HUNTON ANDREWS KURTH

Client Alert

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Investors Should Consider the Benefits of A Qualified Opportunity Zone Investment Authorized by the Tax Cuts and Jobs Act

As a result of changes made to the Internal Revenue Code (the "Code") by the Tax Cuts and Jobs Act, P.L. 115-97, (the "Act"), investors may want to take advantage of benefits provided by "Qualified Opportunity Zones." Investments in Qualified Opportunity Zones may allow investors to (1) defer recognition of capital gains that are reinvested in a "Qualified Opportunity Fund," (2) reduce the amount of deferred gain recognized through an increase in basis, and (3) enjoy exemption from taxation on any appreciation in their Opportunity Zone Fund investment if they meet certain requirements.

Opportunity Zones – Code Section 1400Z-1

New Code section 1400Z-1 authorizes the designation of Qualified Opportunity Zones, which are low-income communities identified and proposed by states and their localities and designated by the Secretary of Treasury (the "Secretary"). Code section 1400Z-1 encourages new long-term investment in these low-income communities.

Designation of Qualified Opportunity Zones. A population census tract that is a low-income community may be nominated as a Qualified Opportunity Zone by a state's governor or a territory's chief executive officer, who then notifies the Secretary of the nomination. The term "low-income community" in this section has the same meaning as it does in the New Markets Tax Credit section 45D(e). If the Secretary then certifies the nomination and designates the tract as a Qualified Opportunity Zone within the consideration period, it becomes a Qualified Opportunity Zone. The Secretary designated the first Qualified Opportunity Zones on April 9, 2018. The current list of approved Qualified Opportunity Zones is found at the following website: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

Special Rules for Capital Gains Invested in Opportunity Zones – Code Section 1400Z-2

Definition of Qualified Opportunity Fund. A Qualified Opportunity Fund is an investment vehicle organized either as a corporation or a partnership for the purpose of investing in "Qualified Opportunity Zone Property". A Qualified Opportunity Fund must hold at least 90% of its assets in Qualified Opportunity Zone Property. Property holdings of the fund are measured "on the last day of the first 6-month period of the taxable year of the fund" and on the last day of the taxable year of the fund. Qualified Opportunity Zone Property includes three types of property:

1. Qualified Opportunity Zone Stock is any stock in a domestic corporation that is a "Qualified Opportunity Zone Business" and was acquired solely in exchange for cash. The corporation must have qualified as a Qualified Opportunity Zone Business for substantially all of the Qualified Opportunity Fund's holding of the stock.

2. Qualified Opportunity Zone Partnership Interest is any capital or profits interest in a domestic partnership that is a Qualified Opportunity Zone Business and was acquired solely in exchange

for cash. The partnership must have qualified as a Qualified Opportunity Zone business for substantially all of the Qualified Opportunity Fund's holding of the interest.

3. Qualified Opportunity Zone Business Property is tangible property used in the trade or business of a Qualified Opportunity Fund. The original use of the property must commence with the Qualified Opportunity Fund or the property must have been substantially improved by the Qualified Opportunity Fund. Substantially all of the use of the property must have been in a Qualified Opportunity Zone during substantially all of the Qualified Opportunity Fund's holding of the property.

A Qualified Opportunity Zone Business is a trade or business that (1) owns or leases substantially all of its tangible property in Qualified Opportunity Zone Business Property, (2) generates at least 50% of its gross income from active business conduct, (3) uses a substantial portion of its intangible property in its business, and (4) has less than 5% of the average of the aggregate unadjusted bases of the property of such entity attributable to nonqualified financial property.

All Qualified Opportunity Zone property must have been acquired after December 31, 2017.
An eligible taxpayer may self-certify as a Qualified Opportunity Fund by completing a form and attaching it to the taxpayer's federal income tax return for the taxable year. The form will be available in the summer of 2018.

Penalties for Violating Investment Standard. If a Qualified Investment Fund does not meet the 90% requirement, it must pay a penalty equal to the product of "(A) the excess of (i) the amount equal to 90% of its aggregate assets, over (ii) the aggregate amount of qualified opportunity zone property held by the fund, multiplied by (B) the underpayment rate" established elsewhere in the Code. If the failure is due to reasonable cause, however, no penalty will be imposed.

Tax Incentives. There are three tax incentives to encourage investment in Qualified Opportunity Funds:

1. An investor may defer income tax on gains from the sale or exchange of capital assets by reinvesting the amount of gain into a Qualified Opportunity Fund within 180 days of the sale or exchange.

2. If the investment in the Qualified Opportunity Fund is held for 5 years, the investor will receive an increase in basis equal to 10% of the deferred gain invested in the fund. If the investment is held for another 2 years, the investor will receive an additional increase in basis equal to 5% of the deferred gain invested in the fund.

3. If the investment in the Qualified Opportunity Fund is held for 10 or more years, the investor will not be taxed on any capital gains resulting from the appreciation of the investment in the Qualified Opportunity Fund.

To illustrate, if an investor realized a gain of $100,000 from the investor sale or exchange of a capital asset and reinvested that money into a Qualified Opportunity Fund within 180 days, the investor would have tax on that $100,000 deferred as long as the investor money remained in a Qualified Opportunity Fund. If the investor left the investment in place for 5 years, the investor would receive a $10,000 increase in basis, which would be excluded from income tax if the investor chose to recognize the deferred gain. If the investor left the investment in place for an additional 2 years, the investor would receive an additional $5,000 increase in basis, amounting to a total of $15,000 excluded from income tax if the investor chose to recognize the deferred gain. If the investor left the investment in place for an additional 5 years, a total of 10 years, the investor would avoid capital gains tax on any appreciation in the $100,000 from the investor Qualified Opportunity Zone investment in addition to the $15,000 increase in basis. Therefore, after 10 years, the investor would be paying tax only on $85,000.

Timeline. Effective on December 22, 2017, the tax incentives provided in Code sections 1400Z-1 and 1400Z-2 will remain in effect until December 31, 2026. Gain recognized before December 22, 2017 may still qualify under this section, providing it was reinvested into a Qualified Opportunity Fund within 180 days. Deferred gain from reinvestments in Qualified Opportunity Funds that have not been sold or exchanged will be recognized on December 31, 2026, in the amount generally of the investor lesser of (1) the deferred capital gain or (2) the fair market value of the investment. Thus, investors who wish to qualify for the full 15% increase in basis must invest in a Qualified Opportunity Fund by 2019.

Rules and Regulations. The Treasury Department and the Internal Revenue Service anticipate promulgating rules and regulations in connection with the Qualified Opportunity Zone incentives in early fall 2018.

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