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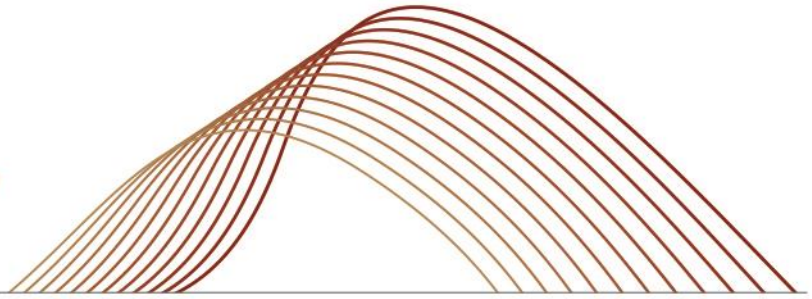

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Update on Qualified Opportunity Zones Added by the Tax Cuts and Jobs Act

By Michael D. Haun & Anna Twardy

On December 22, 2017, President Trump signed into law tax legislation formally known as the Tax Cuts and Jobs Act (the "Act"). The Act added new sections to the Internal Revenue Code of 1986, as amended (the "Code"), providing for a new tax incentive related to "qualified opportunity zones" that seems to be a replacement for the new markets tax credit under Section 45D of the Code (the "NMTC") when it expires after December 31, 2019. In the months following the Act's passing, there have been important updates in this area for investors wanting to benefit from these new incentives.

Overview of Qualified Opportunity Zones

The Senate proposed new tax incentives for "qualified opportunity zones" in new Sections 1400Z-1 and 1400Z-2 of the Code that were included in the Act. Each U.S. possession that is a low-income community (as defined in Section 45D(e) of the Code) is deemed certified and designated as a "qualified opportunity zone." The chief executive officer of each state (which term includes any state, any possession of the United States, and the District of Columbia) may submit nominations for additional opportunity zones to the U.S. Treasury Secretary ("Secretary") for certification and designation. If a state has fewer than 100 low-income communities, the chief executive officer of the state may designate up to 25 tracts as "qualified opportunity zones." If a state has 100 or more low-income communities, the chief executive officer of the state may designate additional tracts as "qualified opportunity zones," but not exceeding 25% of the total number of low-income communities in the state. The provision provides three main tax incentives for investment in "qualified opportunity zones": (1) temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund, (2) elimination of portions of the deferred gain if the interest in the qualified opportunity fund is held by the taxpayer for at least five years, with an additional elimination of deferred gain for an interest held by the taxpayer for at least seven years and (3) exclusion from gross income of the post-acquisition capital gains on investments in opportunity funds that are held for at least ten years. In some ways, a qualified opportunity fund is similar to the structure for the NMTC, as it is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property that holds at least 90% of its assets in qualified opportunity zone property (which includes qualified opportunity zone stock, qualified opportunity zone partnership interests, and qualified opportunity zone business property). Qualified opportunity zone stock and qualified opportunity zone partnership interests must be acquired by the qualified opportunity fund after December 31, 2017, from the corporation or partnership, respectively, solely in exchange for cash. At the time of acquisition, the corporation or partnership, respectively, must be a qualified opportunity zone business (or, in the case of a new entity, must be organized for purposes of being a qualified opportunity zone business) and must continue to be a qualified opportunity zone business during substantially all of the qualified opportunity fund's holding period. A qualified opportunity zone business property is tangible

property used in a trade or business of the qualified opportunity fund, if such property was acquired by the qualified opportunity fund after December 31, 2017. The original use of the property must either commence with the qualified opportunity fund, or the qualified opportunity fund must substantially improve the property. During substantially all of the qualified opportunity fund's holding period for the property, substantially all use of the property must be in a qualified opportunity zone.

With regard to the first and second incentives, the maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. Any amounts of capital gains in excess of the deferral amount will be recognized and included in gross income. If the taxpayer holds its investment in the qualified opportunity zone for at least five years, the basis on the original gain is increased by 10% of the original gain. If the taxpayer holds its investment in the qualified opportunity zone for at least seven years, the basis on the original gain is increased by an additional 5% of the original gain (for a total increase of 15%). The taxpayer will recognize the deferred gain on the earlier of the date on which the qualified opportunity zone investment is disposed of or on December 31, 2026. The basis of the taxpayer's investment is also increased by the same percentages, 10% and an additional 5%, when the investment is held at least five years or seven years, respectively. The five-year and seven-year rules do not provide for adjustments if an investment is made closer to the December 31, 2026 cutoff, so investments need to be made by 2021 in order to receive the 10% basis increase after five years and by 2019 in order to receive the additional 5% basis increase after seven years. If the taxpayer holds its investment until at least December 31, 2026, the basis in the investment increases by the remaining 85% of the deferred gain. If the taxpayer sells or exchanges its investment in a qualified opportunity fund after holding it for more than ten years, the third incentive allows for the taxpayer (not the qualified opportunity fund) to elect that the basis of its investment shall be the fair market value of the investment at the date of sale or exchange. The taxpayer must make this election under Section 1400Z-2(c) of the Code in order for the 100% exclusion to apply to increases in value of the qualified opportunity fund's property held at least ten years.

Nomination Process for Qualified Opportunity Zones

Pursuant to Rev. Proc. 2018-16, the chief executive officer of each state had until March 21, 2018 to nominate tracts within the state to be a qualified opportunity zone. However, they could request a 30-day extension of the Secretary's deadline. All 56 U.S. States and territories either submitted nominations for qualified opportunity zones or requested an extension by the March 21, 2018 deadline. The Secretary is supposed to certify the nominations and designate nominated tracts as a qualified opportunity zone within 30 days of receiving notice of a nomination; therefore, certifications of qualified opportunity zones should be forthcoming by April 20, 2018 for the states that submitted their nominations on March 21, 2018. However, the Secretary's deadline can be extended 30 days by a state's chief executive officer, so the Secretary's certifications may take longer to be announced. Eligible qualified opportunity zones are based on the 2011–2015 American Community Survey five-year data from the Census Bureau that identified over 41,000 population census tracts that are eligible for designation as a qualified opportunity zone. A map of the eligible census tracts can be accessed on the Treasury's Community Development Financial Institutions ("CDFI") Fund website here: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx. All low-income community population census tracts in Puerto Rico were automatically designated as qualified opportunity zones, effective as of the date of the enactment of the Act, pursuant to the Bipartisan Budget Act of 2018 signed by President Trump on February 9, 2018.

Forthcoming Guidance for Qualified Opportunity Zones

More guidance is expected for this new incentive as the Secretary has been tasked with providing regulations to address rules for the certification of qualified opportunity funds. These rules will

ensure a qualified opportunity fund has a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests and will provide guidance on how to reinvest proceeds received from the sale or disposition of qualified opportunity zone property. It is also expected that rules regarding the qualification of qualified opportunity funds will be released by the Treasury and/or the CDFI. These rules will also prevent abuse of this new provision.

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If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings lawyers:

Chicago

Anna Twardy
1.312.499.6025
annatwardy@paulhastings.com

Los Angeles

Michael D. Haun
1.213.683.6119
michaelhaun@paulhastings.com