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2017 Tax Legislation Creates New Tool for Community Development

MICHAEL J. NOVOGRADAC, CPA, NOVOGRADAC & COMPANY LLP

Community development got an unexpected boost from the major tax bill signed into law last year.

Not from community development tax credits, which survived but were weakened by tax reform.

Instead, the good news came when provisions of the Investing in Opportunity Act (IIOA) were included in the final tax legislation passed by Congress and signed by President Donald Trump. This inclusion capped an effort of more than two years to create legislation to encourage new investment in low-income communities, dubbed Opportunity Zones (a new term with familiar roots. More on that later.).

How much investment could result? Supporters of the legislation say that American investors hold an estimated $2.3 trillion in unrealized capital gains on stocks and mutual funds, although it's likely that only a fraction of that will make it into Opportunity Zones. Still, even a fraction of $2.3 trillion is serious money for private capital investment in low-income communities.

And while this new investment opportunity is not driven by tax credits, it will likely be recognizable to the tax credit community–and that is no coincidence. In legislation introduced in each of the past two sessions of Congress, the legislation's authors liberally borrowed from definitions in the new markets tax credit (NMTC) program.

So in an era when lower corporate tax rates may diminish the value of some community development tax credits, there is a new, attractive tool to encourage investment, development and job creation in communities that are most in need.

History

The genesis of the Opportunity Zones concept was triggered by a recognition of the lingering after-effects of the Great Recession in many low-income communities and the growing gap between the communities bouncing back and those left behind. To address this problem, a bipartisan, bicameral

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group of legislators agreed in July 2015 to work to develop solutions to "provide access to capital and new private-sector investment in distressed communities all across the country." The group comprised 10 House members and two senators–including those who would introduce the legislation several months later.

The IIOA was introduced in both the 114th and 115th Congresses.

In early 2016, Reps. Pat Tiberi, R-Ohio, and Ron Kind, D-Wis., introduced the original House version of the bill, which ultimately had 61 co-sponsors, while Sens. Tim Scott, R-S.C., and Cory Booker, D-N.J., introduced the original Senate version of the bill, which picked up nine co-sponsors.

The bills didn't advance, but a year later when reintroduced were even more popular; Scott and Booker again introduced Senate legislation in the 115th Congress, garnering 14 co-sponsors, while Tiberi and Kind introduced the same bill in the House and got 81 co-sponsors.

Proponents made it clear that the proposed incentives would *not* be tax credits–in fact, Tiberi's 2016 press release introducing the first version insisted that, "no tax credits or public sector financing are involved." Observers noted that the IIOA structure was most similar to Internal Revenue Code (IRC) Section 1031 "like-kind" exchange rules–deferring gains realized on other investments if a taxpayer agrees to reinvest them into Opportunity Zones.

While the IIOA deliberately excluded tax credits, the benefits provided by the bill were designed to be *complementary* to the NMTC, low-income housing tax credit (LIHTC), Historic Tax Credit (HTC) and other community development programs. In fact, when he introduced the bill, Tiberi pledged to work to improve and expand the NMTC and LIHTC as part of efforts to further incentivize private capital investment in distressed neighborhoods.

The Opportunity Zone provisions were included first in the Senate version of H.R. 1, and the final tax legislation after surviving the conference meetings. They were signed into law Dec. 22, 2017.

Details, Details

The idea of Opportunity Zones is simple: Offer tax incentives to taxpayers who are willing to invest in economically depressed areas, and provide ever greater incentives for ever longer term investments.

Twenty-five percent of a state's low-income community population census tracts can be designated as qualified Opportunity Zones–a term that has the same definition as "low-income community" under the NMTC program. If there are fewer than 100 such zones in a state, the governor may add as many as 25–think Wyoming, Vermont, Alaska, and other smaller population states. About 40 percent of the census tracts in the country are low-income communities, with about 123 million residents. This means about 10 percent of the country will be eligible for Opportunity Zone status, wherein about 30 million Americans reside.

The new law allows investors to defer paying taxes on gains for up to nine years if the gains are invested in economically distressed communities through what are called qualified Opportunity Funds. The gain must be invested in the fund during a 180-day period that begins on the date of the sale or exchange that generated the gain–essentially within six months of realizing the gain.

The deferral is, for the most part, just that, a deferral. The gain must be recognized at the earlier of two dates: Dec. 31, 2026, or the date the investment in the

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fund is sold or exchanged. The gain recognized is the lesser of the amount of gain originally deferred or the excess of the fair market value of the investment over the taxpayer's basis in the investment. The "for the most part" caveat is included because the program also incentivizes long-term investment by allowing a modest step-up in basis for investments that are held beyond five years and seven years. For investments in Opportunity Funds held at least five years, tax basis is increased by 10 percent of the original gain. For investments held at least seven years, tax basis is increased by an additional 5 percent of the original gain. In short, hold the investment for over seven years, and only 85 percent of the gain will be recognized.

But wait, there is more. For many long-term investors, the greatest attractiveness of this program is that Opportunity Fund investments held for at least 10 years are exempt from any additional gains beyond that which was previously deferred.

Opportunity Funds can be organized in various ways. Funds must be certified by the U.S. Treasury Department and invest at least 90 percent of their assets in Opportunity Zone businesses and/or property. If a fund fails to meet that requirement, it must pay a penalty.

NMTC Versus Opportunity Zones

While Opportunity Zones and the NMTC program are similar, there are differences. Perhaps the most significant is that because of the programs' structures, the NMTC is generally used to subsidize loans to qualified businesses in low-income communities, while Opportunity Funds are required to use funds from deferred gains to make equity investments or acquire property in Opportunity Zones.

The NMTC program is also subject to an annual allocation limit, which in recent years has been $3.5 billion. Opportunity Zones have no such limit; volume will be set only by investor appetite. But the fact that 25 percent of each state's low-income communities will be in Opportunity Zones means that the number of areas eligible to benefit will be significantly less than the NMTC program.

There is a significant question about who will make up the Opportunity Zone investor class. The NMTC program tends to draw major banks, but Opportunity Zones might see more high-net-worth individuals making investments, even though the investments will likely be in areas in which banks can get Community Reinvestment Act credit.

Ultimately, there should be a significant amount of complementary activity between Opportunity Zones and NMTC investments. Many NMTC investments need a little boost to make them economically feasible and Opportunity Zones may provide a vehicle for that. Together, the programs will likely achieve goals that are impossible separately.

What's Coming Next

Opportunity Zones will certainly be a complementary tool to the NMTC while offering a shallower subsidy per dollar of investment. But freedom from relying on an annual allocation means Opportunity Zones could encourage the deployment of more capital than the NMTC. The benefit is spread out geographically, too–each state can designate the same percentage of qualified Opportunity Zones.

Because the stock market's bullish run in recent years has created trillions of dollars of unrealized capital gains, this new incentive could draw significant investment. The next steps are for governors to identify Opportunity Zones, a task that carries a March 22 deadline (although there is the possibility of a 30-day extension). The Treasury Secretary then will have 30 days to certify the governors' nominations.

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Meanwhile, the Treasury Department–most likely led by its Community Development Financial Institutions (CDFI) Fund–is expected to develop rules and guidance on certifying Opportunity Funds. Once that's done, the Treasury Department must certify qualified Opportunity Funds.

Next up, Treasury must announce regulations to guide the program. For context, when the NMTC program launched, it took a couple of years for regulations to be issued, so investors and others involved with Opportunity Zones will need to act in concert to establish standard practices for the program while waiting for official regulations. However, it's expected that community development entities (CDEs) and CDFIs, and other entities, will begin to solicit investors for Opportunity Funds in anticipation of getting certified and the promulgation of Opportunity Zone regulations.

Over the coming months, this new community development tool will continue to take shape.

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Opportunity Zones 101

Beginnings	ORIGINS	Bipartisan group of legislators introduced the Investments in Opportunity Act (IIOA) in the 114th, 115th Congresses.
	BECAME LAW	Provisions of IIOA were part of the tax reform legislation signed into law by President Donald Trump Dec. 22, 2017.
Definitions	OPPORTUNITY ZONES	25 percent of each state's low-income community population census tracts can be designated as qualified Opportunity Zones, which have the same definition as "low-income community" under the New Markets Tax Credit program.
	OPPORTUNITY FUNDS	Funds that are invested in qualified Opportunity Zones. The Funds must be certified by the Treasury Department and invest at least 90 percent of their assets in Opportunity Zone businesses and/or property.
Benefits	BASICS	Investors can defer taxes on gains if they invest in Opportunity Funds within six months of realizing the gain.
	DEFERRAL DEADLINE	Earlier of Dec. 31, 2026 or when the investment in the fund is sold or exchanged.
	BONUS	Investments in Opportunity Funds for at least five years get a 10 percent increase in tax basis of original gain. Investments for at least seven years get a 15 percent increase in the tax basis of the original gain. Investments held for at least 10 years are exempt from any additional gains beyond that which was previously deferred.
Details	WHERE	Opportunity Zones will be in all U.S. states, territories and Washington, D.C.
	SMALL STATES	In states with fewer than 100 Opportunity Zones exist in a state, the governor may add as many as 25.
	POPULATION	About 30 million Americans, roughly 10 percent of the nation's population, live in Opportunity Zones.
	UPCOMING DEADLINES	Governors must identify Opportunity Zones by March 22. Treasury Secretary has 30 days to certify them.
More Info	WEBSITE ADDRESS	For more information, updates, go to our Opportunity Zone Resource Center www.opportunityzoneresourcecenter.com

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Novogradac & Company LLP has an Opportunity Zone working group that will continue to study the provisions and make recommendations to Treasury and other government agencies on implementation. Email cpas@novoco.com if you're interested.

After a yearlong fight to defend and improve community development tax credits, the inclusion of Opportunity Zones in last year's tax legislation reminds us that there are multiple creative ways to encourage investment in the areas that need it most. Now is the time for investors and others to play a role in how this community development tool works.

It's clear that even a combination of the NMTC program and Opportunity Zones isn't enough to meet all the need for private capital in underserved areas. But it's also clear that having two tools is an improvement from where we were before Opportunity Zones.❖

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CONTACT

CORRESPONDENCE AND EDITORIAL SUBMISSIONS
Alex Ruiz
alex.ruiz@novoco.com
415.356.8088

ADVERTISING INQUIRIES
Christianna Cohen
christianna.cohen@novoco.com
925.949.4216

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