Opportunity Zones: A New Tax Incentive for Investment in LICs

by Walter R. Calvert and Tammara F. Langlieb

Walter R. Calvert

Tammara F. Langlieb

Walter R. Calvert is a partner and Tammara F. Langlieb is a staff attorney in Venable LLP's tax and wealth planning group.

In this article, Calvert and Langlieb explore the basics of the opportunity zone program, compare it with similar tax incentive vehicles, and review what would need to happen for investors to make full use of it.

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Since 2001, the new markets tax credit has served as an important tax incentive to promote investment by financial institutions in low-income communities (LICs). The Tax Cuts and Jobs Act (P.L. 115-97) adds a new tax benefit intended to encourage investment in LICs: the opportunity zone program.

The opportunity zone program targets an investor that wishes to sell an existing capital investment by allowing it to defer the realization of its capital gains (potentially until the end of 2026) if the investor rolls the gain into a qualified opportunity fund, which in turn invests in LICs. As additional incentives, the program offers the potential to shield from income tax up to 15 percent of the gain on the original investment and all the gain representing appreciation in the value of the qualified opportunity fund.[1]

Qualification as a Qualified Opportunity Fund

A qualified opportunity fund must have two elements: It must be organized as a partnership or corporation and hold at least 90 percent of its assets in qualified zone property.[2]

The terms "partnership" and "corporation" presumably refer to entities qualified as such for federal income tax purposes. Accordingly, a limited liability company with multiple members that is characterized as a partnership for federal income tax purposes should be eligible to apply for qualified opportunity fund status, as should a corporation that has elected S corporation treatment.

The IRS is working on guidance regarding the certification of the qualified opportunity funds.[3] Because the statute imposes few requirements for fund status and contains no limits on the number of funds, the certification process and its requirements should be relatively simple.[4]

Opportunity Zones

States can identify a limited number of opportunity zones from among their existing LICs. For this purpose, low-income community has the same meaning as used in the new markets tax credit program.[5] Each governor is allowed to

[1] Section 1400Z-1 and -2.

[2] Section 1400Z-2(d)(1).

[3] *See* "Opportunity Zones Resources" on the Community Development Financial Institutions Fund website.

[4] By analogy, qualification as a community development entity under the new markets tax credit program requires only that the applicant be a legal entity at the time of application, have a primary mission of serving LICs, and maintain accountability to the residents of its targeted LICs.

[5] Section 1400Z-1(c)(1).

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nominate tracts not exceeding 25 percent of the number of LICs within the state.[6]

Benefits to an Investor

An investment in a qualified opportunity fund provides three potential income tax benefits to the investor. First, the investor is able to defer gain on the original investment potentially until the end of 2026.[7] If the investor disposes of its interest in the qualified opportunity fund before that date, the gain deferral ends and the investor must recognize the deferred gain on the original investment together with any gain on the fund investment for that tax year.[8]

Second, the investor may have a small portion of the gain on its original investment entirely excluded from income tax if the investment in the fund is held for specific holding periods. If the investor holds the fund investment for at least five years, the investor's basis is increased by 10 percent. If the investor holds it for at least seven years, the investor's basis in its original investment is increased by an additional 5 percent for a total basis increase of 15 percent. Thus, an investor can realize a permanent exclusion of up to 15 percent of the original investment gain if it can hold its investment for seven years.

But obtaining those benefits has a short investment rollover time horizon. Realization of all gains on the original investment is triggered as of the end of 2026 regardless of whether the investor continues to hold the fund investment for a longer period.[9] Thus, an investor must make its gain rollover investment into a fund before the end of 2019 for a seven-year holding period to be achieved and the full 15 percent permanent gain exclusion to be realized. Similarly, only fund investments in place by the end of 2021 will be able to qualify for any of the permanent gain exclusion.

The most powerful benefit of the opportunity zone program is its third: exclusion from taxable income of any gain realized for an investor's investment in the qualified opportunity fund itself if the investor holds that investment for at least 10 years.[10] That exclusion would provide the most tax benefit for an investment in an LIC in which significant appreciation in value can be anticipated. For example, investment in a newly constructed commercial office or retail project in an up-and-coming LIC may offer the potential for significant appreciation in value over a 10-year holding period. Making that investment via a qualified opportunity fund offers the investor the potential to exit the investment after 10 years without any income tax on its resulting gain.

Conversely, a project that offers little or no likelihood of significant appreciation will be a less likely candidate for an investor to maximize the benefits from a fund investment. For example, charter schools, once operating at capacity, typically provide a stable investment through the government stipends that usually support the school's revenue base. However, they provide a small likelihood for substantial appreciation in value and so would not seem to be prime candidates for a fund investment.

Open Questions

The opportunity zone statutory text has several flaws in its drafting that, if not eliminated by IRS guidance or statute amendment, will reduce the attractiveness of the program. Among them is the failure to clearly address the tax consequences to an investor if a fund disposes of its investment in low-income property before the investor disposes of its interest in the fund. The statute can be read as causing taxable gain to be triggered at the fund level in that situation even though the investor may hold its fund investment for the requisite 10-year holding period that would otherwise shield the investor from a tax burden.

Other issues include clarifying which distributions from an investment fund to an investor are deemed to be a sale or exchange that overrides the opportunity zone deferral (thus triggering immediate recognition of the investor's otherwise deferred gain), and the extent to which

[6]Section 1400Z-1(d)(1). If the number of LICs in a state is fewer than 100, a total of 25 tracts may be designated as qualified opportunity zones. *See* "Opportunity Zone Resources," *supra* note 3, for a list of designated opportunity zones and mapping tools.

[7]Section 1400Z-2(b)(1).

[8]*Id*.

[9]Section 1400Z-2(b)(1).

[10]Section 1400Z-2(c).

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an existing business in a LIC with previously acquired property is eligible to be included in an investment fund if the business otherwise qualifies as a qualified opportunity zone business.[11] Unless those questions can be answered with IRS guidance, the certainty of an investor's after-tax return, and concomitantly the benefit of investing in the program, will diminish and the success of the program be put at risk.

Comparison to New Markets Tax Credit Program

The new markets tax credit and opportunity zone programs provide incentives for investment in a LIC while imposing few requirements on the nature of the project or business to be assisted. Moreover, both programs begin with a coordinating private sector entity (community development entities for the new markets tax credit program and qualified opportunity funds for the opportunity zone program) needing certification from the Community Development Financial Institutions Fund. The new markets tax credit program is burdened with an annual cap on the permitted volume of available credits and a cumbersome allocation process for the distribution of the credits among community development entities. Quite favorably by comparison, the opportunity zone program has no similar caps or allocation process. Conversely, while the calculation of the return on investment for an investor in the new markets tax credit program has an established and relatively simple formula, the newness and interpretation issues of the opportunity zone program make establishing a straightforward, uniform model difficult in the short time frame needed to maximize the tax benefits of an investment through it.

Comparison to Section 1031 Rollover

The opportunity zone program has significant tax benefits compared with the like-kind exchange rules under section 1031. First, while the like-kind exchange rules generally require that all sale proceeds be rolled over into a like-kind investment to obtain deferral from income tax for the gain component of those sale proceeds,[12] the opportunity zone program provides that only the gain must roll over.[13] Second, the scope of prior investments that can be sold is much broader under the opportunity zone program because it's solely constrained by the requirement that the gain be capital in nature,[14] while only real property held for productive use or for investment can be exchanged under the like-kind exchange program.[15] On the other hand, tax can be delayed indefinitely under the like-kind exchange program, while capital gains can be deferred only until December 31, 2026, under the opportunity zone program.

Uses With Affordable Housing Projects

Unlike several other tax-favored programs,[16] the opportunity zone program contains little that restricts a qualified opportunity fund from investing in residential rental housing. The 10-year commitment required to reap the greatest tax benefits from investment in a fund harmonizes well with the long commitment generally required for an investment in affordable housing for which federal tax credits are to be obtained. However, a qualified opportunity fund's investment in real estate must be for either new property or existing property purchased after 2017, provided that the existing property is substantially improved after its acquisition. The substantial improvement standard imposed on a fund (additions exceeding basis during a 30-month period) generally is a more burdensome requirement than applies when qualifying for low-income house tax credits ($6,800 per unit or 20 percent of adjusted basis over a 24-month period).[17]

[11] *See* section 1400Z-2(d)(2)(D) requiring that tangible personal property used by a trade or business in which a qualified opportunity fund invests be acquired after 2017.

[12] Section 1031(a)(1).

[13] Section 1400Z-2(a)(1).

[14] Section 1400Z-2.

[15] Section 1031(a)(1).

[16] The new markets tax credit program generally prohibits investment in residential rental housing, and the use of tax-exempt private activity bonds comes with numerous qualifications and restrictions for financing such projects. *See* sections 45D(d)(3) and 142(d).

[17] Section 1400Z-2(d)(2)(D) for opportunity zones compared with section 42(d)(3) for housing tax credits.

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Next Steps

Several steps must be completed before the opportunity zone program will be ready for implementation. First, the identification of opportunity zones should be finalized. That process is nearing completion, as governors had to nominate the tracts to be qualified opportunity zones by March 21, 2018, or April 20, 2018, if a governor requested a 30-day extension.[18]

Second, Treasury must issue regulations establishing the process for certification of qualified opportunity funds. Third, the IRS or the Community Development Financial Institutions Fund should provide guidance to assist with the many interpretation questions that the opportunity zone statutory text and conference report leave open. The Joint Committee on Taxation should issue its general explanation of the TCJA (commonly known as the blue book) providing a description of the present law, reasons for change, and explanation of the act's provisions, but that's unlikely to come in time to help with the quick start-up needed to maximize opportunity zone tax benefits.

Finally, and perhaps most importantly, the accountants and financial advisers must complete the modeling process that enables a potential investor in a qualified opportunity fund to quantify what after-tax internal rate of return can be expected based on an investor's particular circumstances. That return will vary with several factors, including how promptly the investment can be made, the duration of the investor's investment in the fund, and what is foreseen as the fund's return on the underlying LIC.

The novelty of this program and the many questions that remain to be answered about interpretation of permissible investments and projects create some risk for its early investors. But given the timing rules for realizing the full 15 percent basis step-up and 10-year commitment required to eliminate tax on the fund investment, the early investor is the one that could maximize its after-tax return on investment. Thus, now is the time for eligible investors to consult with their financial, tax, and accounting advisers about selling existing investments and rolling into the program as soon as qualified opportunity funds are ready to accept them. ■

[18]Section 1400Z-1(b)(1)(A), (c)(2)(B), and (b)(2). *See also* Rev. Proc. 2018-16, 2018-9 IRB 383. *See* "Opportunity Zone Resources," *supra* note 3.

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