Accelerating U.S. Community Impact Financing:
Understanding Challenges and Solutions

The following Q&A is in response to the National Community Investment Fund's request regarding the opportunity zone program under the Tax Cut and Jobs Act (the "Act").

Opportunity Zones: Tax Beneficial Community Investments

1. What are "qualified opportunity zones" and how are they designated?

Opportunity zones are low-income areas designated by the chief executive (e.g., governor) of a U.S. state or territory based upon the same definition of "low-income" as used for New Markets Tax Credit. This definition requires that (a) a census tract's poverty rate is at least 20%; or (b) the median family income for the tract does not exceed 80% of the area median. Also eligible to be designated as opportunity zones are up to 5% of contiguous census tracts where the median income does not exceed 125% of the median family income. Up to 25% of the total number of low-income census tracts in a state or territory may be designated as an Opportunity Zone (or up to 25 tracts, if the total number of low-income communities in a state is less than 100).

In addition, the legislative history suggests that designation should take into account areas that are:

A. Currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity;

B. Have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and

C. Have recently experienced significant layoffs due to business closures or relocations.

No areas have been nominated to-date to be an opportunity zone, although multiple local municipalities have publicly advocated for recognition by their state. Areas must be nominated by the governor by March 22, 2018, unless a 30-day extension if applied for and granted. The Secretary of the Treasury must then certify and make a final designation within 30 days of nomination, unless the governor/chief executive requests a 30 day extension.

An interactive map displaying applicable census tracts is available via PolicyMap, accessible through the Economic Innovation Group at eig.org/opportunityzones.

2. What are examples of the tax incentives offered by opportunity zones?

There are two tax incentives available under the new law.

First, designation as an opportunity zone allows the deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund (an "**Opportunity Fund**"). When a taxpayer sells appreciated property, the taxpayer has 180 days from the date on which the property was sold to reinvest the gains in an Opportunity Fund and defer the tax on capital gains. An Opportunity Fund can be a corporation or partnership and must invest at least 90% of its funds in qualified opportunity zone property, which includes qualified opportunity zone stock, qualified opportunity zone partnership interest, and any qualified opportunity zone business property. The deferral is coupled with a "stepped-up basis" in the investment. The taxpayer's basis in their investment in the Opportunity Fund starts at zero. After 5 years the taxpayer's basis is equal to 10% of the amount of gain the taxpayer deferred by investing in the Opportunity Fund; after 7 years have passed, the taxpayer's basis increases by another 5%; after 10 years, the taxpayer's basis is equal to the amount of gain deferred (in effect, the taxpayer will never have to pay capital gains tax on the appreciated property the taxpayer originally sold).

Second, capital gains on investments in Opportunity Funds will not be taxed if the investment was held for more than 10 years.

> *Example*: Taxpayer bought Asset #1 for $10 several years ago (meaning basis is equal to $10 and any gain will be long-term capital gain). Taxpayer sells Asset #1 for $110 ($100 of long-term capital gain). Taxpayer reinvests the $100 of gain in an Opportunity Fund in year 0 (Taxpayer has basis of $0 in their interest in the Opportunity Fund). In year 5, taxpayer now has a basis of $10 in their Opportunity Fund interest; in year 7, they have a basis of $15; and in year 10 they have $100 basis.

A. In year 6, taxpayer sells Opportunity Fund interest for $120. Taxpayer has gain of $110.

B. In year 11, taxpayer sells Opportunity Fund interest for $120. Taxpayer has gain of $0. Taxpayer's basis in Opportunity Fund interest is $100 after year 10; further, capital gains on investments in Opportunity Funds are not taxed if held for more than 10 years.

3. Can the designation include investments into banks?

Banks are not generally eligible for tax beneficial investments as a "qualified opportunity zone business" as banks and other financial institutions are not likely to meet the nonqualified financial property test – the requirement that less than 5% of the entity's assets are debt, stock, partnership interests, or other similar property.

4. Can the unrealized gain of portfolio investments that could take advantage of a "qualified opportunity zone" be "sold" to another person to give that person the tax advantage when the gain is realized?

To the extent that gains are reinvested into an opportunity zone, a subsequent purchaser can take advantage of the tax advantage. However, the tax incentive works by increasing the investor's basis in the investment over time. Therefore, if the investor held the property for more than ten years, the taxpayer's basis will be equal to the fair market value of the investment on the date it was sold or exchanged – resulting in no gain on the sale. Therefore, on a cost basis, if the investment were sold to another party, the purchaser's basis would be equal to the purchase price, resulting in no gain.

5. What is the potential impact on opportunity zones on philanthropic donations and donor advised funds?

The provisions have no direct impact on donor-advised funds and philanthropic grants. Indirectly, however, these new tax incentives could result in a reallocation of philanthropic capital. Since, if it is more tax beneficial for private investors to invest into the designated areas that were previously attracted to philanthropic capital (whether as low-interest loans in the form of program related investments or grants), that money can now be reallocated to new projects.

Please be in touch with **Quinn Moss** or **Perry Teicher** with any comments or questions.

- Quinn Moss · +1 212 506 5022 · qmoss@orrick.com
- Perry Teicher · +1 212 506 5254 · pteicher@orrick.com