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CLIENT ALERT

Opportunity Zones: A New Tool for Community Development

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In signing H.R. 1 (the "Act") into law on December 22, 2017, President Trump created a new tool for community development – a tool that provides tax incentives to help unlock investor capital to fund businesses in underserved communities.

The Benefits – Gain Deferral and Exclusion

In short, the Act allows investors to defer (up to 9 years) paying tax on gains if those gains are invested in Qualified Opportunity Funds that in turn invest in economically distressed communities designated by the governor. To qualify, the gain must be invested in the Qualified Opportunity Fund during a 180-day period that begins on the date of the sale or exchange that generated the gain. The deferral is temporary, as the Act requires the gain be recognized on the earlier of December 31, 2026, or the date the investment in the Opportunity Fund is sold or exchanged. The amount of gain includible is the lesser of the amount of gain originally deferred, or the excess of the fair market value of the investment over the taxpayer's basis in the investment.

In addition to the up to 9-year deferral of gain, the provision incentivizes long-term investment by allowing for a modest step-up in basis for investments that are held beyond five and seven years. For investment held at least five years, the taxpayer's basis is increased by 10 percent of the original gain. For investments held for at least seven years, the taxpayer's basis is increased by 5 percent of the original gain.

Furthermore, as an additional incentive to make long-term, patient capital investments, taxpayer's holding Opportunity Fund investments for a period of at least 10 years are exempt from any additional gains beyond that which was previously deferred.

Opportunity Funds

Opportunity Funds can be organized in various ways to raise capital from a wide array of investors. Opportunity Funds must be certified by U.S. Department of the Treasury and are required to hold at least 90 percent of their assets in qualified opportunity zone businesses and/or business property. If an Opportunity Fund fails to meet the 90 percent requirement, then the fund must pay a penalty for each month it fails to meet the investment requirement. The penalty equals the amount of the short fall, times the underpayment rate under Section 6621(a)(2), which is currently 6 percent.

Opportunity Zones

The Act uses the same definition of a "Low-Income Community" that is used by the new markets tax credit (NMTC) as the basis for defining an Opportunity Zone. The Act generally allows for 25 percent of a state's low-income community population census tracts to be designated as qualified Opportunity Zones. Governors are responsible for identifying the areas in their states to be designated as Opportunity Zones and generally have 90 days from enactment to do so.

The Opportunity Zones incentive is a complementary tool to the new markets tax credit. While both incentives help bring needed private capital to low-income communities, they differ in important ways and don't represent duplicative forms of investment. The Opportunity Zones incentive offers a shallower subsidy per investment but the total amount of investments qualifying for the subsidy are not limited by annual allocation amounts. As such the Opportunity Zone incentive has the potential to incentivize the deployment of substantially more capital than the NMTC.

Also, each state is given equal authority to designate a similar number of qualified opportunity zones, ensuring that each state can incentivize private capital to areas they identify. While NMTC can still bring investment to low-income areas outside Opportunity Zones, the limited NMTC annual allocations mean that many low-income communities don't receive any private capital through the NMTC.

It is also worth noting that the two incentives bring different sources of capital: equity in the case of Opportunity Zones and mostly debt in the case of NMTC.
Enactment of the Opportunity Zone incentive is the result of years of bipartisan and bicameral effort by its lead advocates Senators Tim Scott (R-S.C.) and Cory Booker (D-N.J.), and Representatives Pat Tiberi (R-Ohio) and Ron Kind (D-Wis.). Considering the record highs in the stock market that have resulted in trillions of dollars in unrealized capital gains, this new provision could draw significant investment to low-income communities, many of which are underserved by traditional sources of capital for community development.

Next Steps

There are two very important next steps for implementation. First, Governors must identify the low-income areas in their states that will be designated as Opportunity Zones. Second, the Treasury Department must develop the rules that determine how Qualified Opportunity Funds are certified, and then certify those funds meeting the criteria. Once these two steps are taken, capital can begin to flow.

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