QUALIFIED OPPORTUNITY ZONES AND THE POTENTIAL TO DRIVE COMMUNITY DEVELOPMENT

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An investment in a Qualified Opportunity Fund that is in turn invested within a Qualified Opportunity Zone is entitled to certain tax deferral of capital gains, certain basis step-up and, if held long enough, the ability to not have to pay tax on the appreciation of investment within the fund beyond the initial deferred gain.

On December 22, 2017, as part of Congress' House Resolution 1, the concept of a Qualified Opportunity Zone (QOZ) was added to the toolbox of potential community development tools. In this Alert, we explain what a QOZ is and offer strategies to help real estate developers take advantage of the benefits of QOZs. In short, an investment in a Qualified Opportunity Fund that is in turn invested within a QOZ is entitled to certain tax deferral of capital gains, certain basis step-up (which will lower tax on sale/disposition) and, if held long enough (10 years or more), the ability to not have to pay tax on the appreciation of investment within the fund beyond the initial deferred gain. As explained below, QOZs are in low-income areas; thereby, investment in these areas is incented by the creation of the ability to defer gain within them.

WHAT IS A QOZ?

A QOZ is a census tract that is located in a low-income community (LIC), i.e., an area designated as such due to it having a 20 percent poverty rate. The qualification process to designate QOZs will end on March 21, 2018:

- QOZs must be located within a LIC as shown on the census map.
- The governor of each state must nominate their desired LICs to the U.S. Treasury Department by March 21, 2018. Each state may only nominate up to 25 percent of the eligible LICs within a given state, noting that up to five percent of the 25 percent may be non-LIC tracts that are contiguous to other applicable LICs.

WHAT IS THE BENEFIT OF A QUALIFIED INVESTMENT IN A QOZ?

If designated as a QOZ, the bill allows investors to defer short- and long-term capital gains realized on the sale of property if the capital gain portion of the sale or disposition is reinvested within 180 days in a Qualified Opportunity Fund (QO Fund).

BENEFITS OF INVESTING WITHIN A QO FUND

- Owners of low tax basis properties can sell these properties and defer the capital gains to the extent the gains are invested in a QOZ; and

- QOZs are likely to attract investor capital that is looking to defer capital gains, thereby making the QOZs potentially more valuable than non-QOZ properties.

RECOGNITION OF GAIN

- Gain is required to be recognized on the earlier of a disposal of the QO Fund investment or December 31, 2026.
- Gain is reduced over time in the following manner:
  - The basis of the QOZ investment increases by 10 percent of the deferred gain if the investment is held for five years from the date of reinvestment; and
  - The basis of the QOZ investment increases by 15 percent (i.e., an additional five percent) of the deferred gain if the investment is held for seven years from the date of reinvestment. In other words, the gain on which capital gains is paid is reduced to 85 percent of the original gain.
- Appreciation on investments within the QO Fund that are held for at least 10 years are excluded from gross income (i.e., if held for 10 years, the appreciation is not taxed).

WHAT IS A QUALIFIED OPPORTUNITY FUND?

A QO Fund is an investment vehicle that is organized as a corporation or partnership for the purpose of investing in a QOZ property that holds at least 90 percent of its assets in QOZ property. Note, there are presently no limitations on the amount of the investment, and there are no overall limits on the total investment that the collective funds can make. Moreover, the QO Fund, if it so desires, could invest in Low Income Housing Tax Credit deals, historic tax credit deals and New Markets Tax Credit deals if it so desired within the QOZ.

WHY ARE QOZS BEING VIEWED AS AN ECONOMIC DEVELOPMENT TOOL?

The permitted creation of a QO Fund that can: 1) receive appreciated property within 180 days of a sale or disposition; 2) appropriately shelter it with an applicable investment within a QOZ; and 3) enable up to 15 percent of the gain to be deferred until sale of the investment or December 31, 2026, enables a 15 percent increase in the basis of the asset that is subject to gain recognition, which results in a very powerful means to reduce applicable tax.

Moreover, if one does not sell or dispose of the property within the QO Fund in the QOZ for 10 years or more, the appreciation of such property (beyond the initial deferred gain, which is taxable), will be not be subject to tax. This potential to appropriately avoid capital gains on a future sale should encourage funds to be invested in QO Funds that will in turn invest in QOZs. These QOZs, as noted above, will be in LICs that might not otherwise have seen such an investment, which should thereby act as an economic driver within these more difficult investment areas.

Owners of properties within LICs should be considering whether to reach out to the applicable governing authorities within their state to have their properties tendered by their governor for inclusion within the QOZ designation. If a property is not proposed as a QOZ by March 21, 2018, the opportunity to be designated as a QOZ is likely to be lost forever (absent a future reopener, which is uncertain).

Attorneys in the Real Estate Practice Group and the Corporate Practice Group at Duane Morris will continue to monitor and provide updates on any related developments once applicable regulations from the Treasury Department are issued.

If you have any questions about this alert, please contact Brad A. Molotsky, Arthur J. Momjian, any of the attorneys in the Real Estate Practice Group, attorneys in the Corporate Practice Group or the attorney in the firm with whom you are regularly in contact.

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