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Opportunity Knocks under Tax Reform

February 19, 2018

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As part of the new tax law, a taxpayer may elect to defer capital gain from the sale or exchange of property by investing in a qualified opportunity zone fund until the earlier of the disposition of the investment or December 31, 2026. A portion of the capital gain from the sale or exchange may be excluded permanently if the investment is held for at least five years. Also, gain from the sale of the investment may be permanently excluded if the investment is held for at least 10 years. This article provides an overview of the new rules for qualified opportunity zone investments.

Capital Gains Deferral Benefit

The recent Tax Act,¹ section 1400Z, provides a deferral in capital gains income for investments in certain funds that invest in active businesses located in low-income areas that are designated as qualified opportunity zones.

Eligible fund investments include investments in stock, partnership interests, or business property (“qualified opportunity zone property”) but only if, during substantially all of the applicable holding period, the corporation, partnership, or business qualified as a “qualified opportunity zone business.”

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¹ P.L. 115-97, 131 Stat. 2054, § 1400Z (2017) (the “Tax Act”).

A qualified opportunity zone business is a trade or business:

- ◆ In which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property;
- ◆ at least 50 percent of the business' total gross income is derived from the active conduct of the trade or business;
- ◆ A substantial portion of the business' intangible property of which is used in the active conduct of the trade or business;
- ◆ In which less than five percent of the average of the aggregate unadjusted bases of its property is attributable to nonqualified financial property; and
- ◆ Which is not a 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.

Qualified opportunity zone business property means any tangible property used in a trade or business if:

- ◆ The property was acquired by the qualified opportunity fund by purchase after 2017;
- ◆ The original use in the qualified opportunity zone commenced with the qualified opportunity fund or the qualified opportunity fund substantially improves the property; and
- ◆ During substantially all of the qualified opportunity fund's holding period, substantially all of the use of the property was in a qualified opportunity zone.

Corporate and partnership investments must be made in cash—i.e., in-kind contributions or promissory notes issued to a qualified opportunity zone business are not qualified investments. Qualified opportunity zone businesses must be acquired by purchase.²

Eligible taxpayers must make their investments in qualified opportunity zone property through a “qualified opportunity fund.” A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in and holding at least 90 percent of its assets in qualified opportunity zone property. It appears that a qualified opportunity fund must be certified in a manner similar to the new markets tax credit (“NMTC”) program, which is currently administered by Treasury’s Community Development Financial Institutions Fund.

² For the definition of “purchase,” see section 179(d)(2) of the Internal Revenue Code of 1986, as amended (the “Code”) and the applicable regulations promulgated pursuant to the Code (the “regulations”).

Failure to meet the 90 percent asset requirement results in a monthly penalty equal to the excess of: (1) an amount equal to 90 percent of gross assets over (2) the aggregate amount of qualified opportunity zone property multiplied by the underpayment rate³ for the month.

Gain Deferral/Exclusion

To take advantage of the new law, first, a taxpayer must sell property to, or exchange property with, an unrelated party⁴ in a transaction that generates capital gains income, and then, within 180 days of the sale, the taxpayer must elect to make an investment in a qualified opportunity fund. Under the provision, the taxpayer's gain on the initial sale is deferred to the extent the gain is invested in a qualified opportunity fund.

The deferred gain is recognized as of the earlier of the date that: (1) the interest in the qualified opportunity fund is sold, or (2) December 31, 2026. The amount of gain included in income is the excess of the lesser of the deferred gain or the fair market value of the investment over the taxpayer's basis in the investment.

The taxpayer's initial basis in a qualified opportunity fund is zero. In the case of an investment held for at least five years, the basis of the investment is increased by 10 percent of the deferred gain. If the investment is held for at least seven years, the basis of the investment is increased an additional five percent of the deferred gain.

If the investment is held for at least 10 years, and, if the taxpayer so elects, the basis of the property is equal to the fair market value of the investment on the date that the investment is sold or exchanged.

Designation of Qualified Opportunity Zones

The Internal Revenue Service (IRS) recently issued guidance under Revenue Procedure 2018-16 outlining the procedures for designating population census tracts as opportunity zones. If a state (defined to include U.S. possessions⁵ and the District of Columbia) wishes to take advantage of this new provision, the chief executive officer of the state may submit to Treasury population census tracts representing no more than 25 percent of the state's census tracts that are qualified low-income communities.⁶

A qualified low-income community has the same definition as under the NMTC rules.⁷

In addition, up to five percent of census tracts that are not qualified low-income communities under the NMTC rules, but are contiguous to a qualified opportunity zone may be designated as a qualified

³ Section 6621(a)(2) of the Code.

⁴ For this purpose, related party status is determined under sections 267(b)/707(b) of the Code, using a greater than 20 percent threshold.

⁵ For Puerto Rico, each population tract that is a low income community is deemed to be certified and designated as a qualified opportunity zone. Section 41115 of the Tax Extender Act of 2017

⁶ Twenty-five may be designated if the state has less than 100 tracts.

⁷ Section 45D(e) of the Code.

opportunity zone if the median family income (“MFI”) does not exceed 125 percent of the MFI of the contiguous opportunity zone.

Under the revenue procedure, each state has until March 21, 2018 (but may request a 30-day extension) to nominate its population census tracts. Once submitted, Treasury has 30 days to consider the nominations for certification and designation. However, the state may request, and receive a 30-day extension of the Secretary’s deadline.

Community Economic Development

In addition to the qualified opportunity zone nomination procedure outlined in Revenue Procedure 2018-16, Treasury must also develop and implement a certification process for qualified opportunity funds.

Once all these procedures are in place, investors will have a new opportunity—in addition to the existing NMTC program—to obtain tax benefits while investing in underserved economic areas of the country that promote economic growth and job creation.

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