The Tax Cuts and Jobs Act of 2017 - Qualified Opportunity Zones

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Enacted in December 2017, the Tax Cuts and Jobs Act of 2017 (the "TCJA") contains a provision that incentivizes long-term investments in economically distressed areas designated as Opportunity Zones ("OZ").

The TCJA added §1400Z to the Internal Revenue Code (the "IRC"), which provides for the deferral of capital gains tax, a step-up in basis, and possible permanent exclusion of capital gains realized from Qualified Opportunity Fund ("QOF") investments. As a condition to receiving these incentives, IRC §1400Z establishes 5, 7 and 10-year holding milestones.

New York State designated 514 census tracts as OZ, of which 208 are located in Upstate New York. A full listing of those OZ can be found at: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

The Qualifying Fund and Business

A QOF is an investment vehicle which is organized as a corporation or a partnership for the purpose of investing at least 90% of its assets in "Qualified Opportunity Zone Property". The IRS indicates that a QOF may self-certify by completing a form to be released by the IRS and attaching it to the QOF's tax return.[1]

Qualified Opportunity Zone Property is defined as:

i) qualified opportunity zone stock;
ii) qualified opportunity zone partnership interest; or
iii) qualified opportunity zone business property.

"Qualified Opportunity Zone Business Property" is tangible property acquired by the QOF after December 31, 2017, used in a trade or business of the QOF, and located in an OZ. In addition, the original use of the property must commence with the QOF investment, or the QOF must substantially improve the property within 30 months of acquisition.

"Qualified Opportunity Zone Stock" or "Qualified Opportunity Zone Partnership Interests" means an interest acquired solely for cash after December 31, 2017, in a "Qualified Opportunity Zone Business" which is defined as a trade or business in which: (i) substantially all of the tangible property owned or leased by the taxpayer is located in a qualified Opportunity Zone; (ii) at least 50% of the business's total gross income is derived from the active conduct of such business within a qualified Opportunity Zone; (iii) less than 5% of the average of the aggregate unadjusted bases of the business's property must be attributable to nonqualified financial property; and (iv) a substantial portion of the taxpayer's intangible property is used in the active conduct of the business. A Qualified Opportunity Zone Business must be qualified for the entire holding period of the investment.

IRC §1400Z excludes from the definition of a Qualified Opportunity Zone Business 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.

[1] *See* FAQs released by the IRS (https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions).

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How it Works and the Tax Benefits for Investors

The tax benefits that may be realized by investing in QOF increase the longer the investment is held.

Deferral of Capital Gains Tax

An investor can exclude from gross income the capital gain realized on any third-party sale or exchange of property provided that such gain is reinvested in a QOF within 180 days of the sale or exchange. Under IRC §1400Z, an investor can defer the inclusion of the capital gain in its gross income until the earlier of: (i) the date on which such investment is sold or exchanged; or (ii) December 31, 2026.

If the investor holds the QOF investment for five (5) years, the investor will benefit from a ten percent (10%) step-up in the basis of its investment. If the investment is held for seven (7) years, the investor will benefit from an additional five percent (5%) step-up in basis. The investor has to report the applicable capital gain in year 2026 (resulting in a tax on 90% of the capital gain if held for five years but only 85% if held for seven years).

Exclusion of Capital Gains on Investment

An investment in the QOF for at least ten (10) years will also allow the investor to step-up his tax basis for the investment to fair market value and thus exclude income from any capital gains realized from the QOF investment.

Several questions remain with regard to the implementation of IRC §1400Z. For example, it is unclear whether the basis of an investment held for more than 10 years is fixed at the year 10 fair market value or stepped-up to the fair market value when the investment is sold or exchanged. The IRS is expected to issue further guidance that will address many unanswered questions and provide the framework for implementation of IRC §1400Z.

Conclusion

We consider this new OZ legislation another significant tax incentive for developers, municipalities and investors. We will continue to monitor the further guidance expected from the IRS on this opportunity and issue follow-up Alerts on potential strategies to take advantage of this new legislation.

Bousquet Holstein Public Finance Practice Group

The team of professionals in the Bousquet Holstein Public Finance Group has broad and deep experience assisting our clients in delivering and taking advantage of tax incentives offered by the Internal Revenue Code and New York State law to encourage and support projects that serve the public, promote economic development and advance charitable and public purposes. These incentives include tax-exempt bonds, tax credits and the abatement of real property, sales and use and mortgage recording taxes. If we can provide you with additional insight and information regarding changes to the law please contact:

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