

New Tax Law Provisions Encourage Investments in Low-Income Communities

Impact Investing Alert

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New tax incentives for investments in low-income communities were created under the recent federal tax legislation, Public Law 115-97 (the "Act"), signed into law on December 22, 2017. Investors selling any property may elect to defer capital gain taxes otherwise payable arising from the sale of such property so long as they invest the amount of any gain in a "qualified opportunity fund" within 180 days after the sale. Furthermore, if such an investor holds its investment in a qualified opportunity fund over an extended period, the Act is intended to allow the investor to (i) reduce the previously deferred tax and (ii) potentially eliminate tax on post-acquisition appreciation in value of the qualified opportunity fund investment.

A lot of things need to happen before these tax incentives become available. The Act provides for a process whereby state governors may nominate up to 25% of the low-income community census tracts in their respective states as "qualified opportunity zones" (except that if a state has fewer than 100 low-income communities, then up to 25 of such tracts may be nominated as qualified opportunity zones). Those nominations are required to be made in writing to the Secretary of the Treasury within 90 days following the date of enactment of the Act (i.e., no later than March 21, 2018) and take into account factors described in the legislative history. The Act does provide that a state governor may request a 30-day extension for those nominations. The Act further provides that the Secretary of the Treasury shall prescribe regulations necessary or appropriate to carry out the purposes of the new rules, including rules for the certification of qualified opportunity funds and rules to prevent abuse.

The Act defines a qualified opportunity fund as any "investment vehicle" that is a corporation or a partnership (including, presumably, a limited liability company) organized for the purpose of investing in "qualified opportunity zone property" and that holds at least 90 percent of its assets in qualified opportunity zone property at the required times. The qualified opportunity zone property held by the investment vehicle can be either (i) an equity interest (i.e., not debt) in another corporation or partnership in which substantially all of the tangible property owned or leased by such entity consists of "qualified opportunity zone business property" and various other criteria are met, or (ii) a direct interest in qualified opportunity zone business property. The corporation or partnership in which the investment vehicle acquires an equity

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interest must be engaged in a “qualified opportunity zone business.” In addition, unless the applicable qualified opportunity zone business property is “new” property whose original use commences with the owner entity, any amounts invested in “used” qualified opportunity zone business property must be “substantially improved” during a 30-month period beginning after the property is acquired.

If the gain from a sale of property is invested and held in a qualified opportunity fund, then in addition to deferring the payment of taxes based on such gain, the Act is intended to allow an investor to permanently reduce the deferred tax liability by receiving certain increases in its tax basis in the fund (which is initially deemed to be zero). Specifically, the investor’s basis in the fund is increased by 10% of the deferred gain if it holds its investment in the fund for more than five years. Another increase in basis equal to 5% of the deferred gain can be obtained by holding the investment in the qualified opportunity fund for two more years (for a total of seven). Although the statutory mechanics are not entirely clear, an investor is generally required to recognize the deferred gain on December 31, 2026 (assuming that it has not previously sold its interest) – after taking into account any prior basis adjustments – coupled with an additional step-up in basis in the fund equal to the gain then recognized. A further incentive provision applies if the qualified opportunity zone investment is held for more than 10 years – in which case the Act is intended to eliminate tax on post-acquisition appreciation in value (through the mechanism of an elective step-up in basis to fair market value on the date of sale) – without affecting tax on the original deferred gain.

In the short run, communities that want to take advantage of the benefit of these tax incentives will need to be sure that the governor of their state nominates them as a “qualified opportunity zone” by the required deadline. Organizations that want to facilitate investments in qualified opportunity funds may want to participate in the process of formulating the Treasury Department regulations, which will define the requirements for the qualified opportunity funds. Once the regulations have been issued, organizations that want to sponsor such funds will need to work with experienced legal counsel in establishing such funds and investing the capital they raise so as to maximize the benefits to their investors.

We are available to assist clients in planning to take advantage of this new program.