted basis of such property at the beginning of the 30 month period.

A qualified business is a trade of business in which substantially all of the tangible property owned and leased by the taxpayer is qualified business property. Qualified business property means tangible property used in the trade or business of the qualified business. Moreover at least 50% of the qualified business's gross income is derived from the active conduct of such business and the average of the aggregate unadjusted bases of the qualified business property attributable to "nonqualified financial property" is less than 5%.

A qualified business cannot be engaged in any of the following businesses: 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. In the event tangible property ceases to be qualified business property, it will continue to be treated as qualified business property for the earlier of: (i) 5 years after the date it ceases to be qualified, or (ii) the date on which it is no longer held by the qualified business

The opportunity fund must hold at least 90% of its assets in qualified property and, if the opportunity fund does not meet the 90% requirement, the opportunity fund is required to pay a penalty for each month that it fails to meet the requirement. The amount of the penalty will be equal to the excess of (a) the amount equal to 90% of the aggregate assets, over (b) the aggregate amount of qualified property held by the opportunity fund, multiplied by the underpayment rate established in Section 6621(A)(2) for each month. If the opportunity fund is a partnership, the penalty is to be taken into account proportionally as part of each partner's distributive share of the partnership.

Opportunity zones are census tracts that are low-income communities, which are designated as such by the chief executive officer of each state or possession of the United States "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 promise zones, the new markets tax credit, empowerment zones, and renewal communities; and (3) have recently experienced significant layoffs due to business closures or relocations."

The Treasury Secretary has 30 days upon receipt of the CEO's nomination to determine whether the census tracts will qualify as an opportunity zone. The number of census tracts in a state designated as opportunity zones may not exceed 25% of the number of low-income communities in the state and remain in effect for 10 years following the designation.

In addition to the low-income community census tracts, the chief executive officers may also designate "population census tracts" that are not low-income community census tracts as opportunity zones if (a) the tracts are contiguous with the low-income community that is designated as an opportunity zone, and (b) the median family income of the population census tract does not exceed 125 percent of the median family income of the low-income community tract that is contiguous. No more than 5% of the designated opportunity zones may be population census tracts.