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Opportunity Zones: An Opportunity to Apply Lessons Learned from the New Markets Tax Credit Program

The Internal Revenue Service (IRS) is currently working on guidance on how the qualified opportunity zone (OZ) benefit under Internal Revenue Code (IRC) 1400Z-2 will be administered. Thus far, the IRS has posted a list of Frequently Asked Questions about OZs with additional guidance in the form of interim regulations anticipated in the very near future.

There hasn't been this much interest or excitement in a community and economic development incentive since the New Markets Tax Credit (NMTC) program was established as part of the Community Renewal Tax Relief Act of 2000. It is not surprising, therefore, that Opportunity Zones (OZ) legislation borrowed some of the same attributes of the NMTC in attracting private investment in low-income communities. Particularly notable is the census tracts eligible for designation as OZs mirror the low-income tract criteria for the NMTC program.

Other similarities between the two incentives include, but are not limited to

1. the list of "sin" businesses in the statute that a qualified opportunity zone business can not engage;
2. the 180-day time requirement for taxpayer investments in opportunity funds to qualify for deferral versus 12 months for CDEs to invest taxpayer equity under the NMTC program;
3. Less than 5 percent of the average of the aggregate unadjusted bases of the property of an OZ business or qualified active low-income community business (QALICB) may be attributable to nonqualified financial property;
4. At least 50 percent of the total qualified OZ business or QALICB's gross income must be derived from the active conduct of such business; and
5. Both are tax-driven incentives under the Internal Revenue Code.

Despite these similarities, there is one particularly noticeable distinction: the means by which private investment in low-income communities will be incentivized. In the case of OZ investments, capital will flow from an untapped reservoir of unrealized capital gains estimated to be approximately $6 trillion, according to the Economic Innovation Group. In stark contrast, the NMTC is subject to congressional allocations of tax credit authority that currently extends through 2019 at $3.5 billion annually. Furthermore, allocations of NMTCs are awarded through a very competitive annual award process, with typically only one in three applications receiving awards.

With the potential to stimulate private investment well beyond the NMTC program's annual limits of tax credit authority, it's no wonder that a great deal of attention is getting paid to ensuring guidance forthcoming from the Treasury Department addresses key issues of interest to investors and potential fund managers related to the tax treatment of investments and the implementation of qualified opportunity funds.

One aspect of the OZ incentive that should not be overlooked is the need to ensure that the real estate bias that occurred with the NMTC in the early years is not replicated with the OZ incentive

when it comes to investing in small businesses. To mitigate against a real estate bias, the CDFI Fund added a question about innovative uses of an NMTC allocation several years ago that now includes providing qualified low-income community investments (QLICIs) where the total QLICIs received by the QALICB are $4 million or less, making QLICIs as debt or equity with an original term less than or equal to 60 months, and providing QLICIs for non-real estate activities such as working capital, inventory or equipment purchases. While unscored, the CDFI Fund was clear that responses to this question would be considered in Phase II of the allocation application reviews and could affect the size of an applicant's NMTC allocation. This incentivized some CDEs to either pivot from strictly real estate investing or to increase their commitment to financing operating businesses.

Taking lessons learned from the NMTC program, it would be optimal to have the initial guidance from Treasury attempt to ensure investments into small businesses are on a par with real estate development. Toward that end, it would be particularly helpful to have interim gains receive favorable tax treatment provided they were reinvested within an OZ thereby allowing for the liquidation and redeployment of capital during the ten-year holding period for permanent exclusion of any post-acquisition appreciation in the investment. This added flexibility would encourage diversification between real estate and operating businesses investments.

It would also be beneficial to extend the deployment timeline well beyond the current 180-day timeframe to allow sufficient time to assemble and underwrite OZ businesses. Extending the timeframe to 12 months beginning on the date the cash is received by the opportunity fund would be similar to the time permitted to community development entities to invest taxpayer equity under the NMTC program.

Another consideration would be to set a "substantially all" standard of 70 percent for business' tangible property in order for a business to qualify as an OZ business in recognition of the fact that there are many normal costs/tangible properties of operating businesses that are not likely qualified as OZ property.

Addressing these issues now will send an important signal that the OZ incentive is open for small businesses.

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