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ALERT

Tax Reform's New Incentives for Investments in Low-Income Communities: Part 1

State Governors Given Responsibility for Nominations of Opportunity Zones

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HIGHLIGHTS:

» A new tax incentive in the recently enacted Tax Cuts and Jobs Act would allow investors selling appreciated securities or other investment property to defer tax on those gains to the extent that the proceeds are reinvested in an Opportunity Zone Fund. Further tax incentives would allow for exclusion of both some of the deferred gain and any post acquisition gain if the Fund is held long enough.

» Each of the 50 states and the District of Columbia (as well as U.S. possessions) will have an opportunity to nominate a minimum of 25 Opportunity Zones located within the state, district or territory.

» Eligible zones must generally must be nominated by the governor of a state within a 90-day period starting on the Act's date of enactment (by approximately March 22, 2018, unless a 30-day extension is applied for and granted).

The Tax Cuts and Jobs Act (the Act), signed into law on Dec. 22, 2018, contains new tax incentives for making investments in low-income communities. The first tax incentive would allow investors selling appreciated securities or other investment property to defer tax on those gains to the extent that all of the proceeds are reinvested in an Opportunity Zone Fund. In addition to deferring gains that are reinvested in Opportunity Zone Funds, the provision would reduce such gain subject to tax for those who hold their investments at least five years and would reduce it even further if held at least seven years. The second tax incentive would exempt from tax any post-acquisition gains on investments in the Opportunity Zone Funds themselves – if they are held at least 10 years.

Under the Act, each of the 50 states and the District of Columbia (as well as U.S. possessions) will have an opportunity to nominate a minimum of 25 Opportunity Zones located within the state, district and territory. Eligible zones must generally must be nominated by the chief executive of a state within a 90-day period starting on the Act's date of enactment and under rules described below. The nominated zones must either be "low-income communities" as defined below or "contiguous" to designated low-income communities subject to certain statutory limitations.

Because of the short period within nominations must be made, this Holland & Knight client alert focuses primarily on the rules applicable to the Opportunity Zone nomination and designation process. Subsequent alerts will focus on the rules for Opportunity Zone Fund formation and how the
Background

The Opportunity Zone concept first surfaced in 2016 in legislation introduced on a bipartisan basis by Reps. Pat Tiberi (R-Ohio) and Ron Kind (D-Wisc.), as well as Sens. Tim Scott (R-S.C.) and Cory Booker (D-N.J.), to help revitalize economically distressed communities that suffer from a lack of investment and business growth. As re-introduced in 2017, the Investing in Opportunity Act (H.R. 828 and S. 293) attracted a total of 95 co-sponsors (14 in the Senate and 81 in the House). Thus, it was no surprise that the earlier legislation found its way into the Tax Cuts and Jobs Act, initially through its inclusion in the Senate bill and eventually in the final conference agreement.

A central tenet of the legislation is to give state governors the responsibility for nominating Opportunity Zones so long as they comply with certain definitions and rules as set forth below.

Nomination and Designation of Qualified Opportunity Zones

The Act's designation process contains two main components and time frames:

» Nomination of the zones by the governor, which must be submitted in writing within 90 days of the enactment date, unless an extension is applied for (in which case, an additional 30 days may be granted)

» Certification and final designation by the Secretary of the Treasury, which must be completed within a 30-day consideration period after written nominations are made, unless a 30-day extension is requested by the applicable governor.

Nomination of Qualified Opportunity Zones

Section 13823 of the Act adds a new section of the Internal Revenue Code (Section 1400Z-1) setting forth the rules for the nomination by each state's governor of certain "low-income community" population census tracts as "qualified opportunity zones." The Act specifies that the same definition of "low-income community" that is contained in Code Section 45D(e) (governing the New Markets Tax Credit) will generally apply for Opportunity Zone purposes.

Code Section 45D(e) defines a "low-income community" as any census tract if:

» a) the poverty rate is at least 20 percent, or

» b) the median family income does not exceed 80 percent of statewide median family income or, if in a metropolitan area, the greater of 80 percent statewide median family income or 80 percent of metropolitan area median family income

Section 1400Z-1(e) also provides that a population census tract that does not qualify as a "low-income community" under the definition may also be designated as a qualified opportunity zone if 1) it is contiguous to a low-income community population census tract that has been designated as a qualified opportunity zone and 2) the median family income of the tract does not exceed 125 percent of the median family income of the low-income community with which the tract is contiguous: Section 1400A-1(e)(2) limits the number of population census tracts designated as Opportunity Zones on the basis of their contiguity to a designated "low-income community" to no more than 5 percent of the total zones designated within a state.

The legislative history of the provision suggests that governors nominating census tracts for designation should pay particular consideration to areas that:

» are currently the focus of mutually reinforcing state, local or private development initiatives to
attract investment and foster startup activity

» have demonstrated success in geographically targeted development programs such as promise zones, the New Markets Tax Credit, empowerment zones and renewal communities, and

» have recently experienced significant layoffs due to business closures or relocations

However, these provisions were not included in the statute as enacted. Thus, governors are free to develop their own criteria beyond the basic thresholds based on poverty rate, median income and contiguity.2

**Number of Zones That May Be Designated as Qualified Opportunity Zones**

As a general rule, the number of zones that may be designated as Opportunity Zones within each state, the District of Columbia or territory is limited to 25 percent of the total number of low-income communities within each state. Many states have well over 1,000 "low-income community" census tracts.

» As an example, there are 3,511 population census tracts meeting the definition of "low-income community" in California, 2,050 in New York, 1,698 in Florida, 1,292 in Illinois and 1,036 in Georgia.

However, if the number of low-income communities in a state is less than 100, then a total of only 25 of such tracts may be designated as Opportunity Zones.

» For example, there are a total of only 44 low-income community census tracts in the state of North Dakota, 54 in Alaska and 77 in Rhode Island.

There is no limit on the number of zones that may be nominated, but it is expected that most governors will not nominate more than the maximum number of zones that may be designated in their states.

**Provision for Automatic Designation of Communities in Possessions as Opportunity Zones**

The conference agreement reported that the House and Senate Conference Committee agreed to add a provision that "each population census tract in each U.S. possession that is a low-income community is deemed certified and designated as a qualified opportunity zone effective on the date of enactment." However, no such provision was included in the statutory language, although the enacted bill continues to define the term "state" to include U.S. possessions. According to an article in *The Bond Buyer*, House Ways & Means Chairman Kevin Brady told reporters that "opportunity zones" were in the final bill, though a provision allowing Puerto Rico to qualify was stripped out because it would have violated the U.S. Senate's Byrd Rule.3

Note: Based on our reading of the legislation, it appears that only the automatic designation of low-income communities in U.S. possessions was stripped out, and that the governors of Puerto Rico and other U.S. possessions nonetheless will be able to nominate communities within their jurisdictions for designation by the U.S. Department of the Treasury as Opportunity Zones.

**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. 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.
Notes

1 Due to the short time periods for nomination and designation, and because a census tract can qualify based on contiguity only if it is contiguous to a "low-income community" that has been designated by the Treasury Department, it appears that governors should not wait to nominate a contiguous tract until its neighboring tract has received designation, but should nominate both simultaneously.

2 It should be noted that, over the years since the New Markets Tax Credit was enacted, the CDFI Fund (the branch of the Treasury Department that administers the New Markets Tax Credit) has developed several criteria of higher economic distress that go well beyond the statutory definition of "low-income community" as a condition to a competitive application the New Markets Tax Credit. Governors nominating qualified opportunity zones may elect to impose their own additional criteria of higher economic distress for low-income communities nominated in order to target this new tool to the most economically distressed communities in their states.

3 See The Bond Buyer, "Puerto Rico's blow from federal tax reform may be softened," Dec. 18, 2017.

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.

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