

¶145 Qualified Opportunity Zones and Treatment of Capital Gain Reinvested in Qualified Opportunity Zones

NEW LAW EXPLAINED

Creation of qualified opportunity zones.—A population census tract that is a low-income community, as defined for purposes of the new markets tax credit under Code Sec. 45D may be designated as a qualified opportunity zone (Code Sec. 1400Z-1(a) and (c)(1), as added by the Tax Cuts and Jobs Act).

The chief executive officer of a state may nominate a low-income community for this designation by notifying the Secretary of Treasury in writing by March 22, 2018 (i.e., the determination period). The Secretary must certify the nomination within 30 days of receiving the nomination (i.e., the consideration period). The chief executive officer may request a 30-day extension of either the determination period or the consideration period, or both (Code Sec. 1400Z-1(b)(2), as added by the 2017 Tax Cuts Act).

For purposes of this provision, a "state" includes any U.S. possession and a "chief executive officer" generally refers to a state's governor, but also includes the mayor of the District of Columbia (Code Sec. 1400Z-1(c)(3), as added by the 2017 Tax Cuts Act; Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Number of designations. The number of population census tracts designated as qualified opportunity zones in a state may not exceed 25 percent of the low-income communities in that state (Code Sec. 1400Z-1(d)(1), as added by the 2017 Tax Cuts Act). However, if there are less than 100 low-income communities in a state, 25 population census tracts may be designated (Code Sec. 1400Z-1(d)(2), as added by the 2017 Tax Cuts Act).

Contiguous tract designation. A population census tract that is not a low-income community may still be designated as qualified opportunity zones if the tract is contiguous to a low-income community that is designated as a qualified opportunity zone and the median family income of the tract does not exceed 125 percent of the contiguous qualified opportunity zone (Code Sec. 1400Z-1(e), as added by the 2017 Tax Cuts Act). This contiguous tract designation is limited to no more than five percent of the qualified opportunity zones in the state (Code Sec. 1400Z-1(e)(2), as added by the 2017 Tax Cuts Act).

Period of designation. The designation as a qualified opportunity zone remains in effect through the end of the 10th calendar year beginning on or after the date of designation (Code Sec. 1400Z-1(f), as added by the 2017 Tax Cuts Act).

Exclusion of gain reinvested in qualified opportunity fund.—A taxpayer may elect to exclude from gross income, gain on the sale or exchange of any property to an unrelated party in the tax year of the sale or exchange if the gain is reinvested in a qualified opportunity zone within 180 days of the sale or exchange (Code Sec. 1400Z-2(a)(1)(A), as added by the 2017 Tax Cuts Act). The amount of gain that can be excluded is equal to the amount of gain invested in the qualified opportunity fund (Code Sec. 1400Z-2(a)(1)(B), as added by the 2017 Tax Cuts Act). Only one election may be made with respect to a sale or exchange (Code Sec. 1400Z-2(a)(2), as added by the 2017 Tax Cuts Act).

CAUTION

No election may be made for any sale or exchange after December 31, 2026.

Deferral of gain. The election allows the taxpayer to defer including the gain in the taxpayer's gross income until the tax year in which:

- the investment is sold or exchanged, or
- December 31, 2026, whichever is earlier (Code Sec. 1400Z-2(b)(1), as added by the 2017 Tax Cuts Act).

If deferred gain is recognized on December 31, 2026 before the fund investment is sold, the recognized gain increases the basis in the fund for purposes of determining any gain that will be recognized on a subsequent sale (Code Sec. 1400Z-2(b)(2)(B)(ii), as added by the 2017 Tax Cuts Act).

CAUTION

The reference in Code Sec. 1400Z-2(b)(2)(B)(ii) to increasing basis by the gain recognized by reason of Code Sec. 1400Z-2(a)(1)(B) was apparently intended to be to Code Sec. 1400Z-2(b)(1)(B), relating to the mandatory December 31, 2026 recognition date.

The amount of gain the taxpayer must include is the excess of:

- the amount of gain excluded or the fair market value of the property on the date of the sale or exchange, whichever is less, over
- the taxpayer's basis in the investment (Code Sec. 1400Z-2(b)(2)(A), as added by the 2017 Tax Cuts Act).

Determination of basis. For purposes of determining the amount of deferred gain that is recognized, the taxpayer's basis in the investment is treated as zero (Code Sec. 1400Z-2(b)(2)(B)(i), as added by the 2017 Tax Cuts Act). However, the longer the taxpayer holds the investment, the more his or her basis in the investment is increased. If an investment is held:

- for at least 5 years, the zero basis is increased by 10 percent of the gain originally deferred (Code Sec. 1400Z-2(b)(2)(B)(iii), as added by the 2017 Tax Cuts Act), and
- for at least 7 years, basis is increased by 5 percent of the gain originally deferred, in addition to the amount of basis increase for investments held for at least 5 years (Code Sec. 1400Z-2(b)(2)(B)(iv), as added by the 2017 Tax Cuts Act).

COMMENT

If the qualified opportunity fund is sold before 5 years, the basis is \$0 for purpose of determining the recognized deferred gain and the entire deferred gain is recognized. If the fund is held at least 5 years but less than 7 years, the \$0 dollar basis is increased by 10 percent of the deferred gain and 90 percent of the deferred gain is recognized if the fund is sold. If the fund is held at least 7 years but less than 10 years before it is sold the \$0 basis is increased by 15 percent of the investment and 85 percent of the deferred gain is recognized. The deferred gain will be recognized as income on December 31, 2026, if the fund has not been sold by that date, determined by increasing the \$0 basis by 5 percent if the fund was held at least 5 years but less than 7 years and by 15% if the fund was held at least 7 years.

If the value of the fund investment has decreased on the date it is sold or, if earlier, on the mandatory December 31, 2026 recognition date, a taxpayer determines the amount of deferred gain that is recognized by reference to the fair market value on the date of sale or the earlier December 31, 2026 recognition date (Code Sec. 1400Z-2(b)(2)(A), as added by the 2017 Tax Cuts Act). For this purpose, basis is also considered \$0 and is increased as described above if the fund investment has been held at least 5 years.

Finally, if the investment in the qualified opportunity fund is held for at least 10 years a taxpayer may elect to treat the basis on the date of sale as the fair market value of the qualified opportunity fund on the date of its sale or exchange. Consequently, if the value of the fund has increased beyond the initial amount of invested deferred gain and the election is made gain on the appreciation in the fund is not recognized (Code Sec. 1400Z-2(c), as added by the Tax Cuts Act).

EXAMPLE

On January 2, 2018, ABC Corp sells property to an unrelated party and has a resulting gain of \$1 million, which ABC Corp then reinvests in InvestFund, a qualified opportunity fund, on March 30, 2018. ABC Corp sells its investment in InvestFund on April 2, 2021 for \$1,500,000. Since ABC Corp held its investment in InvestFund for under 5 years, its basis in the investment is \$0. In its 2021 tax year, ABC Corp must recognize the deferred gain of \$1 million as well as the \$500,000 in appreciation.

EXAMPLE

Assume same facts as Example above, except that ABC Corp sells the investment in 2025. Since the investment is held for more than 7 years, ABC Corp's basis increases from \$0 to \$150,000, thus reducing the amount of deferred gain it must include to \$850,000 (\$1,000,000 - \$150,000). The additional \$500,000 in appreciation must also be recognized.

10% of deferred gain --	\$100,000
5% of deferred gain --	\$50,000
	\$150,000

At the election of a taxpayer, a taxpayer's basis in an investment held for at least 10 years is equal to the fair market value of the property on the date of sale or exchange (Code Sec. 1400Z-2(c), as added by the 2017 Tax Cuts Act).

EXAMPLE

ABC invests \$1 million of deferred gain in a qualified opportunity fund on January 1, 2025. On December 31, 2026, ABC must recognize the entire \$1 million deferred gain (\$1 million deferred gain less \$0 basis) even though the investment in the fund has not been sold. The \$0 basis in the investment is not increased because ABC has not owned the fund for at least 5 years. On January 1, 2037, ABC sells its interest in the fund for \$1.5 million. Since ABC has held the investment for 10 or more years, it may elect to treat the basis as \$1.5 million and no additional gain is recognized. If ABC does not make the election, its basis is considered to be \$1 million (under the provision deferred gain that was previously recognized on December 31, 2026 increases basis) and \$500,000 gain is recognized.

EXAMPLE

Assuming the preceding facts except that the value of the fund has decreased to \$400,000. Here ABC will not make the fair market value election, and recognizes a \$600,000 loss (\$400,000 less \$1,000,000 previously recognized gain).

Mixed investment. If a taxpayer pays more for a qualified fund than the gain from a sale or exchange that it wishes to defer under this provision, the investment in the qualified opportunity fund is treated as two separate investments. The deferral rules would only apply to the investment with respect to the gain which is deferred (Code Sec. 1400Z-2(e)(1), as added by the Tax Cuts Act).

COMMENT

The creation of qualified opportunity zones is intended to spur investment in low-income communities by allowing taxpayers to defer gain from the sale of any asset by reinvesting that gain in a qualified opportunity fund. To encourage long-term investment, taxpayers may exclude appreciation (post-acquisition gain) in the fund if they retain the investment for at least 10 years. The maximum amount of initially deferred gain (i.e., the original investment in the fund) that can totally escape taxation is 15 percent if the fund is held at least 7 years.

Qualified opportunity fund. A qualified opportunity fund is a corporation or partnership organized for the purpose of investing in qualified opportunity zone property that holds at least 90 percent of its assets in such property (Code Sec. 1400Z-2(d)(1), as added by the 2017 Tax Cuts Act) The determination of the 90-percent requirement is the average of the percentage of qualified zone property held by the fund on the last day of the first 6-month period of the fund's tax year and on the last day of the fund's tax year.

Qualified opportunity zone property is:

- qualified opportunity zone stock,
- qualified opportunity zone partnership interest, or
- qualified opportunity zone business property (Code Sec. 1400Z-2(d)(2), as added by the 2017 Tax Cuts Act).

Qualified opportunity zone stock is original issue stock in a domestic corporation acquired after December 31, 2017, solely in exchange for cash (Code Sec. 1400Z-2(d)(2)(B), as added by the 2017 Tax Cuts Act). The corporation must be a qualified opportunity zone business at the time of issue (or was being organized as such if a new corporation) and for substantially all the fund's holding period. The qualified small business stock redemption rules of Code Sec. 1202(c)(3) apply to qualified opportunity zone stock (Code Sec. 1400Z-2(d)(2)(B)(ii), as added by the 2017 Tax Cuts Act).

A qualified opportunity zone partnership interest is any capital or profits interest in a domestic partnership acquired after December 31, 2017, from the partnership solely in exchange for cash (Code Sec. 1400Z-2(d)(2)(C), as added by the 2017 Tax Cuts Act). The partnership must be a qualified opportunity zone business at the time of acquisition (or was being organized as such if a new partnership) and for substantially all the fund's holding period.

Qualified opportunity zone business property is tangible property used in a trade or business of the qualified opportunity fund, if:

- purchased, as defined in Code Sec. 179(d)(2), by the qualified opportunity fund after December 31, 2017,
- originally used or substantially improved by the qualified opportunity fund, and
- used in a qualified opportunity zone during substantially all of the qualified opportunity fund's holding period (Code Sec. 1400Z-2(d)(2)(D)(i), as added by the 2017 Tax Cuts Act).

The related party rules of Code Sec. 179(d)(8) apply (Code Sec. 1400Z-2(d)(2)(D)(iii), as added by the 2017 Tax Cuts Act).

CAUTION

The reference in Code Sec. 1400Z-2(d)(2)(D)(iii) to the related party rules applying to qualified opportunity zone stock Code Sec. 1400Z-2(d)(2)(A)(i) was apparently intended to be to Code Sec. 1400Z-2(d)(2)(D)(i)(I), relating to the definition of purchase for the purposes of qualified opportunity zone business property.

Property is considered to be substantially improved if, during the 30-month period beginning after the date of acquisition, additions to basis with respect to the property in the hands of the qualified opportunity fund exceed its adjusted basis at the beginning the 30-month period (Code Sec. 1400Z-2(d)(2)(D)(ii), as added by the 2017 Tax Cuts Act).

CAUTION

The reference in Code Sec. 1400Z-2(d)(2)(D)(ii) to determining substantial improvement for purposes of a qualified opportunity zone partnership interest Code Sec. 1400Z-2(d)(2)(A)(ii) was apparently intended to be to Code Sec. 1400Z-2(d)(2)(D)(i)(II), relating to substantial improvement of the qualified opportunity zone business property by the qualified opportunity fund.

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 (Code Sec. 1400Z-2(d)(3)(A), as added by the Tax Cuts and Jobs Act of 2017). For this purpose, qualified opportunity zone business property is determined in the same manner as under Code Sec. 1400Z-2(d)(2)(D), except that the term "qualified opportunity business" is substituted for "qualified opportunity fund." The business must also satisfy the requirements as an enterprise zone business under Code Sec. 1397C (2), (4) and (8), but not as a qualified redevelopment bond under Code Sec. 144(c)(6)(B) (Code Sec. 1400Z-2(d)(3)(A)(ii) and (iii), as added by the 2017 Tax Cuts Act).

If tangible property ceases to be qualified opportunity zone business property, it will continue to be treated as such for the lesser of (a) five years after the date it ceases to be qualified opportunity zone business property or (b) the date it is no longer held by a qualified opportunity zone business (Code Sec. 1400Z-2(d)(3)(B), as added by the 2017 Tax Cuts Act).

Failure to maintain 90-percent Investment Standard. A qualified opportunity fund must pay a penalty for each month it fails to hold at least 90 percent of its assets in qualified opportunity zone property (Code Sec. 1400Z-2(f)(1), as added by the 2017 Tax Cuts Act), unless the failure is due to reasonable cause (Code Sec. 1400Z-2(f)(3), as added by the 2017 Tax Cuts Act). The amount of the penalty is the:

- excess of 90 percent of its aggregated assets over the aggregate amount of qualified opportunity property held,
- multiplied by the underpayment rate under Code Sec. 6621(a)(2) for that month.

A qualified opportunity fund that is organized as a partnership must proportionally take the penalty into account as part of each partners' distributive share (Code Sec. 1400Z-2(f)(2), as added by the 2017 Tax Cuts Act).

EXAMPLE

Ninety percent of all assets of BuildFund Partnership, a qualified opportunity zone fund, is qualified opportunity property. The assets cease to be qualified opportunity property as of May 15, 2020. BuildFund must pay a penalty for each month that more than 10 percent of the total amount of its assets are not qualified opportunity fund property. For example, assume BuildFund had total assets worth \$1 million, 80% of which were qualified opportunity property for a six-month period before once again meeting the 90 percent threshold. Assuming an underpayment penalty for those months of 4%, BuildFund must pay a penalty of \$4,000 (\$900,000 - \$800,000 x 4%) each month for 6 months.

Applicable rules. For purposes of Code Sec. 1400Z-2, persons are treated as related if they meet the definition under Code Sec. 267(b) or Code Sec. 707(b)(1), except that direct or indirect ownership limitation in the outstanding stock of the corporation or capital interest or profit interest in the partnership is "20 percent" rather than "50 percent" (Code Sec. 1400Z-2(e)(2), as added by the 2017 Tax Cuts Act).

If the taxpayer is a decedent and the inclusion of the deferred gain is not properly included in his or her gross income, the amount is to be included in the gross income of the estate under Code Sec. 691 (Code Sec. 1400Z-2(e)(3), as added by the 2017 Tax Cuts Act).

The IRS is authorized to issue regulations to carry out the purposes of Code Sec. 1400Z-2, including rules:

- for certification of qualified opportunity funds,
- to ensure qualified opportunity funds have reasonable time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and reinvest proceeds from the disposition of qualified opportunity zone property, and
- to prevent abuse (Code Sec. 1400Z-2(e)(4), as added by the 2017 Tax Cuts Act).

COMMENT

The certification process for a qualified opportunity fund will be done by the Community Development Financial Institutions Fund (CDFI Fund) in a similar manner to the process in place for allocating the new markets tax credit (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

COMMENT

Beginning December 22, 2022, the IRS, or its delegate, must submit an annual report to Congress on the opportunity zone incentives. The report is to include: (a) an assessment of investments held by the qualified opportunity fund at both the national and state level; (b) the number of qualified opportunity funds; (c) the amount of assets held by class; (d) the percentage of qualified opportunity zone census tracts designated that received qualified opportunity fund investments; and (e) an assessment of impact of the investments on economic indicators such as job creation, poverty reduction and new businesses (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Effective date. This provision is applicable on December 22, 2017, the date of enactment (Act Sec. 13823(d) of the Tax Cuts and Jobs Act).