Opportunity Zone Program – Federal Qualified Opportunity Zones

A Tax Deferral Tool

The 2017 Tax Cuts and Jobs Act (P.L. 115-97) introduced the Qualified Opportunity Zone ("QOZ") program under I.R.C. Section 1400Z-1 and 1400Z-2. The QOZ program is an economic development platform intended to encourage private investment into low-income communities throughout the United States and U.S. territories[i] and is generally effective January 1, 2018, through December 31, 2026.[ii]

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Federal Tax Deferral

The QOZ gives taxpayers a federal tax deferral (as well as a potential partial permanent tax savings) of realized capital gains on the sale of appreciated assets. The taxpayer will still need to recognize the ordinary gain portion on the initial sale, but can effectively defer the portion of the gain subject to 20% or 23.8% capital gains tax, depending on the taxpayer's specific facts and circumstance. For example, taxpayers will experience different marginal rates depending if the original investment was active, passive, or investment portfolio activity. Note that further guidance from the Internal Revenue Service ("IRS") is required in this area.

As previously mentioned, the QOZ program is somewhat similar to an I.R.C. Section 1031 transaction. In both cases, the gains from a sale of an asset are deferred into the future through an exchange transaction. The upside of the QOZ is that the taxpayer can retain cash related to their original investment/tax basis for both ordinary and capital gains and does not require a third party intermediary to handle the sale and reinvestment. The taxpayer only has to transfer all or a portion of the capital gain portion from the sale of any assets to the QO Fund. A taxpayer, however, cannot contribute an existing QOZ trade or business into a QO Fund – they must sell the business and contribute cash. Taxpayers may contribute additional cash, not from the original sale to the QO Fund but it will not be eligible for tax deferral.[iii]

Unlike an I.R.C. Section 1031 transaction, if the taxpayer holds the QO Fund for five years, the basis in the fund will increase by 10%.[iv] Another 5% step-up in basis will accrue after the QO Fund has been held for seven years.[v] After the fund has been held for 10 years, 15% of the original gain and 100% of the appreciation in value will be permanently deferred.[vi] It is yet unclear how the regulations will deal with the 15% basis step up since the full 10-year holding period may not be realized by December 31, 2026, on QO Fund investments purchased after January 1, 2018. Additional guidance is required from the IRS in this area.

To illustrate, on June 1, 2018, Susanne realizes a $1,500,000 gain from the sale of her active business entity. She realizes $500,000 in ordinary gains and $1,000,000 in capital gains. Susanne consults with her attorney and CPA and creates a QO Fund. Within 180 days of the initial sale of her business, she transfers $1,000,000 to the QO Fund. On her 2018 federal income tax return, she reports $500,000 ordinary gains from the sale of her active trade or business and reports a $1,000,000 deferral of her capital gains. Through the QO Fund vehicle, the fund purchases $1,000,000 worth of QOZ-qualified property. Assuming a 5% annual fair market value appreciation rate on the QOZ Fund, the following table is a simple illustration of Susanne's potential after-tax funds if she holds her QO Fund for five years, seven years or 10 years.

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Qualified Opportunity Zone Appreciation

Capital Gain	$	1,000,000
QO Fund Investment	$	1,000,000

Yrs.	Appreciation	Beginning Value	Ending Value
1	50,000	1,000,000	1,050,000
2	52,500	1,050,000	1,102,500
3	55,125	1,102,500	1,157,625
4	57,881	1,157,625	1,215,506
5	60,775	1,215,506	1,276,282
6	63,814	1,276,282	1,340,096
7	67,005	1,340,096	1,407,100
8	70,355	1,407,100	1,477,455
9	73,873	1,477,455	1,551,328
10	77,566	1,551,328	1,628,895

Fed - Capital Gain Tax Rate	23.8%	5+ Year Basis Step Up	10%
Appreciation Rate	5%	7+ Year Basis Step Up	15%

10 Year Hold		7 Year Hold		5 Year Hold	
Capital Gain	1,000,000	Capital Gain	1,000,000	Capital Gain	1,000,000
Tax	-	Tax	-	Tax	-
Investment in Opportunity Fund	1,000,000	Investment in Opportunity Fu	1,000,000	Investment in Opportunity Fund	1,000,000
Basis increase (15%)	150,000	Basis increase (15%)	150,000	Basis increase (10%)	100,000
Proceeds after 10 years	1,628,895	Proceeds after 7 years	1,407,100	Proceeds after 5 years	1,276,282
Tax on appreciation	-	Tax on appreciation	96,890	Tax on appreciation	65,755
Deferred Capital gain Tax	202,300	Deferred Capital gain Tax	202,300	Deferred Capital gain Tax	214,200
After Tax Funds	1,426,595	After Tax Funds	1,107,911	After Tax Funds	996,327
Cumulative After-Tax Return	42.7%	Cumulative After-Tax Return	10.8%	Cumulative After-Tax Return	-0.4%
Annual After-Tax Return	4.3%	Annual After-Tax Return	1.5%	Annual After-Tax Return	-0.1%

This next table illustrates Susanne's potential after tax-funds if she holds a **Non-QO Fund investment for five years, seven years or 10 years.**

Non-QO Fund Investment Appreciation

Capital Gain	$	1,000,000
Non-QO Fund Investment	$	762,000

Yrs.	Appreciation	Beginning Value	Ending Value
1	38,100	762,000	800,100
2	40,005	800,100	840,105
3	42,005	840,105	882,110
4	44,106	882,110	926,216
5	46,311	926,216	972,527
6	48,626	972,527	1,021,153
7	51,058	1,021,153	1,072,211
8	53,611	1,072,211	1,125,821
9	56,291	1,125,821	1,182,112
10	59,106	1,182,112	1,241,218

Fed - Capital gain tax rate	23.8%	5+ Year Basis Step Up	0%
Appreciation Rate	5.0%	7+ Year Basis Step Up	0%

10 Year Hold		7 Year Hold		5 Year Hold	
Capital Gain	1,000,000	Capital Gain	1,000,000	Capital Gain	1,000,000
Tax	238,000	Tax	238,000	Tax	238,000
Non-QO Fund Investment	762,000	Non-QO Fund Investment	762,000	Non-QO Fund Investment	762,000
Basis Increase Allowed (0%)	-	Basis Increase Allowed (0%)	-	Basis Increase Allowed (0%)	-
Proceeds after 10 years	1,241,218	Proceeds after 7 years	1,072,211	Proceeds after 5 years	972,527
Tax on appreciation	114,054	Tax on appreciation	73,830	Tax on appreciation	50,105
Deferred Capital gain Tax	-	Deferred Capital gain Tax	-	Deferred Capital gain Tax	-
After Tax Funds	1,127,164	After Tax Funds	998,380	After Tax Funds	922,421
Cumulative After-Tax Return	12.7%	Cumulative After-Tax Return	-0.2%	Cumulative After-Tax Return	-7.8%
Annual After-Tax Return	1.3%	Annual After-Tax Return	0.0%	Annual After-Tax Return	-1.6%

Therefore, Susanne can potentially receive more after-tax funds if she holds a QO Fund rather than a Non-QQ Fund investment.

Designated Opportunity Zones

QOZ are a group of census tracts that are all nominated by the governor of each state and such nominations are certified and designated by the U.S. Treasury Secretary.[vii] In general, a census tract is a geographic area with a population size between 2,500 and 8,000 people.[viii] To qualify as a QOZ, a census tract must be a "low-income" community. A low-income community is defined as: (1) any population census tract where the poverty rate for such tract is at least 20%, (2) if the tract is not located in a metropolitan area, the median family income does not exceed 8% of the statewide median family income,

or (3) if the tract is within a metropolitan area, the median family income for the tract does not exceed 8% of the greater statewide median family income or the metropolitan area median family income.[ix]

QOZ are limited to 25% of the total low-income communities per state.[x] For example, if there are 100 designated low-income communities in a state then only 25 will be allowed to participate in this program.[xi] While low-income communities are the target of this program, the code does allow adjacent tracts to be included.[xii]

For an interactive QOZ map, address search tool, and census tracts please see:

https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml
https://www.irs.gov/pub/irs-drop/n-18-48.pdf.

Qualified Taxpayer

A qualified taxpayer for purposes of creating a QO Fund is an individual, estate, trust, corporation, or partnership.[xiii] A taxpayer does not have to reside within a QOZ to take advantage of the tax deferral opportunity. Taxpayers have the flexibility to invest in the QOZ of their choice. For example, a California taxpayer can invest capital gains from California or another state into a QO Fund located in another state. The taxpayer must sell the original asset to an unrelated party, and must also sell or exchange the QOZ property to an unrelated party within the meaning of IRC Section 267(b) or 707(b) (determined by substituting "20 percent" for "50 percent"), in order to qualify for the capital gain deferral.[xiv]

Qualified Opportunity Zone Fund

A QO Fund is a U.S. tax entity set up as either a partnership or a corporation. Although not clearly defined in the tax code, whether "a corporation" refers to a C Corporation or an S Corporation requires further guidance from the IRS. The fund must contain QOZ property as 90% of its total assets. This requirement is evaluated after the first six months of the fund's taxable year and on the last day of the taxable year of the fund.[xv] If the fund fails to hold 90% of QOZ property, a penalty of 90% of the funds' aggregate assets is assessed for every month that the fund fails to meet the requirement.[xvi] No penalty shall be imposed if it is shown that such failure is due to reasonable cause.[xvii] To become a QO Fund, an eligible taxpayer must self-certify by completing a form (to be released summer of 2018) and attaches that form to their federal income tax return for the taxable year. The taxpayer's federal income tax return must also be filed timely, taking extensions into account.[xviii]

Qualified Opportunity Zone Property and Qualified Opportunity Zone Business

QOZ Property is defined as either corporate stock, partnership interest, or business property.[xix] Although not clearly defined in the tax code, it can be inferred that "corporate stock" refers to a C Corporation stock rather than an S Corporation stock as the later would result in the QO Fund as an ineligible shareholder. Further guidance from the IRS is required in this area.

QOZ stock is any stock in a domestic corporation located within a QOZ that meets these criteria: (1) the stock is purchased by the QO Fund after December 31, 2017, at its original issue in exchange for cash, (2) when the stock is issued, the corporation is a QOZ Business or is formed with the intent of being a QOZ Business, **and** (3) during substantially all of the fund's holding period of such stock, the corporation is a QOZ Business.[xx]

QOZ Interest is a capital or profits interest in a domestic partnership located within a QOZ that meets these criteria: (1) the interest is purchased by the QO Fund after December 31, 2017, from a partnership in exchange for cash, (2) when the interest is purchased, the partnership is a QOZ Business or is formed with the intent of being a QOZ Business, **and** (3) during substantially all of the fund's holding period of such interest, the partnership is a QOZ Business.[xxi]

QOZ Business Property is tangible property used in a trade or business located within a QOZ that meets these criteria: (1) the business property is purchased (as defined in IRC Section 179(d)(2)) by the QO Fund after December 31, 2017, (2) original use starts with the QO Fund or the fund substantially improves the business property, **and** (3) during substantially all of the fund's holding period of such property, substantially all of the business property is located in a QOZ.[xxii] To meet the "substantial improvement" requirement, the property must be improved within the 30-month period after the date of acquisition by the QO Fund, through increases in basis in the hands of the QO Fund.[xxiii] This allows taxpayers to purchase and rehabilitate used QOZ Business Property without having to meet the original use requirement.

A QOZ Business is a trade or business that meets the following criteria: (1) substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property, (2) at least 50% of total gross income of the QOZ Business comes from an active trade or business, (3) the majority of the intangible property is used in an active trade or business, (4) less than 5% of the average of the aggregate unadjusted bases of the business property of the entity is nonqualified financial property, and (5) the business is not described in I.R.C. Section 144(c)(6)(B).[xxiv]

Businesses described in I.R.C. Section 144(c)(6)(B) that do not qualify under the QO program include: any 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.

Conclusion

This QOZ program can provide both deferrals and permanent tax savings opportunities for taxpayers wishing to fund capital into low-income communities with the intent that these communities might thrive in the future as funds from numerous QO Funds and other investors are deployed in these communities. However, this program is not ideal for risk-averse taxpayers, or taxpayers that may require the funds within the next 10 years. Please note that while I.R.C. Section 1031 transactions are limited to real property[xxv], the QOZ program could prove to be a better alternative as it offers more investment choices and enhanced cash flow flexibility. Therefore, it is highly recommended that taxpayers with any significant gains in the future consider a QOZ as a tax planning option.

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i I.R.C. § 1400Z-1(c)(3)
ii P.L. 115-97, 12/22/2017
iii I.R.C. § 1400Z-2(e)(1)
iv I.R.C. § 1400Z-2(b)(2)(B)(iii)
v I.R.C. § 1400Z-2(b)(2)(B)(iv)
vi I.R.C. § 1400Z-2(c)
vii I.R.C. § 1400Z-1(b)
viii https://www.census.gov/geo/reference/gtc/gtc_ct.html
ix I.R.C. § 45D(e)
x I.R.C. § 1400Z-1(d)(1)
xi I.R.C. § 1400Z-1(d)(2)
xii I.R.C. § 1400Z-1(e)
xiii Not defined in I.R.C. § 1400Z-1 or I.R.C. § 1400Z-2. Assumed to be broadly defined until further I.R.S. guidance is provided.

xiv I.R.C. § 1400Z-2(e)(2)

xv I.R.C. § 1400Z-2(d)(1)

xvi I.R.C. § 1400Z-2(f)(1)

xvii I.R.C. § 1400Z-2(f)(3)

xviii https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

xix I.R.C. § 1400Z-2(d)(2)

xx I.R.C. § 1400Z-2(d)(2)(B)

xxi I.R.C. § 1400Z-2(d)(2)(C)

xxii I.R.C. § 1400Z-2(d)(2)(D)

xxiii I.R.C. § 1400Z-2(d)(2)(D)(ii)

xxiv I.R.C. § 1400Z-2(d)(3)

xxv I.R.C. § 1031(a)(1)