

## Opportunity Zone Investments under the Tax Act

The following is a summary, prepared for National Community Investment Fund, of key provisions of the “Opportunity Zone” program under the recently-passed Tax Cut and Jobs Act (“Tax Act”) and a discussion of a number of key issues under those provisions. Terms appearing below as initially capitalized terms and not otherwise defined have the meanings given such terms (in lower case) in the Tax Act.

### New Tax Incentives

The Tax Act added a new Section 1400Z of the Code, which includes provisions that allow an investor to elect to defer recognition of gain that such investor realizes from the sale or exchange of any property with an unrelated person, by reinvesting the proceeds of such gain in a Qualified Opportunity Fund (or “QOF”) within 180 days following the date of such sale or exchange. The period during which recognition of such gain is deferred begins on the date of such sale or exchange and ends on the earlier of (i) the sale or exchange of the investor’s interest in the QOF or (ii) December 31, 2026.<sup>1</sup> If the investor still holds its interest in the QOF as of this latter date, then gain must be recognized as of such date (whether or not there is a sale or other transaction that would generate funds with which to pay the tax on such gain). This election is no longer available for sales or exchanges that occur after December 31, 2026.

Additional benefits from investing in a QOF include (i) elimination of 10% of the deferred gain if the interest is held for at least 5 years, (ii) elimination of an additional 5% of the deferred gain if the interest is held for at least 7 years, and (iii) if the investment is held for at least 10 years, the basis in the investment in the QOF is adjusted to its fair market value as of the end of such 10-year period.<sup>2</sup> It should be noted that:

- (a) it is unclear whether an investor can benefit from the elimination of gain under (i) and/or (ii) above if the end of the 5 or 7 year holding period occurs after 12/31/2026;<sup>3</sup> and
- (b) the basis adjustment that would occur if the investment is held for at least 10 years only shields the investor from gain on any appreciation of its investment in the QOF in excess of the amount of deferred gain initially invested, since the investor will have had to recognize all or a portion of its deferred gain on its investment as of 12/31/2026 (so that its basis will have been increased by the amount of the gain so recognized).

When recognized, the amount of the gain will be (i) upon a disposition of the investor’s interest in the QOF, the amount realized from such disposition over the investor’s basis (generally zero unless adjusted

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<sup>1</sup> This deferral operates by assigning the investor a basis of zero in its investment in the Qualified Opportunity Fund to the extent of that portion of the investment made from proceeds that represent the gain being deferred. If the investor invests more than the amount of the gain, it would have basis in such investment to that extent.

<sup>2</sup> The elimination of gain associated with the 5-year and 7-year holding periods operates by increasing the investor’s basis in its interest in the Qualified Opportunity Fund by 10% and 5%, respectively, at the end of these holding periods.

<sup>3</sup> Unless there is some clarification or modification of the statute, the 7-year holding period benefit will be lost by the end of 2019, and the 5-year holding period benefit will be lost by the end of 2021, since in each case the deferred gain will have been recognized on 12/31/2026, before the end of the required holding period.

as described above) or (ii) at December 31, 2026, the fair market value of its interest in the QOF over the investor's basis in the QOF. An investor may recognize losses on its investment in a QOF. However, due to the requirement that such investment have a zero basis initially, with relatively small increases after 5 years and 7 years, its ability to benefit from such losses may be limited.

The above provisions refer only to the investor's interest in the QOF. The statute is silent regarding the time period in which a QOF is required to use the proceeds of investments it receives to make qualifying investments. As to the effect of sales, exchanges, or other dispositions by the QOF of the investments it makes, the Tax Act contemplates that the Secretary of the Treasury will prescribe rules to ensure that a QOF has a reasonable period of time in which to reinvest the return of capital from such investments into other qualifying investments.<sup>4</sup> Among other things, such rules will need to address whether, when, and how gains and losses incurred by the QOF affect the investor and the intended deferral of gain on its investment in the QOF.

#### Defined Terms and Investment Requirements

A Qualified Opportunity Fund is any corporation or partnership that is formed for the purpose of investing in Qualified Opportunity Zone Property and invests at least 90% of its assets in such property, and that has been certified as a "qualified opportunity fund" in accordance with rules to be established by the Secretary of the Treasury (which are expected to be similar to those for CDEs under the New Markets Tax Credit program). Given the absence of any limitations in the statute, it appears that such a fund could be formed to make a multitude of investments, or it could be formed to make a single investment. The Tax Act contemplates that the Secretary of the Treasury will prescribe rules for the certification of such entities.

A Qualified Opportunity Zone is any low-income census tract (or to a limited extent a census tract adjacent to a low-income census tract) that has been designated by the governor of the state where located, within 90 days of passage of the Tax Act (i.e., before March 21, 2018), subject to a 30-day extension if requested by the governor, which must then be certified by the Secretary of the Treasury within 30 days after receipt of such designation. "Low-income" for this purpose is has the same definition as under Section 45D (the 80% of median income and 20% poverty thresholds), and not more than 25% of the low-income census tracts in a state may be so designated.<sup>5</sup>

Qualified Opportunity Zone Property includes (i) stock in a Qualified Opportunity Zone Business, (ii) a partnership interest in a Qualified Opportunity Zone Business, and (iii) Qualified Opportunity Zone Business Property.

A Qualified Opportunity Zone Business (a "QOZB") is any domestic corporation or domestic partnership in which (a) 50% of the gross income is derived from the active conduct of business within a Qualified

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<sup>4</sup> It seems likely that such rules would be similar to those that apply to reinvestments under the New Markets Tax Credit program, though we will not know for certain until they are adopted.

<sup>5</sup> If a state has fewer than 25 low-income census tracts, then the limit is 25 such census tracts. For this purpose, "state" includes the District of Columbia and U.S. Territories.



Opportunity Zone,<sup>6</sup> (b) substantially all of the tangible property owned or leased by the QZOB is Qualified Opportunity Zone Business Property, (c) a substantial portion of the intangible property is used in the active conduct of the QZOB's trade or business,<sup>7</sup> (d) less than 5% of the aggregate unadjusted basis of the property of such entity is non-qualified financial property, and (e) the business may not engage in certain excluded businesses (which are the same as the so-called "sin businesses" proscribed under Section 45D). There are no limitations on whether the business is a real estate business or non-real estate business or is residential or non-residential in nature. Also, the restriction under Section 45D that prohibits investments in businesses involved in the sale or licensing of intangibles does not appear in Section 1400Z-2.

In the case of investments in stock or partnership interests in a QOZB, such stock or partnership interests must be acquired after 12/31/2017, at original issue, for cash. The "original issue" requirement would preclude acquisitions from existing shareholders or partners, and the funds cannot be used to redeem out other shareholders or partners (per the reference to Section 1202(c)(3) of the Code). The statute does not appear to impose limitations regarding whether the business in which the QOF invests is related to the QOF and/or any investor(s) in the QOF. Additionally, during "substantially all" of the QOF's holding period for such stock or partnership interest, the corporation or partnership must qualify as a QZOB. There is no definition of "substantially all" in the statute, so this will need to be prescribed by regulations.

As investments in QOZBs must take the form of stock or partnership interests, they must clearly be equity interests, and the investor is therefore subject to equity investment risk. However, the Tax Act uses the terms "any stock" in a corporation and "any capital or profits interest" in a partnership, so acquisitions of preferred stock and/or preferred interests in partnerships would appear to be permissible, which can help ameliorate some of this risk.

Aside from the above, there are few limitations on how the money so invested in a Qualified Opportunity Zone Business is used.<sup>8</sup> However, the restriction on non-qualified financial property ("NQFP") would generally prevent the money from being used by the business to form or acquire equity interests in other entities or making loans, or being invested in businesses that hold subsidiaries, loans or other financial assets to any material extent. One issue of significance is that the Tax Act imposes the NQFP restrictions

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<sup>6</sup> As to this requirement, the Tax Act incorporates Section 1397C(b)(2), which requires that 50% of the gross income of the business be derived from "such business", which is a reference to Section 1397C(b)(1) requiring that "every trade or business of such entity is the active conduct of a trade or business within an empowerment zone." However, the Tax Act does not incorporate Section 1397C(b)(1), which (if done) would have required that every trade or business of the Qualified Opportunity Zone Business be conducted in a Qualified Opportunity Zone. Given the absence of a reference to Section 1397C(b)(1), it seems that the likely intent is as indicated above.

<sup>7</sup> The Tax Act references and incorporates Section 1397C(b)(4), which refers to *intangible* property (whereas Section 1397C(b)(3) deals with tangible property). Given that Section 1400Z-2(d)(3)(A)(i) separately requires that substantially all of the tangible personal property of the business be located in a Qualified Opportunity Zone, Section 1400Z-2(d)(3)(A)(ii) appears to impose a similar requirement with respect to the use of intangible property of the business in a Qualified Opportunity Zone. It is not clear how location of the use of intangible property will be determined. Also, Sections 1397C(b)(3) and (4) refer to a "substantial portion" of such assets. The exact threshold will need to be prescribed by regulations. This same language appears in Section 45D, so it seems likely that this would be the same as (or similar to) what the regulations under the New Markets Tax Credit program provide, though we will not know for certain until regulations are adopted.

<sup>8</sup> It is possible that, pursuant to the general authority given to the Secretary to prescribe regulations, regulations could be adopted that constrain how investment proceeds are used by the business.

by reference to Section 1397C(b), not Section 45D. It is therefore unclear whether, for example, the safe harbor for funds held for construction under Section 45D would be applicable.

In addition to investments in Qualified Opportunity Zone Businesses, Qualified Opportunity Zone Property also includes Qualified Opportunity Zone Business Property, which is defined as tangible property used in the trade or business of the Qualified Opportunity Fund if (i) acquired by purchase (as defined in Section 179(d)(2) - effectively excluding related party and controlled group purchases and carryover basis) after 12/31/2017, (ii) the original use of the property commences with the Qualified Opportunity Fund or the QOF substantially improves the property<sup>9</sup>, and (iii) during substantially all of the QOF's holding period for such property, substantially all of the use of such property occurs in a Qualified Opportunity Zone. This definition focuses solely on the Qualified Opportunity Fund, and there is no apparent requirement that the property of the Qualified Opportunity Fund be used in the trade or business of a Qualified Opportunity Zone Business.<sup>10</sup>

A QOF is subject to a penalty for failure to continuously meet the 90% investment requirement, calculated for each month the QOF does not meet the 90% requirement at the underpayment rate under Section 6621(a)(2) multiplied by the investment deficiency. Importantly, such failure does not appear to trigger recognition of the investor's deferred gain.<sup>11</sup>

### Investment Alternatives

It appears that there are two very distinct forms of investment contemplated by Section 1400Z-2: (1) equity investments in businesses, and (2) equity investments in real property or tangible personal property. In the latter case, the Qualified Opportunity Fund itself can acquire, develop, and presumably lease or otherwise make use of the property, apparently without regard to who the tenants or other users are, so long as the property is located in a Qualified Opportunity Zone.<sup>12</sup> As noted above, it appears that a Qualified Opportunity Fund can be a single-purpose entity, which would facilitate separate investments in separate properties.

Thus, for example, a developer would be able to raise money from investors interested in deferring gains, using a single-purpose Qualified Opportunity Fund, to build and lease an essentially unlimited variety of real estate projects, so long as the property is located in a Qualified Opportunity Zone. Indeed, Section

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<sup>9</sup> Property is treated as substantially improved only if, during any 30-month period beginning after the date of acquisition, additions to basis of the property in the QOF's hands exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period. However, substantial improvements are not required where the original use of the property commences with the QOF.

<sup>10</sup> It is possible that, pursuant to the general authority given to the Secretary to prescribe regulations, such a requirement might be imposed by regulation.

<sup>11</sup> It will be interesting to see whether regulations allow a "reasonable expectation" safe harbor for investments by QOFs, similar to what the New Markets Tax Credit regulations provide. Absent such a safe harbor, the QOF would be subject to ongoing risk that a business or property that qualified initially might later fail to qualify, exposing the QOF to penalties and/or forcing the QOF to liquidate the non-qualifying investment and reinvest the proceeds.

<sup>12</sup> The statute does not reference or incorporate limitations on the nature of the businesses of tenants, such as those that are contained in the regulations under Section 45D. However, the Tax Act contemplates the issuance of regulations, so (i) it seems likely that the restrictions against "sin business" activities by tenants would be incorporated, and (ii) it is at least possible that regulations would include a requirement that the Qualified Opportunity Zone Property must be used in a Qualified Opportunity Zone Business.



1400Z presents an alternative to Section 1031 like-kind exchanges as a means of deferring gain. Although Section 1400Z has the disadvantage of having an end-date on the deferral of gain (12/31/2026), there is also a partial elimination of the gain that is not available under Section 1031. Perhaps more importantly, Section 1400Z applies to defer gain from any kind of property by reinvestment of any kind of property, not just “like-kind” property.

An investor willing to take equity risk and perhaps looking for growth opportunities would be more interested in a Qualified Opportunity Fund that made equity investments in businesses. An investor looking for a more secure investment, or generally interested in real estate investments, would be more interested in a Qualified Opportunity Fund that itself invested in Qualified Opportunity Zone Business Property for leasing to others. While the latter investment would still be an equity investment, it is more secure in that, if the underlying tenant(s) were to fail, the Fund would still own the property and perhaps be able to recover a portion of its investment.

#### Prerequisites for Investments

Before investors can start making investments under Section 1400Z, there are a number of things that need to happen:

- The governor of each state must designate the Qualified Opportunity Zones in their respective states, and the Secretary of the Treasury must certify such designations. Based on the timing provided in the Tax Act, that should conclude within the next 120 to 150 days.
- The Secretary needs to adopt rules for the certification of Qualified Opportunity Funds. There is no timeline for this process in the Tax Act.
- It may be necessary for certain ambiguities in Section 1400Z (as discussed above) to be corrected or clarified. Perhaps the more important of these can be addressed through a technical corrections bill, but when that might happen is unclear.
- As was the case when the New Markets Tax Credit statute was passed, there are a lot of details that have been left to regulations that would need to be adopted. Among the more important items include:
  - (i) the interplay between the gain elimination for 5-year and 7-year holding periods and the 12/31/2026 gain recognition date (if not addressed by technical corrections);
  - (ii) rules regarding the time period allowed to a QOF to make its initial investment(s) from funds received from its investor(s) and rules regarding reinvestments of capital by a QOF;
  - (iii) rules addressing the impact of gains and losses incurred by the QOF on the investor and the intended deferral of gain on its investment in the QOF;
  - (iv) specifying the “substantial all” thresholds applicable to tangible and intangible property held by a QOFB and providing guidance on how to determine where intangible property is treated as being used;

- (v) the meaning of “substantially all” in the contexts of the holding period for stock and partnership interests in stock in Qualified Opportunity Zone Businesses and the holding period for investments in Qualified Opportunity Zone Property;
- (vi) possible limitations regarding the use of investment proceeds by Qualified Opportunity Zone Businesses; and
- (vii) possible limitations regarding the leasing or other use of Qualified Opportunity Zone Business Property acquired or developed by Qualified Opportunity Funds.

There is no prescribed timeline for the adoption of such regulations. Thus, it may be some time before an active investment market can develop under this new program.