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Tax Reform's New Incentives for Investments in Low-Income Communities: Part 2

Certification and Operation of Qualified Opportunity Funds

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HIGHLIGHTS:

- [Part 1 of this series](#) of Holland & Knight alerts described a new tax incentive contained in the Tax Cuts and Jobs Act for investments in low-income communities designated as "Opportunity Zones." Part 1 also explained the process for nomination by state governors and designation of Opportunity Zones by the U.S. Department of the Treasury.
- In Part 2, we discuss the requirements for formation and certification of an Opportunity Fund and the rules governing its operations. A qualified Opportunity Fund is defined as any investment vehicle organized as a corporation or a partnership 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."
- In an upcoming Part 3, we will discuss benefits for investing taxpayers.

Part 1 of this series of Holland & Knight alerts described a new tax incentive contained in the Tax Cuts and Jobs Act (the Act) for investments in low-income communities designated as "Opportunity Zones." The Opportunity Zone incentive is now embodied in Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code. [Part 1 of this series](#) discussed the process for nomination by state governors and designation of Opportunity Zones by the U.S. Department of the Treasury. Part 2 discusses the requirements for formation and certification of an Opportunity Fund and the rules governing its operations. In an upcoming Part 3, we will discuss the benefits for investing taxpayers, namely the deferral or exclusion from gain from the sale or exchange of an asset by a taxpayer who invests in an Opportunity Fund, as well as the potential exclusion of gain from disposition of an investment in an Opportunity Fund.

Formation and Certification of Opportunity Funds

A qualified Opportunity Fund (Opportunity Fund) is defined in Section 1400Z-2(d)(1) as any investment vehicle organized as a corporation or a partnership 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."¹

Section 1400Z-2(e)(4) requires the Secretary of the Treasury to prescribe regulations necessary or appropriate to carry out the purposes of this provision, including rules for the certification of Opportunity Funds. The legislative



history indicates that it is intended that the certification process will be done in a manner "similar to the process for allocating the New Markets Tax Credit (NMTC)". Accordingly, the Community Development Financial Institutions Fund (CDFI Fund), the branch of the Treasury Department that administers the NMTC, is expected to handle the certification process.² It makes sense for the CDFI Fund to certify Opportunity Funds because the requirements for Opportunity Funds are very similar to the certification requirements for NMTC community development entities (CDEs). In fact, it is possible that an existing CDE that has been certified by the CDFI Fund could automatically qualify for certification as an Opportunity Fund. The CDFI Fund plans to issue guidance on the process for nominating and designating Opportunity Zones as well as the certification process for Opportunity Funds in the near future.

Many of the provisions of Sections 1400Z-1 and 1400Z-2 are similar to the rules for the NMTC, and we will note the similarities where relevant.

What Is Qualified Opportunity Zone Property?

Section 1400Z-2(d)(2) defines qualified Opportunity Zone property as one of the following:

- qualified Opportunity Zone stock
- qualified Opportunity Zone partnership interests, or
- qualified Opportunity Zone business property

Based on the foregoing, an Opportunity Fund could acquire an equity interest in a business corporation (but not a nonprofit corporation), a partnership or a limited liability company taxed as a partnership (but not a limited liability company that is disregarded for tax purposes), or could acquire and hold directly the assets of a "qualified opportunity zone business." Unlike the NMTC, it does not appear that an Opportunity Fund could make a loan to a "qualified opportunity zone business."³

A special rule provides for the treatment of "mixed funds," where only a portion of the fund consists of investments made under the Opportunity Zone incentive.

What Is Qualified Opportunity Zone Stock?

Qualified Opportunity Zone stock is stock in a domestic corporation acquired after Dec. 31, 2017, at its original issue by the corporation solely in exchange for cash. In addition, the corporation invested in must be, or be organized to be, a "qualified opportunity zone business" at the time of issuance of the stock, and it must continue to qualify as a "qualified opportunity zone business" for "substantially all" of the holding period of the stock.⁴ It is not clear what "substantially all" of the holding period of stock means. Presumably, this will be addressed in forthcoming guidance.⁵

What Is a Qualified Opportunity Zone Partnership Interest?

A qualified Opportunity Zone partnership interest is any capital or profits interest in a domestic partnership that is acquired by the Opportunity Fund after Dec. 31, 2017, from the partnership solely in exchange for cash. In addition, the partnership invested in must be, or be organized to be, a "qualified opportunity zone business" and must remain so for "substantially all" of the Opportunity Fund's holding period in the interest.

What Is Qualified Opportunity Zone Business Property?



Qualified Opportunity Zone business property is tangible property used in a trade or business of the Opportunity Fund if:

- such property was acquired by purchase (as defined in Section 179(d)(2) of the Code⁶) after Dec. 31, 2017
- the original use of such property in the Opportunity Zone commences with the Opportunity Fund or the Opportunity Fund substantially improves the property⁷, and
- during "substantially all" of the Opportunity Fund's holding period, "substantially all" of the use of such property was used in an Opportunity Zone

A special statutory rule provides that tangible property that ceases to be qualified Opportunity Zone business property continues to be treated as qualified Opportunity Zone business property for the lesser of 1) five years after the date on which such tangible property ceases to be so qualified or 2) the date on which such tangible property is no longer held by the qualified Opportunity Zone business.

What Is a Qualified Opportunity Zone Business?

A qualified Opportunity Zone business means a trade or business in which "substantially all" of the tangible property owned or leased by the taxpayer is "qualified opportunity zone business property" (determined by substituting "qualified opportunity zone business" for Opportunity Fund in each place it appears), and which meets the following requirements:

- at least 50 percent of its gross income is derived from the active conduct of such trade or business [in an Opportunity Zone]
- a substantial portion of its intangible property is used in the active conduit of such trade or business [in an Opportunity Zone]
- less than 5 percent of the average of the aggregate unadjusted bases of such entity's property is attributable to "nonqualified financial property"⁸
- such entity's business is not 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 premises⁹

The requirements for a "qualified opportunity zone business" are very similar to the requirements for a "qualified active low-income community business" (QALICB) for purposes of the NMTC. Accordingly, it appears that an Opportunity Fund could easily undertake a side-by-side investment with a NMTC CDE, or it could qualify as both an Opportunity Fund and a NMTC CDE and make a single investment that qualifies for both incentives. Finally, an Opportunity Fund could acquire qualified Opportunity Zone property to use in a trade or business and itself qualify as a NMTC QALICB.

What Happens If an Opportunity Fund Fails to Meet the Minimum Investment Standard?

If an Opportunity Fund fails to meet the requirement that 90 percent of its assets be invested in qualified Opportunity Zone property (the "Minimum Investment Standard"), the Opportunity Fund must pay a monthly penalty for each month in which it fails to meet this requirement. The penalty is calculated by multiplying the underpayment rate established under Section 6621 (a)(2) for the applicable month by an amount equal to the excess of 1) 90 percent of the Opportunity Fund's aggregate assets over 2) the aggregate amount of qualified Opportunity Zone property it holds. Notwithstanding the foregoing, no penalty is to be imposed with respect to any failure if it's shown that the



failure is due to reasonable cause. Because there is no explanation of "reasonable cause," this will presumably need to be addressed in forthcoming guidance.

Regulations

The Secretary of the Treasury is directed in Section 1400Z-2(e)(4) to prescribe regulations necessary or appropriate to carry out the purposes of this Section. Specifically called out are rules for the certification of Opportunity Funds, rules to prevent abuse and rules to ensure that an Opportunity Fund has a reasonable period of time to reinvest proceeds from investments in qualified Opportunity Zone property, presumably if received prior to the expiration of the various statutory holding periods.¹⁰ Other aspects of the Act's Opportunity Zone provisions will require regulatory clarification as well.

Conclusion and Considerations

Congress has enacted a potent tax incentive for investors to reinvest investment gains in funds designed to provide capital to businesses in distressed communities. As noted in Part 1 of this alert series, states have a very limited time period (until March 22, 2018, unless a 30-day extension is applied for and granted) to nominate qualifying Opportunity Zones within their jurisdictions. Governors will have to balance targeting the tax incentives to the most needy areas and selecting communities where new businesses are likely to be successfully launched.

Many issues still need to be worked out in guidance by the Department of the Treasury and the CDFI Fund before the Opportunity Zone incentive can be fully implemented. In the meantime, the statutory language implies many synergies between the NMTC and the new Opportunity Zone incentive, which may inform forthcoming guidance. Clients should work to ensure that their state governors are engaged and weigh in with the Department of the Treasury and the CDFI Fund to prompt guidance that embodies the intent of Congress, namely to encourage investment in distressed communities.

Notes

¹ Whether a qualified Opportunity Fund holds 90 percent or more of its assets in qualified Opportunity Zone property is determined by averaging the percentage of qualified Opportunity Zone property held by the Fund (A) on the last day of the first six-month period in the applicable taxable year of the Fund and (B) on the last day of the applicable taxable year of the Fund. This is similar to the "substantially all" test under Section 45D of the Code, by which it is determined whether a New Markets Tax Credit community development entity (CDE) has invested "substantially all" of its equity in qualified low-income communities.

² The CDFI Fund, a department of the U.S. Treasury, has authority both to allocate NMTCs to CDEs and to certify CDEs as qualified to receive an allocation.

³ For technical reasons, NMTC "investments" are typically structured as loans, although it is possible to make an NMTC equity investment in the stock or partnership interests of an NMTC qualified low-income community business.



⁴ Rules similar to those described in Code Section 1202 (c) (3) will apply to prevent a corporation from redeeming and then reissuing its stock to an opportunity fund.

⁵ This issue also affects the definitions of "qualified opportunity zone partnership interest" and "qualified opportunity zone business property."

⁶ The reference to Section 179(d)(2) of the Code would limit the acquisition of property from a related party. Section 1400Z-2(d)(2)(D)(iii) also provides a special variation from the related party rule of Section 179(d)(2)(A) whose meaning and application is unclear due to apparent drafting errors.

⁷ For this purpose, property is treated as "substantially improved" by the Opportunity Fund only if, during any 30-month period beginning after the date of acquisition, additions to basis with respect to such property in the hands of the Opportunity Fund exceed an amount equal to the adjusted basis of such property at the beginning of the 30-month period.

⁸ The first three requirements are set forth by cross-referencing Section 1397(C)(2), (4), and (8) of the Code. Similar requirements apply to NMTC projects.

⁹ The requirement is set forth by cross-referencing Section 144(C)(6)(B) of the Code. A similar requirement applies to projects utilizing the NMTC.

¹⁰ This rule appears to be similar to the rules for redeployment of NMTC investments if returned or repaid prior to the end of the NMTC holding period.

Information contained in this alert is for the general education and knowledge of our readers. It is not designed to be, and should not be used as, the sole source of information when analyzing and resolving a legal problem. Moreover, the laws of each jurisdiction are different and are constantly changing. If you have specific questions regarding a particular fact situation, we urge you to consult competent legal counsel.
