Qualified Opportunity Funds: A Win-Win Situation

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An exciting economic development incentive program buried in the Tax Cut and Jobs Act of 2017 is gaining more and more attention in recent weeks due to certain economically distressed census tracts being nominated by states and approved by the Department of Treasury as Qualified Opportunity Zones (QO Zones). Congress created the program, based primarily on the white paper from Economic Investment Group's Sean Parker (of Facebook, Napster, and Plaxo), to encourage private investments in QO Zones. Although one in six Americans live in these types of communities, this is the first federal tax incentive program in over a decade specifically designed to assist low-income communities.

To qualify for the program's tax benefits, a taxpayer would dispose of an appreciated capital asset (short-term or long-term), and then within 180 days, reinvest the capital gain proceeds arising from such disposition into a Qualified Opportunity Fund (QO Fund). The QO Fund would then, in turn, invest in one or more QO Zone investments. Importantly, there is no maximum amount of capital gain that a taxpayer can invest in a QO Fund, and the disposed capital asset does not need to be connected in any way to a QO Zone.

There are three major tax incentives to investing in a QO Fund. An investor may, if certain requirements are satisfied, be eligible to:

1. Temporarily defer the recognition of capital gain for tax purposes until the earlier of the date the taxpayer sells its QO Fund investment or December 31, 2026;
2. Permanently exclude up to 15 percent of the original capital gain invested in the QO Fund from taxation; and
3. Permanently exclude capital gain taxes attributable to the appreciation of the QO Fund investment at the time of exit.

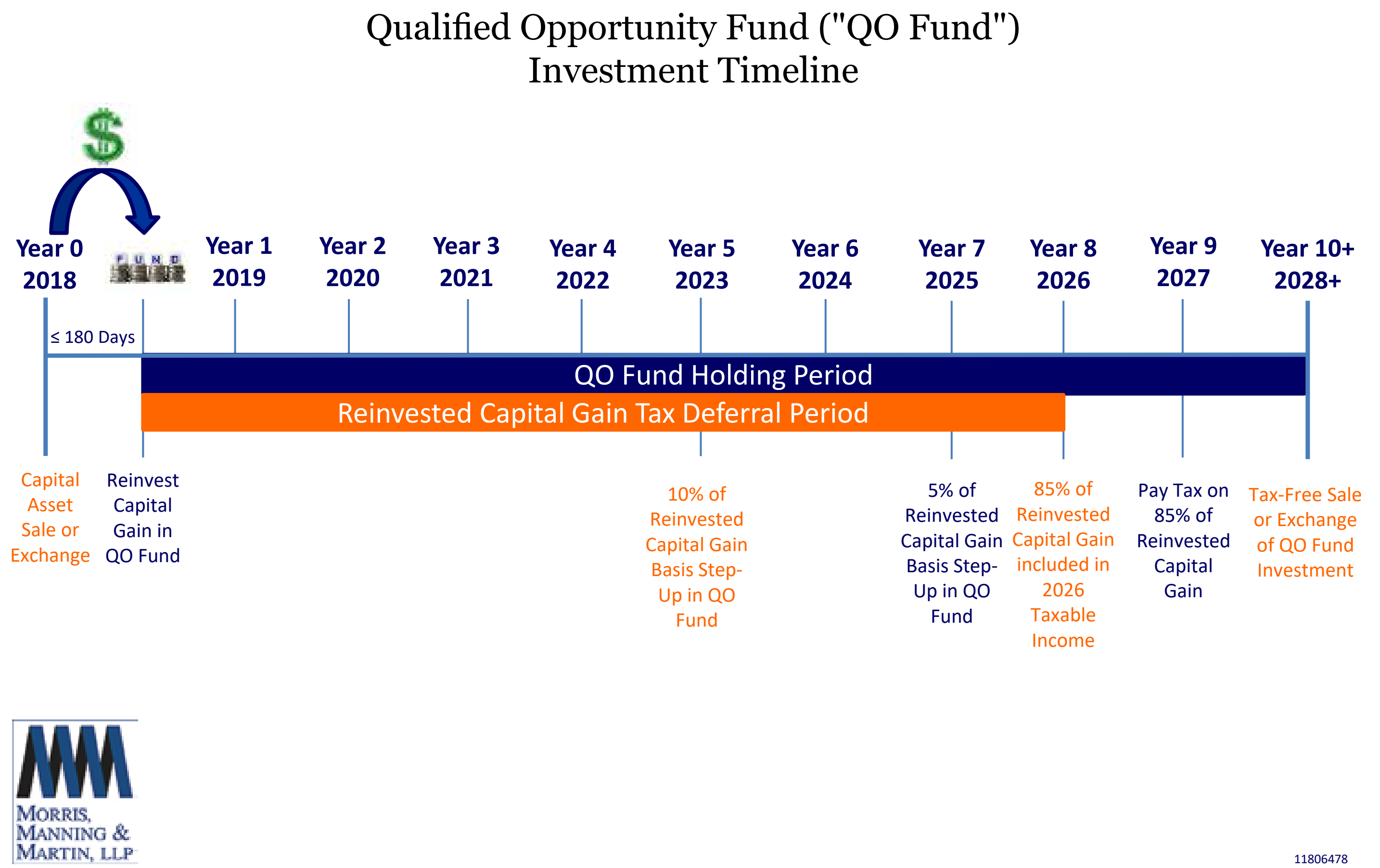
A timeline of a QO Fund investment reflecting the above-described tax benefits is included as Figure 1 on page 16.

Qualified Opportunity Fund

A QO Fund is a corporation or partnership that self-certifies as a QO Fund on its timely-filed federal information return and whose purpose is to invest in QO Zones.

A QO Fund must hold at least 90 percent of its assets in QO Zone property, which includes certain types of stock, partnership interests, and tangible property. Except for a few "sin" businesses like golf courses, gambling facilities, and liquor stores, QO Funds can invest in a wide variety of projects, including infrastructure; commercial, industrial, and residential real estate; and existing or start-up businesses. By granting the QO Fund such flexibility, the new law allows QO Funds to respond to the specific needs of each unique QO Zone, giving a strong boost to each such community.

Figure 1



If the QO Fund fails to satisfy the semi-annual asset test, it must pay a penalty for each month it fails to satisfy the test, unless the QO Fund can demonstrate reasonable cause for such failure.

Qualified Opportunity Zones

A QO Zone is an economically distressed community that has been designated as a Qualified Opportunity Zone by the Secretary of Treasury (the "Secretary"). These communities, which may be rural, suburban, or urban, suffer from persistent poverty and have not recovered as quickly from the most recent recession as other communities. Once an eligible tract becomes a designated QO Zone, it holds such designation for ten years.

In general, the Chief Executive Officer (e.g., a governor) of each state and U.S. territory (the "CEOs") could nominate up to 25 percent of its "low-income community" population census tracts and certain contiguous population census tracts to be designated as QO Zones.

CEOs from all 50 states and six territories submitted nominations or requested a 30-day extension by the March 21, 2018 deadline. Without significant guidance from the Secretary and a tight deadline, CEOs approached the nomination process in a variety of ways. According to Enterprise Community Partners, some CEOs who may have been wary of political risks opted to nominate census tracts without input from, and provided very little information to, the public. At least some of these CEOs analyzed quantitative data such as unemployment and poverty rates to determine which census tracts to nominate.

QO Zones, continued on page 16

Other CEOs engaged the public, either by obtaining recommendations from the public for consideration, or by first selecting potential QO Zone nominees and then requesting public comment.

After receiving each CEO's nominations, the Secretary had 30 days to officially approve and designate nominated tracts as QO Zones, subject to an additional 30-day extension. As of May 18, 2018, the Secretary has designated QO Zones in all states and territories except for Florida, Nevada, Pennsylvania, and Utah.

Although a few states nominated up-and-coming neighborhoods, like areas in Los Angeles and Brooklyn, CEOs generally prioritized the most impoverished communities. For example, Georgia's Governor Nathan Deal nominated only low-income communities, comprised of both rural (60 percent) and urban (40 percent) communities located in 83 counties.

Looking Forward

The program appears to be a 10-year test case, but it ultimately targets creating jobs and assisting impoverished communities to pull themselves up economically. This should in turn, increase economic viability of neighboring communities and the country as a whole. There remain several open questions regarding this new program. We anticipate the Secretary will promulgate regulations in Q4-2018, including guidance on eligible investments in QO Zones, but the exact timing of such regulations is currently unknown.

Nevertheless, out of more than 42,100 eligible census tracts, approximately 8,700 designated QO Zones (over 8,500 of which are "low-income communities") are now ripe for QO Fund investment, development, and rehabilitation. The Economic Innovation Group estimates the potential capital eligible for reinvestment in QO Funds is over $6 trillion – approximately $4 trillion from individuals and $2 trillion from corporations. Undoubtedly, even if only a fraction of this unrealized capital gain is deployed into QO Funds, the potential benefits are substantial and a potential long-term win-win for both investors and the country.

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