HAWKINS ADVISORY

QUALIFIED OPPORTUNITY ZONES – NEW IRC SECTIONS 1400Z-1 and 1400Z-2

A. Background.

The Tax Cuts and Jobs Act of 2017 (P.L. 115-97) (the "**TCJA**"), introduced a temporary provision in new sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code of 1986, as amended (the "**Code**"), which are intended to incentivize economic growth and development in certain low-income communities which have been designated and recognized as "**qualified opportunity zones**" or "**QOZs**", as defined below. The provision provides two main tax incentives to encourage investment in QOZs. The first incentive allows a taxpayer to defer the inclusion in gross income of capital gains that are invested in a "**qualified opportunity fund**" or "**QOF**", as defined below. The second incentive allows a taxpayer to exclude from gross income qualifying capital gains on investments in QOFs.

B. Benefits to Investor.

1. Temporary Deferral of Tax on Reinvested Original Capital Gain. A taxpayer may defer a capital gain derived from the sale or exchange existing property to an unrelated person, if the taxpayer invests such gain in a QOF during the 180-day period immediately following the sale date. Any capital gains from the sale or exchange of the existing property that are not reinvested in a QOF within the 180-day period will be included in the taxpayer's gross income without regard to section 1400Z of the Code.

If the taxpayer maintains its investment in a QOF for at least five years, the basis of the original capital gain will be increased by 10 percent of such original capital gain. This means 10 percent of the capital gain on the sale or exchange of the existing asset will be eliminated if the taxpayer holds its investment in a QOF for at least five years.

If the taxpayer maintains its investment in a QOF for at least seven years, the basis of the original capital gain will be increased by an additional five percent of the original capital gain, for a total 15 percent increase in basis. This means an additional five percent, or a total of 15 percent, of the capital gain on the sale or exchange of the existing asset will be eliminated if the QOF investment is held for at least seven years.

The deferred gain is recognized on the earlier of the date on which the taxpayer disposes of its investment in a QOF or December 31, 2026.

2. Step-up in Basis for Reinvested Original Capital Gain. The basis of an investment in a QOF immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis of the QOF investment is increased by 10 percent of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis of the investment is increased by an additional five percent of the deferred gain, for a total of 15 percent. If the investment is held by the taxpayer until at least December 31, 2026, the basis of the investment may be increased by the remaining 85 percent of the deferred gain. It is unclear what the calculation should be if the QOF investment is made closer to December 31, 2026.

3. Deferral of Tax on Capital Gain on Investment in a QOF. The post-acquisition capital gains on investment in a QOF that is held for at least 10 years are permanently excluded from gross income. Specifically, in the case of the sale or exchange of an investment in a QOF held for more than 10 years, at the election of the taxpayer, the basis of such investment in the hands of the taxpayer shall be the fair market value of the investment at the date of such sale or exchange. Taxpayers can continue to recognize losses associated with investments in QOFs as under current law. Notwithstanding the foregoing, the taxpayer may still owe tax on its original capital gain, as described above.

4. Operating Rules. If only a portion of the investments in a QOF are investments of gain in respect of which an election under section 1400Z-2 is in effect, such investment shall be treated as two separate investments: one including only the amounts to which section 1400Z-2 applies, and one consisting of other amounts. The provisions of section 1400Z-2 will apply only to eligible investments for which an election has been properly made.

C. QOZ Eligibility and Designation.

1. QOZ Defined. A QOZ is any population census tract (either a nominated low-income community (a "**low-income community**" or "**LIC**") or a nominated non-LIC contiguous census tract) that is designated as a QOZ.

2. Qualifying Tracts. In general, the term "**low-income community**", is defined by reference to section 45D(e) of the Code with respect to New Market Tax Credits.

3. Contiguous Tracts. A tract that is not an LIC is eligible for designation if both of the following conditions are met:

- the non-LIC tract is contiguous with an LIC that is designated as a QOZ (the contiguous LIC QOZ need not be in the same state); and
- the median family income of the non-LIC tract does not exceed 125 percent of the median family income of that contiguous LIC QOZ.

D. Designation of QOZ.

Not later than 90 days after the date of enactment of the TCJA (i.e., March 21, 2018), the chief executive officer of a state (or a possession of the United States or the District of Columbia)

must have nominated the eligible population census tract for designation as a QOZ, and must have notifed the Secretary of the Treasury in writing of such nomination.

The Secretary must then certify the nomination and designate the tract as a QOZ before the end of the "consideration period", i.e., the 30-day period beginning on the date on which the Secretary receives notice of the nomination. A state (or possession or District of Columbia) may have requested the Secretary to extend the periods set forth above by 30 days.

The number of population census tracts in a state that may be designated as QOZs may not exceed 25 percent of the number of low-income communities within the State; however, if the number of low-income communities within a state is less than 100, then a total of 25 of such communities may be designated as QOZs. Not more than five percent of the tracts designated in a state may be non-LIC, contiguous tracts as described in C.3. above.

The designation period for a QOZ shall remain in effect for the period beginning on the date of the designation and ending at the close of the 10th calendar year beginning on or after such date of designation. The benefits of the designation described in section 1400Z-2, however, do not appear to extend beyond December 31, 2026.

E. Rev. Proc. 2018-16.

Rev. Proc. 2018-16 (the "**Rev. Proc.**") was published on February 8, 2018, to provide guidance to the chief executive officer of any state, any possession of the United States, and the District of Columbia regarding the procedures for designating population census tracts as QOZs. The Rev. Proc. recognizes the **2011-2015 American Community Survey (ACS) 5-Year data from the Census Bureau** (https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx), a public, online resource identifying over 41,000 population census tracts that are eligible for designation as a QOZ as a "safe harbor" resource for purposes of selecting eligible tracts. If a tract is eligible under the most recent available ACS 5-Year data, the tract may be nominated for designation, however, the nomination must have been accompanied by an analysis demonstrating the tract's eligibility, including appropriate supporting data from that survey.

In addition, the Rev. Proc. describes a "**Nomination Tool**," which has been developed for the benefit of chief executive officers of the eligible jurisdictions for the purposes of nominating census tracts for designation as QOZs. This Nomination Tool is accessible online and was reportedly sent individually to all chief executive officers.

On April 9, 2018, the U.S. Department of the Treasury and the IRS designated QOZs in 18 eligible jurisdictions: American Samoa; Arizona; California; Colorado; Georgia; Idaho; Kentucky; Michigan; Mississippi; Nebraska; New Jersey; Oklahoma; Puerto Rico; South Carolina; South Dakota; Vermont; Virgin Islands; and Wisconsin.

F. Qualified Opportunity Fund.

1. In General. The amount of gain from the sale or disposition of existing property that can be deferred from inclusion in gross income is equal to the amount of such gain invested in a QOF, i.e., any investment vehicle organized as a corporation or partnership for the purpose of investing in "**qualified opportunity zone property**", as defined below. In order to qualify as a QOF, at least 90 percent of the fund's assets must be held in qualified opportunity zone property. The 90 percent requirement is determined by averaging the percentage of qualified opportunity zone property held by the fund on the last day of the first six-month period of the fund's tax year and on the last day of the fund's tax year.

Unless the failure to do so is for reasonable cause, the QOF must pay a penalty for each month the 90-percent requirement described immediately above is not satisfied. The amount of the penalty is the (a) excess of 90 percent of the QOF's aggregated assets over the aggregate amount of qualified opportunity zone property held, (b) multiplied by the underpayment rate under Code section 6621(a)(2) for that month.

2. Qualified Opportunity Zone Property Defined. "Qualified opportunity zone property" means:

- "**qualified opportunity zone stock**";
- "**qualified opportunity zone partnership interest**"; or
- "**qualified opportunity zone business property**".

a. "**Qualified opportunity zone stock**" is defined as stock in a domestic corporation acquired by a QOF after December 31, 2017, at the stock's original issuance, solely in exchange for cash. The corporation must be a qualified opportunity zone business at the time of issue (or was being organized as a qualified opportunity zone business if a new corporation) and for substantially all the QOF's holding period.

b. "**Qualified opportunity zone partnership interest**" is any capital or profits interest in a domestic partnership acquired by a QOF after December 31, 2017, from the partnership solely in exchange for cash. The partnership must be a qualified opportunity zone business at the time of acquisition (or was being organized as a qualified opportunity zone business, if a new partnership) and for substantially all of the QOF's holding period.

c. "**Qualified opportunity zone business property**" is tangible property used in a trade or business of the QOF, if:

- the property is purchased by the QOF from an unrelated person after December 31, 2017,
- the original use of the property in the QOZ commences with the QOF or the property is substantially improved by the QOF; for this purpose, property will be considered substantially improved, if additions to the basis of the acquired property during the 30-month period beginning on the date the property is acquired exceeds the basis of the property on its acquisition date, and
- the property was used in a QOZ during substantially all of the QOF's holding period for such property.

3. Qualified Opportunity Zone Business. A "qualified opportunity zone business" is a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is "qualified opportunity zone business property".

Qualified opportunity zone business property is determined in the same manner as qualified opportunity zone business property, as set forth above, except that the term "qualified opportunity business" is substituted for "QOF" each place it appears. The business must also satisfy the requirements for an enterprise zone business under Code section 1397C(b)(2), (4) and (8); i.e., with respect to any taxable year, at least 50 percent of the gross income of the entity is derived from the active conduct of the qualified opportunity zone business, a substantial portion of the intangible property of such entity is used in the active conduct of any such business, and less than five percent of the average unadjusted bases of the property of the entity is attributable to nonqualified financial property. Nonqualified financial property means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property, except that such property shall not include amounts of working capital held as cash, cash equivalents, or debt instruments with a term of 18 months or less, or notes receivable acquired in the ordinary course of a trade or business. A qualified opportunity zone business may not include 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 premises (see, Code section 144(c)(6)(B)).

Tangible property will continue to be treated as qualified opportunity zone property for purposes of the foregoing, even if it ceases to qualified, for the lesser of (a) five years after the date on which it ceases to be qualified opportunity zone business property, or (b) the date it is no longer held by a qualified opportunity zone business.

G. Anticipated Future Guidance.

Treasury and the IRS plan to issue additional information in respect of QOFs. The additional guidance will address the certification of QOFs which are required to have at least 90 percent of fund assets invested in QOZs.

****

Please contact a member of the Hawkins Delafield & Wood LLP tax department with any questions.

Faust N. Bowerman	fbowerman@hawkins.com
Jennifer B. Cordova	jcordova@hawkins.com
Michela Daliana	mdaliana@hawkins.com
James R. Eustis, Jr.	jeustis@hawkins.com
Neil J. Kaplan	nkaplan@hawkins.com
Russell A. Miller	rmiller@hawkins.com
Brian Organ	borgan@hawkins.com
Kathleen Orlandi	korlandi@hawkins.com
Kam Wong	kwong@hawkins.com
Peter Lam	plam@hawkins.com
Sharon Brown	sbrown@hawkins.com
Robert Radigan	rradigan@hawkins.com

About Hawkins Advisory

The Hawkins Advisory is intended to provide occasional general comments on new developments in Federal and State law and regulations that we believe might be of interest to our clients. Articles in the Hawkins Advisory should not be considered opinions of Hawkins Delafield & Wood LLP. The Hawkins Advisory is not intended to provide legal advice as a substitute for seeking professional counsel; readers should not under any circumstance act upon the information in this publication without seeking specific professional counsel. Hawkins Delafield & Wood LLP will be pleased to provide additional details regarding any article upon request.

New York
7 World Trade Center
250 Greenwich Street
New York, NY 10007
Tel: (212) 820-9300

Washington, D.C.
601 Thirteenth Street, N.W.
Washington, D.C. 20005
Tel: (202) 682-1480

Newark
One Gateway Center
Newark, NJ 07102
Tel: (973) 642-8584

Hartford
20 Church Street
Hartford, CT 06103
Tel: (860) 275-6260

Ann Arbor
2723 South State Street
Ann Arbor, MI 48104
Tel: (734) 794-4835

Sacramento
1415 L Street
Sacramento, CA 95814
Tel: (916) 326-5200

Los Angeles
333 South Grand Avenue
Los Angeles, CA 90071
(213) 236-9050

San Francisco
One Embarcadero Center
San Francisco, CA 94111
Tel: (415) 486-4200

Portland
200 SW Market Street
Portland, OR 97201
Tel: (503) 402-1320

Hawkins
DELAFIELD & WOOD LLP