Opportunity Zones: A New Tool for Community Development

Economically distressed communities received a new investment tool with the passage of tax reform legislation in December 2017: the opportunity zones incentive. The incentive allows taxpayers to postpone until 2026 taxes on gains if those profits are reinvested in opportunity funds–which are equity funds that invest in businesses in opportunity zones.

In simplest terms, the opportunity zones incentive works like this: A taxpayer who recognizes a gain from the sale of stock can invest the gain in an opportunity fund and postpone taxes on those gains until 2026. If the taxpayer holds the fund shares for five years, there is a 10 percent basis step-up. After seven years, there is another 5 percent basis step-up. When the taxpayer sells the investment or Dec. 31, 2026–whichever comes first–the taxpayer must pay tax on the deferred capital gains. After 10 years, the taxpayer can exclude any additional gains beyond that which was previously deferred.

The opportunity zones incentive provides incentives for the investor to invest in capital-starved urban and rural areas that typically have relied upon investments from philanthropic organizations; federal, state and local governments; financial institutions, including community development financial institutions (CDFIs); and community development corporations (CDCs) and community development entities (CDEs) that receive new markets tax credit (NMTC) allocations from U.S. Department of the Treasury's Community Development Financial Institutions Fund (CDFI Fund) to stimulate investment. Opportunity zones make these areas attractive targets for investment for the holders of unrealized capital gains. Those gains are estimated by the Economic Innovation Group to be in the trillions of dollars.

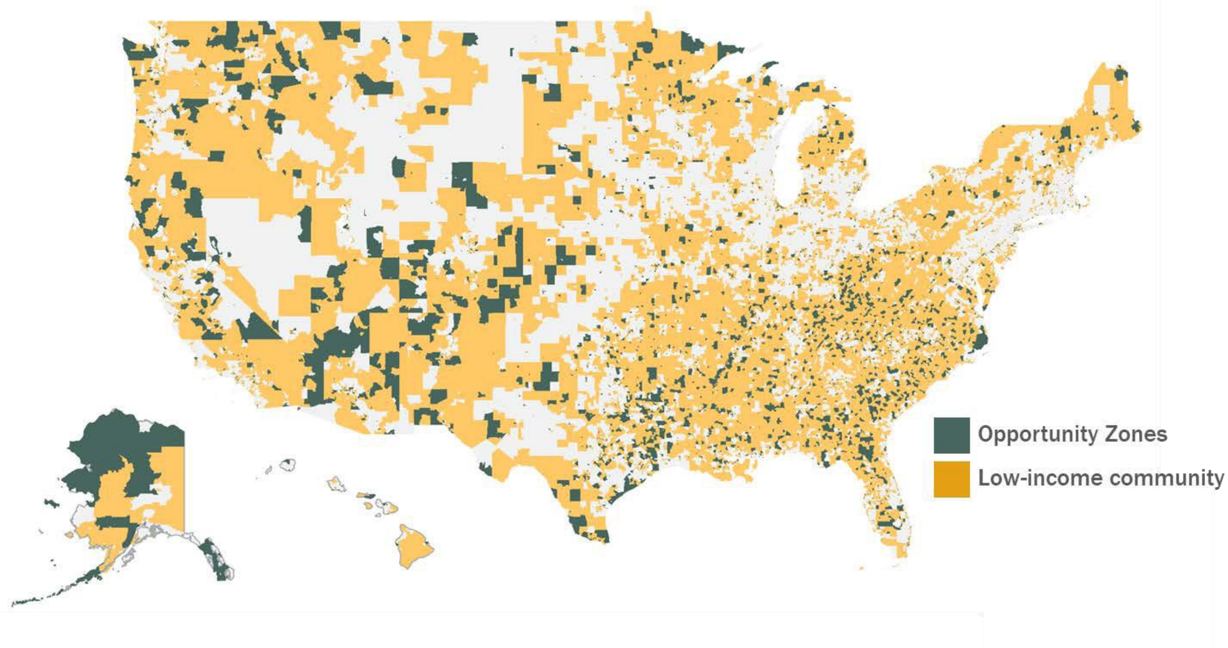
Opportunity zones are the result of years of a bipartisan and bicameral effort led by Sens. Tim Scott, R-S.C., and Cory Booker, D-N.J., and former Rep. Pat Tiberi, R-Ohio, and Rep. Ron Kind, D-Wis.

Following are some key facts about the opportunity zones incentive:

A Unique Incentive

The opportunity zones incentive is different from existing community and economic development tools such as the low-income housing tax credit (LIHTC) and NMTC. The LIHTC and NMTC include a **competitive** application process administered by state housing finance authorities and the federal government, respectively. With the opportunity zones incentive, any eligible taxpayer–individuals or corporations–can make investments funded by realized gains in opportunity funds. There is no cap.

Opportunity Zones



Source: CDFI Fund; Novogradac & Company LLP

Opportunity zones are generally census tracts in low-income communities experiencing economic distress, under the definition of "low-income community" used in the NMTC program. The legislation creating the incentive generally allowed for up to 25 percent of a state's low-income community population census tracts to be designated by governors as qualified opportunity zones, with up to 5 percent of those tracts being moderate income adjacent tracts. The Secretary of the Treasury certified the nominated tracts as opportunity zones and in July 2018, the Internal Revenue Service published a list of more than 8,700 qualified opportunity zones in the 50 states and U.S. territories.

Opportunity Fund

An opportunity fund is the investment vehicle created to invest in opportunity zone properties. Any entity can establish an opportunity fund, as long as it follows guidelines set by the statute and self-certifies according to guidance from the U.S. Department of the Treasury. An opportunity fund is required to hold at least 90 percent of its assets in qualified opportunity zone businesses and/or business property. If the opportunity fund fails to meet the 90 percent requirement, it must pay a penalty for each month it fails to meet the investment requirement. Opportunity funds can be formed as a partnership or corporation to raise capital from investors. Investments can include:

- stock or a partnership interest in an opportunity zone business, or
- opportunity zone business property.

Investor Benefits

The benefit to an investor in an opportunity fund is the ability to defer paying tax on gains if those gains are invested in qualified opportunity funds. To qualify, the gain must be invested in a qualified opportunity fund during a 180-day period that begins on the date of the sale or exchange that generated the gain. The deferral is temporary, as the gain must be recognized on the earlier of Dec. 31, 2026, or the date the investment in the opportunity fund is sold or exchanged. The amount of gain includible is:

- Whichever is less between the amount of gain originally deferred and the fair market value
- MINUS the taxpayer's basis in the investment.

The deferral of gains to 2026 isn't the only benefit. The opportunity zones incentive allows a modest step-up in basis for investments that are held beyond five and seven years. For investment held at least five years, the investor's basis is increased by 10 percent of the original gain. For investments held for at least seven years, the investor's basis is increased by 5 percent of the original gain. If an investor holds the investment in the opportunity fund for at least 10 years, there are no taxes on gains from the sale the investment in the fund beyond that which was previously deferred.

Low-Income Community Benefits

Investments in opportunity zones stand to significantly help distressed communities, since estimates of the unrealized gains held by investors is in the trillions of dollars. Even a fraction of this amount in form of equity investments in businesses, real estate and business assets located in qualified opportunity zones could have a significant impact. The benefits include new businesses or existing businesses expanding within or into opportunity zones and real estate development or rehabilitation of vacant or abandoned properties. Opportunity zones investments will bring much-needed commercial and community goods and services to areas, will develop or preserve affordable housing and will provide myriad other benefits to low-income communities.

Opportunity Zones and Tax Credits

Pending guidance from Treasury, the opportunity zones incentive should be compatible with other tax credit programs, such as the NMTC, LIHTC and historic tax credit (HTC), as well as other government economic and community development programs.

The opportunity zones incentive is complementary to the NMTC. While both incentives help bring needed private capital to low-income communities, they differ in important ways and don't represent duplicative forms of investment. The opportunity zones incentive offers a shallower subsidy per investment, but the total amount of investments qualifying for the subsidy are not limited by annual allocation amounts. That means the opportunity zones incentive has the potential to incentivize the deployment of substantially more capital than the NMTC.

Also, each state was given equal authority to designate a similar percentage of qualified opportunity zones, ensuring that each state can incentivize private capital to areas they identify. While NMTC can still bring investment to low-income areas outside opportunity zones, the limited NMTC annual allocations mean that many low-income communities don't receive any private capital through the NMTC. It is also worth noting that the two incentives bring different sources of capital: equity in the case of opportunity zones and mostly debt in the case of NMTC.

Concerning other tax credits, the opportunity zones incentive can provide additional investment in LIHTC or HTC developments that take place in qualified opportunity zones.

Opportunity Zones Working Group

In order to more efficiently and effectively implement the opportunity zones incentive, Novogradac formed an Opportunity Zones Working Group. The members of the OZ Working Group come from a wide range of participants in the community development finance field: investors, lenders, developers (both for-profit and nonprofit), CDFIs, CDEs, trade organizations and more.

The OZ Working Group encourages and facilitates the collaboration of industry professionals in their efforts to resolve technical and administrative incentive issues. Each month, members of the group participate in a conference call, discuss issues of concern and–based on those discussions–provide comments and suggestions that are submitted in writing to the U.S. Department of the Treasury, Internal Revenue Service, the Community Development Financial Institutions (CDFI) Fund, members of Congress and other federal and state agencies.

For more information on the OZ Working Group, contact Karen Destorel at Karen.Destorel@nc-llp.com.

More Information

Novogradac has a designated opportunity zones resource center, complete with an opportunity zones mapping tool, guidance, legislation, reports and other resources connected to the new incentive. Visit www.opportunityzonesresourcecenter.com.