TAX ASPECTS OF QUALIFIED OPPORTUNITY ZONE FUNDS – A PREQUEL

August 28, 2018

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The Tax Cuts and Jobs Act of 2017 (the "Act"), signed into law by President Trump on December 22, 2017, created a series of new tax incentives for taxpayers willing to make long-term investments in certain qualified low-income population census tracts designated by the Governors of each State and certified by the U.S. Treasury as "qualified opportunity zones" ("O- Zones") for purposes of stimulating private investment in projects or companies situated in said O-Zones. Investors that wish to defer recently realized capital gains recognized upon a sale or exchange of an appreciated asset to an unrelated party may invest that gain in a "qualified opportunity fund" ("O-Zone Fund"), which in turn invests in so-called "qualified opportunity zone property," either directly or through a subsidiary corporation or partnership. In an article dated July 18, 2018, Forbes magazine described the tax incentives created by the Act as "The Most Unbelievable Tax Break Ever." As a follow-up to this blog, which provides a broad overview of the powerful tax incentives created by the Act and the current status of the O-Zone program, we expect to address narrower, real estate industry-specific considerations and structuring issues in one or more subsequent blogs.

An O-Zone Fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in "qualified opportunity zone property" (other than another O-Zone Fund) and that holds at least 90 percent of its assets in "qualified opportunity zone property." The rules and definitions relevant to determining what constitutes "qualified opportunity zone property" and related statutory requirements are beyond the scope of this blog.

By and through Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code of 1986, as amended, the Act creates O-Zones and three primary tax incentives to encourage investment in O-Zones. First, the Act allows for the temporary deferral of inclusion in gross income for capital gains attributable to the sale or exchange of an appreciated asset to an unrelated party that are reinvested in an O-Zone Fund. The maximum amount of the deferred gain is equal to an amount not to exceed the taxpayer's total realized gain from the sale and reinvested by the taxpayer in an O-Zone Fund during the 180-day period, beginning on the date of sale of the asset to which the deferred gain is attributable. The deferred gain is recognized on the earlier of the date on which the O-Zone Fund interest is disposed of or December 31, 2026. The basis of a taxpayer's interest in an O-Zone Fund immediately after its acquisition is zero.

Second, if the O-Zone Fund interest is held by the taxpayer for at least five years, the basis on the original gain is increased by an amount equal to ten percent (10%) of the original gain. If the O-Zone Fund interest is held by the taxpayer for at least seven years, the basis on the original gain is increased by an amount equal to an additional five percent (5%) of the original gain. Thus, and because the five-year and seven-year holding period hurdles are determined by reference to a deferral period ending no later than December 31, 2026, a taxpayer desiring to take maximum advantage of this second primary tax incentive needs to acquire its O-Zone Fund interest by the end of 2019. There will be no "basis increase" for capital gains that are reinvested in an O-Zone Fund after 2021 because at that point in time it will not be possible to attain either a five-year or a seven-year holding period in the O-Zone Fund interest prior to December 31, 2026.

The third main tax incentive created by the Act excludes from gross income the post-acquisition capital gains attributable to appreciation of O-Zone Fund interests that are held for at least ten years. After ten years, the taxpayer can sell its O-Zone Fund interest free of federal income tax, regardless of how much the O-Zone Fund interest has increased in value. Specifically, at the end of a ten-year holding period, and at the election of the taxpayer, the taxpayer's basis in the O-Zone Fund interest will be equal to the fair market value of such interest on the date the O-Zone Fund interest is sold or exchanged. There is no exclusion available for investments in O-Zones made after December 31, 2026.

The official list of designated O-Zones was published in June of 2018, and the Treasury proclaimed its intent to provide further guidance regarding the Opportunity Zone program during the summer of 2018. However, the published guidance promised by the U.S. Treasury in the form of Proposed Treasury Regulations is still pending, and potential investors and prospective fund managers are waiting for that guidance to illuminate uncertainty as to how O-Zone Funds can comply with certain critical statutory requirements. Regular and continuous compliance with the technical provisions of the Act is critically important, as a failure to comply could potentially trigger a significant penalty tax or even compromise the deferral of gain, the potential fifteen percent (15%) basis increase, and/or the ability to sell an otherwise eligible O-Zone Fund interest at the end of a 10-year holding period free of federal income tax.

Although there are a number of material uncertainties pertaining to O-Zone Fund statutory requirements the Proposed Treasury Regulations are expected to address, the Act and existing preliminary published guidance provide sufficient context for potential investors and prospective fund managers to begin developing proposed investment strategies and structures for O-Zone Funds pending issuance by Treasury of the more definitive guidance needed to actually launch or invest in, as the case may be, an O-Zone Fund. Consideration should be given to engaging appropriate tax advisors to assist with understanding these new rules and planning to structure investments in O-Zone Funds properly.

For more information, please contact authors, Mark Wisniewski or Bryan Appel, on our Business, Finance and Tax Team.

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