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City of Springfield Receives Approval to Designate 3 Areas as "Qualified Opportunity Zones"

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Missouri Governor Eric Greitens and U.S. Senator Roy Blunt (R-MO) recently announced the selection of 161 census tracts receiving designation as "qualified opportunity zones," including ten census tracts located in the City of Springfield[1]. The ten census tracts receiving designation in Springfield are concentrated in three distinct areas of the city: center city, north Springfield, and a portion of central Springfield. The qualified opportunity zones program was adopted as part of the recent tax reform legislation and is designed to spur economic and infrastructure growth in areas with high poverty and low job growth.

The program will offer substantial benefits to investors and developers alike, as well as the communities that will benefit from these projects by offering investors the opportunity to defer recognizing capital gains income and offering developers an additional resource for raising equity for projects in distressed areas. In addition, developers may be able to pair the benefits of the qualified opportunity zone program with other sources of tax equity, such as the new markets tax credit ("NMTC") program, thus further enhancing investment value.

Developers and investors wishing to take advantage of the qualified opportunity zone program should contact their legal advisors concerning potential investments. In addition, institutions wishing to be classified as a "qualified opportunity fund" will need to self-certify with the IRS.

WHAT IS A "QUALIFIED OPPORTUNITY ZONE"?

The Tax Cuts and Jobs Act ("TCJA") added a new economic and infrastructure-driven incentive known as the "Qualified Opportunity Zone." Specifically, TCJA amends the Internal Revenue Code of 1986, as amended (the "Code") by adding new Section 1400Z.

Pursuant to Section 1400Z-1(a) of the Code, "qualified opportunity zone" means any population census tract that: (1) constitutes a "low-income community" for purposes of determining eligibility for the NMTC program pursuant to Section 45D(e) of the Code; and (2) has been nominated for designation as a "qualified opportunity zone" by the governor of the state in which the tract is located. The number of qualified opportunity zones a state may nominate is limited to 25% of designated low-income communities in each state. For example, if a state has 100 low income communities for purposes of determining eligibility for the NMTC, that state may designate no more than 25 qualified opportunity zones. However, there is an exception for states having fewer than 100 low income communities. In that case, the state may designate a total of 25 qualified opportunity zones.

Census tracts that do not qualify as low-income communities for purposes of Code Section 45D(e) may still be designated as qualified opportunity zones to the extent that they are contiguous with another low-income community if the median family income of the tract does not exceed 125% of the median family income of the contiguous low-income community. *See,*Code Section 1400Z-1(e). The number of qualified opportunity zones designated pursuant to Code Section 1400Z-1(e) may not exceed 5% of the total number of tracts designated as qualified opportunity zones.

Once a tract has been designated as a qualified opportunity zone, such designation will remain in effect for a period of 10 years, beginning with the date of designation.

Code Section 1400Z-2 allows taxpayers to defer recognition of both short term and long term capital gains if, within 180 days of the disposition of the underlying capital asset, the capital gain proceeds are reinvested into a "qualified opportunity fund." A qualified opportunity fund means any corporation or partnership organized for the purpose of investing in qualified opportunity zone property (other than investment in other qualified opportunity funds), if at least 90 percent of its assets constitute qualified opportunity zone property. *See*, Code Section 1400Z-2(d)(1).

"Qualified opportunity zone property" includes equity interests in qualified opportunity zone businesses. *See,*Code Section 1400Z-2(d)(2). While the definition of "qualified opportunity zone business" varies somewhat from the definition of "qualified active low-income community business" for purposes of determining eligibility for the NMTC, there are several similarities, and thus, as discussed in the section below, it is likely that a QALICB would also satisfy the definition of "qualified opportunity zone business."

Though initial guidance indicated that certification as a qualified opportunity fund would be administered by the Community Development Financial Institutions Fund, a recently released list of answers to frequently asked questions by the IRS now confirms that eligible taxpayers will self-certify as qualified opportunity funds[2]. Thus no additional IRS or other administrative action will be necessary for a taxpayer to certify as a qualified opportunity fund. A self-certification form will be released by the IRS sometime during the summer of 2018 for this purpose which can be attached to the taxpayer's federal income tax return. The IRS has also announced that additional details, including legal guidance regarding the qualified opportunity zones program will be released within the coming months.

Initially, a taxpayer's basis in a qualified opportunity fund investment is deemed to be zero. However, to the extent that the taxpayer holds its investment for a period of at least 5 years, the taxpayer is entitled to increase its basis by an amount equal to 10% of the amount of gain deferred as a result of making the investment. If the investment is held for a period of at least 7 years, the taxpayer is entitled to increase its basis by an additional 5%. If the investment is held for 10 years, the taxpayer may elect to adjust its basis to fair market value. *See,*Code Section 1400Z-2(c). Thus, if the taxpayer holds its investment for a full ten years, the taxpayer will be insulated from any risk associated with fluctuations in the value of the investment by having the option of either adjusting its basis in the investment to fair market value in order to avoid any gain to the extent the property's value has appreciated, or, alternatively, to elect not to adjust the basis, thus allowing the taxpayer to claim a capital loss to the extent that the value of the property has depreciated.

Section 1400Z-2(b) mandates that all taxpayers investing in qualified opportunity funds, regardless of the length the investment is held, to recognize gain equal to the excess of taxpayer's basis in the investment (taking into account basis adjustments) over the lesser of: (1) the amount of the deferred gain; and (2) the fair market value of the property.

COMBINING WITH NMTC

The NMTC program was created to encourage investment and development activities in undercapitalized and underserved areas by attracting private investment through the availability of a federal tax credit. The amount of the NMTC is equal to 39% of the investor's qualified equity investment in a qualified community development entity (a "QCDE") if the QCDE makes a "qualified low-income community investment" (a "QLICI") in a "qualified active low-income community business" (a "QALICB"), and is spread over a period of 7 years.

Given the number of references to the NMTC program contained in the qualified opportunity zone statutes, it appears likely that the simultaneous use of both programs was contemplated prior to the enactment of the QOZ legislation. In order to pair QOZ benefits with the NMTC, a QCDE would also need to obtain status as a qualified opportunity fund.

Typically, NMTC transactions are leveraged transactions. In the typical structure, the NMTC investor uses both loan proceeds and equity proceeds to make an equity investment in the QCDE. The QCDE then loans those proceeds to the QALICB. On the other hand, investors wishing to take advantage of the QOZ program must make their investments in the form of equity to the qualified opportunity zone business/QALICB.

Section 45D(h) of the Code requires the investor in an NMTC transaction to reduce its basis in its investment by the amount of the NMTC claimed. Because the QOZ program requires the taxpayer to begin with a zero basis with respect to its investment, it is possible that the investor may not have sufficient basis to claim the NMTC if QOZ benefits are also being claimed. In addition, the QOZ program requires the investor to hold its investment for a period of ten years before realizing the benefits of being able to adjust its basis to fair market value. On the other hand, an NMTC investment is generally only held for the duration of the 7-year NMTC recapture period. These nuances are likely to conflict with the requirements of a potential NMTC investor. Thus, developers and sponsors seeking to raise outside capital through utilization of the NMTC and QOZ programs will likely need to attract separate investors with respect to each program.

[1] For a complete listing, please visit https://ded.mo.gov/sites/default/files/Opportunity%20Zone%20List_0.pdf

[2] *See*, https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

This is an updated post to include additional guidance recently released by the IRS concerning the process for self-certifying as a qualified opportunity fund.

This blog post was drafted by Nicholas Irmen, an attorney in the Spencer Fane LLP Springfield, MO office. For more information, visit spencerfane.com.