Change in Tax Law Provides Window of Opportunity to Investors

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Under newly enacted Section 1400Z of the Internal Revenue Code of 1986 (the "***Code***"), beginning on December 22, 2017, taxpayers may defer, and in some cases partially eliminate, capital gains by making certain investments in "qualified opportunity zones." A qualified opportunity zone is a "population census tract" in a state designated low-income community. Moreover, an investor that holds its interest in this investment for at least 10 years will not be subject to tax on its gain from the sale or exchange of the investment.

Who can take advantage of this opportunity?

All taxpayers with capital gain, may take advantage of this tax deferral/partial elimination opportunity. To take advantage of this opportunity, a taxpayer must satisfy the following three requirements.

First, the taxpayer must have capital gain from a sale of property to, or exchange with, an unrelated person ("***Sale Gain***"). The determination as to whether a sale or exchange is with an unrelated person is made under complex related party rules of the Code, which will not be detailed here but, very generally, parties are related if one owns 20 percent or more of the other, or there is 20 percent or more common ownership.

Second, the taxpayer must reinvest the Sale Gain in a "qualified opportunity fund" (described below) during the 180-day period beginning on the date of the sale or exchange.

Third, the taxpayer must elect to have this Code section (Section 1400Z) apply. Currently, it is not clear how to make the election. However, an IRS "frequently asked questions" publication ("***IRS FAQ***") states that a taxpayer with gain from a sale of stock at the end of 2017, that invested in a qualified opportunity fund within the 180-day period, may make the deferral election on its 2017 federal income tax return. The IRS FAQ notes that information about the sale of the stock is required to be included in the 2017 tax return using IRS Form 8949. Finally, the IRS FAQ notes that precise instructions on how to elect deferral of the gain on the 2017 tax return will be forthcoming shortly. These instructions have yet to be issued.

What are the benefits to the taxpayer/investor?

1. Deferral of sale gain

First, the Sale Gain is deferred up to the amount of gain invested by the taxpayer in the qualified opportunity fund. The Sale Gain is deferred until the earlier of (A) the date the taxpayer sells or exchanges its qualified opportunity fund interest or (B) December 31, 2026. Therefore, a calendar-year taxpayer that sells property in 2018 and defers its Sale Gain by investing in a qualified opportunity fund can achieve a maximum of eight tax years of deferral (2018 through 2025) by holding its qualified opportunity fund interest through 2026. Note that because December 31, 2026

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is a fixed date, an investor that is a calendar year taxpayer that sells property in 2019 and defers its Sale Gain can achieve a maximum of only seven tax years of deferral (2019 through 2025). The Sale Gain is preserved for tax purposes by giving the investor an initial basis of zero in its qualified opportunity fund interest.

2. Elimination of up to 15 percent of sale gain

Second, if the investor holds its qualified opportunity fund interest for at least five years, 10 percent of the deferred Sale Gain is permanently eliminated. Furthermore, if the investor holds its qualified opportunity fund interest for at least seven years, an additional five percent of the original deferred Sale Gain is permanently eliminated, for a total elimination of fifteen percent of the deferred Sale Gain. Mechanically, the Code accomplishes this result by increasing the investor's initial basis of zero in the qualified opportunity fund interest by 10 percent of the deferred Sale Gain at five years and by an additional five percent of the original deferred Sale Gain at seven years.

Note that because Sale Gain cannot be deferred past December 31, 2026, there will come a time when it is no longer possible to hold the interest for seven years or five years, respectively, before the Sale Gain must be included. Absent a legislative amendment, this elimination of gain provision will sunset itself.

> **Example 1:** A taxpayer has a capital gain of $100 from a sale of property to an unrelated person, invests $100 within 180 days in a qualified opportunity fund, makes the appropriate election on its federal income tax return, and has an initial basis of zero in its qualified opportunity fund interest. If the taxpayer holds its qualified opportunity fund interest for five years, its basis in the qualified opportunity fund interest increases by $10, and if the taxpayer holds its qualified opportunity fund interest for a total of seven years, its basis in the qualified opportunity fund interest increases by an additional $5, for a total basis increase of $15. Therefore, if the taxpayer later disposes of the qualified opportunity fund Interest, the taxpayer includes only $85 of the $100 original deferred Sale Gain in its federal income tax return, assuming there have been no other adjustments to basis and the fair market value of the qualified opportunity fund interest is at least $100.

3. Elimination of gain from post-acquisition appreciation

Third, if the taxpayer holds the qualified opportunity fund interest for at least 10 years and makes an election under section 1400Z-2(c), the taxpayer excludes from its income all post-acquisition appreciation from the qualified opportunity fund interest and its basis in this interest is increased to equal its fair market value on the date the qualified opportunity fund interest is eventually sold or exchanged.

> **Example 2:** Same as Example 1, plus the investor holds the qualified opportunity fund interest for a total of at least 10 years and makes an election under section 1400Z-2(c). The investor then sells the interest for $120, and the investor's $100 basis in the qualified opportunity fund interest is increased to $120. Therefore, the investor pays no tax on the appreciation in value of the qualified opportunity fund interest (*i.e.*, the difference between $120 and $100).

What is a qualified opportunity fund?

A qualified opportunity fund is any investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property, other than another qualified

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opportunity fund (this is intended to exclude “funds of funds”). At least 90 percent of the assets of a qualified opportunity fund must be “qualified opportunity zone property.”

According to the IRS FAQ, an eligible corporation or partnership may certify itself as a qualified opportunity fund. No approval or action by the IRS is required. To certify itself, the eligible corporation or partnership completes a form and attaches the form to its timely filed federal income tax return for the taxable year. The IRS FAQ states that the election form will be released in the summer of 2018 but the form has not yet been released.

What is qualified opportunity zone property?

1. Qualified opportunity zone stock

Qualified opportunity zone stock is any stock in a domestic corporation if (A) the qualified opportunity fund acquires the stock after December 31, 2017 at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash, (B) at the time the stock is issued, the corporation is a “qualified opportunity zone business” (described below), or in the case of a new corporation, the corporation is being organized for purposes of being a qualified opportunity zone business, and (C) during substantially all of the qualified opportunity fund’s holding period for the stock, the corporation qualifies as a qualified opportunity zone business.

2. Qualified opportunity zone partnership interest

A qualified opportunity zone partnership interest is any capital or profits interest in a domestic partnership if (A) the qualified opportunity fund acquires the interest after December 31, 2017 from the partnership solely in exchange for cash, (B) as of the time the interest is acquired, the partnership is a qualified opportunity zone business (or, in the case of a new partnership, such partnership is being organized for purposes of being a qualified opportunity zone business) and (C) during substantially all of the qualified opportunity fund’s holding period of the interest, the partnership qualifies as a qualified opportunity zone business.

3. Qualified opportunity zone business property

Qualified opportunity zone business property is tangible property used in a trade or business of a qualified opportunity fund if (A) the qualified opportunity fund acquires the property by purchase after December 31, 2017, (B)(i) the original use of the property in the qualified opportunity zone commences with the qualified opportunity fund, or (ii) the qualified opportunity fund substantially improves the property, and (C) during substantially all of the qualified opportunity fund’s holding period for the property, substantially all of the use of such property is in a qualified opportunity zone.

Property is treated as substantially improved by the qualified opportunity fund only if, during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of the 30-month period in the hands of the qualified opportunity fund.

> **Example 3:** On June 1, 2018, a qualified opportunity fund purchases an existing office building in an opportunity zone for $100 and continues to lease space in the office building to the historic tenants. Because the office building was already in use when the qualified opportunity fund acquired it, the original use of the office building in the qualified opportunity zone did not commence with the qualified opportunity fund. However, the office building still

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can satisfy the definition of qualified opportunity zone business property if the qualified opportunity fund “substantially improves” the property by making improvements to the office building that increase the adjusted basis of the office building in the hands of the qualified opportunity fund to more than $200 over a 30-month period.

What is a qualified opportunity zone business?

A qualified opportunity zone business is a trade or business in which (A) substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property, (B) at least 50 percent of the income of the entity is derived from the active conduct of the business, (C) a substantial portion of the intangible property of the entity is used in the active conduct of the business, and (D) less than five percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to nonqualified financial property. A qualified opportunity zone business cannot be 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.

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