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LEGAL ADVISORY
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FINDING OPPORTUNITIES IN QUALIFIED OPPORTUNITY ZONES

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The Tax Cuts and Jobs Act of 2017 ("TCJA"), enacted in December 2017, now allows investors to delay including capital gains from various investments in income by reinvesting those gains into so-called Qualified Opportunity Funds, which are investment vehicles designed for the purpose of investing in Qualified Opportunity Zones. This report serves to educate investors on what Qualified Opportunity Zones and Qualified Opportunity Funds are, how such funds work, and how investors can maximize the benefits of this new law.

What are Qualified Opportunity Zones and Qualified Opportunity Funds?

Qualified Opportunity Zones are low income census tracts nominated by governors and designated by the United States Treasury Department. On May 18, 2018, the US Treasury approved Governor Charlie Baker's application to designate 138 tracts as Opportunity Zones, spanning 79 Massachusetts communities.

A Qualified Opportunity Fund is the investment vehicle that offers the preferential tax benefits. The Fund must be organized as a corporation or a partnership[1] for the purpose of holding at least 90% of its assets in Qualified Opportunity Zone Property[2], which includes:

- **Business Property—**tangible property used in a trade or business of the Qualified Opportunity Fund if three criteria are met. First, the property must be purchased after December 31, 2017. Second, the property's original use either commences with the Qualified Opportunity Fund or the Qualified Opportunity Fund substantially improves the property. Third, substantially all of the property's use is in a Qualified Opportunity Zone during substantially all of the Qualified Opportunity Fund's holding period.
- **Stock—**stock in a domestic corporation that was obtained by the fund after December 31, 2017. The corporation must be a Qualified Opportunity Zone Business[3] at the time of purchase. New corporations qualify if they are organized for the purpose of being a Qualified Opportunity Zone Business. The corporation must maintain its designation as a Qualified Opportunity Zone Business for a substantial duration of the fund's holding period.
- **Partnership Interests—**capital or profits interest in a domestic partnership if such interest is acquired after December 31, 2017. The partnership must be a Qualified Opportunity Zone Business at the time of purchase. New partnerships qualify if organized for the purpose of being a Qualified Opportunity Zone Business. The partnership must maintain its designation as a Qualified Opportunity Zone Business for a substantial duration of the Fund's holding period.

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[1] The statute explicitly states that a fund must be either a corporation or a partnership. It is anticipated that forthcoming guidance will clarify LLC eligibility.

[2] A Fund does not qualify as a Qualified Opportunity Fund by investing in another Qualified Opportunity Fund.

[3] A Qualified Opportunity Zone Business is a trade or business that owns or leases substantially all of its tangible property in Qualified Opportunity Zone. The business must generate at least 50% of its total gross income from the active conduct of the business, a substantial portion of the intangible property for such business must be used in the active conduct of such business, and less than 5% of the average of the aggregate unadjusted bases of the property of such business must be attributable to nonqualified financial property. Also, the business cannot be a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, facility used for gambling, or store that principally sells alcoholic beverages for consumption off premises.

Do Benefits of Investing in a Qualified Opportunity Fund Exist?

The benefits of investing in a Qualified Opportunity Fund are twofold:

- First, rolling capital gain from other investments into a Qualified Opportunity Fund allows an investor to defer including that gain in income for the tax year it was realized. The law thus allows the investor flexibility in dictating which tax year he or she wants to include the deferred gain in income in the future.
- Second, the investor receives increasingly preferential tax treatment for keeping a capital gain invested for longer periods of time.

Investors cannot defer a capital gain indefinitely, however. A deferred gain must be included in income upon the occurrence of one of two circumstances:

- First, the deferred gain must be included in income for the tax year that the investment in the Qualified Opportunity Fund is sold or exchanged.
- Second, if a capital gain remains invested in a Qualified Opportunity Fund by December 31, 2026, the deferred gain must be included in income for the 2026 tax year even if the investment is not sold or exchanged.

The length of time between investment and the sale or exchange of that investment dictates how much of the gain must be included in income under the two circumstances described above. A deferred gain that must be included in income will be reduced according to the following rules:

- If the investment is sold or exchanged, or December 31, 2026 occurs, less than five years after the investment, the taxpayer must include the total deferred amount in income for that tax year.
- If the investment is sold or exchanged, or December 31, 2026 occurs, after five years but before seven years, the taxpayer must only include 90% of the original deferred amount in income for that tax year.
- If the investment is sold or exchanged, or December 31, 2026 occurs, after seven years, the taxpayer must only include 85% of the original deferred amount in gross income for that tax year.

Once the deferred gain is included in income, the basis of the Qualified Opportunity Fund investment is stepped up to match the amount included. Additionally, if the investment is held for ten years, the investment's basis becomes equal to fair market value, allowing the investor to recognize neither gain nor loss for the investment's subsequent sale or exchange.

The rules described above are summarized in the following table:

Time between deferment and inclusion in gross income[4]	Amount of deferred gain included in gross income[5]	Basis in the investment after gain is recognized[6]
0–4 years	(DA or FMV)-0	(DA or FMV)-0
5 years	(DA or FMV)-(DA x 0.1)	(DA or FMV)-(DA x 0.1)
7 years	(DA or FMV)-(DA x 0.15)	(DA or FMV)-(DA x 0.15)
10 years	N/A[6]	FMV

[4] This time is capped either by the sale or exchange of the investment property, or by the mandatory December 31, 2026 deadline.

[5] The equation is the lesser of the deferred amount (DA) or fair market value (FMV) at the date described in footnote 1, subtracted by the basis of the investment before the gain is recognized.

[6] Gain cannot be deferred for ten years because the length of the investment would exceed the mandatory December 31, 2026 deadline.

How Can an Investor Maximize a Qualified Opportunity Zone Investment?

To maximize the benefits of this new rule, investments should be made before December 31, 2019. Investing before this date would afford investors the ability to utilize the seven-year rule and reduce the deferred gain 15% by the December 31, 2026 deadline. The investor would then only include 85% of the deferred gain in their gross income for the 2026 tax year. The basis in the investment would then equal the 85% of the deferred gain that was included in gross income.

To avoid having to recognize gain for subsequent appreciation of the investment, the investor should then keep the investment in the fund for the remainder of the ten-year period. Once the investment is held for ten years, the basis should equal fair market value and the investor would not recognize gain on the appreciation in excess of the previously deferred gain.

Are There Restrictions on Qualified Opportunity Fund Investments?

There are several restrictions that an investor should be aware of before taking advantage of this rule:

- This rule applies to an amount up to, but not exceeding, the amount of the capital gain. In other words, if the capital gain is $1 million, an investor could invest $2 million in a Qualified Opportunity Fund, but could defer only up to $1 million.
- Investors can only apply this rule once per capital gain at any given time. Using the same example above, if the capital gain is $1 million, an investor could invest $500,000 in a Qualified Opportunity Fund and defer that amount, but could not subsequently invest and defer the remaining $500,000.
- Investments must be made within 180 days of the sale or exchange that produced the capital gain.
- The sale or exchange that produced the capital gain must be with an unrelated party.
- Investments must be made before December 31, 2026.

THIS ADVISORY WAS PREPARED BY MELISSA SAMPSON MCMORROW, A MEMBER OF NUTTER'S TAX DEPARTMENT. FOR MORE INFORMATION, PLEASE CONTACT MELISSA OR YOUR NUTTER ATTORNEY AT 617.439.2000.

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