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October 19, 2018

MEMORANDUM

To: EDC Committee
From: Caroline Sevier, Legislative Director, Economic Development and Commerce Committee
Re: **Opportunity Zones Program**

OPPORTUNITY ZONES PROGRAM

Backgrounder
October 2018

TAKEAWAYS

- H.R. 1, the [Tax Cuts and Jobs Act](#), authorized the Opportunity Zones program when it was signed into law on December 22, 2017.
- The Opportunity Zones program provides incentives for investors to re-invest unrealized capital gains into Opportunity Funds in exchange for temporary tax deferral, which will then be used to provide access to capital in low-income communities, or to receive the same benefit with the direct investment of the gains into “qualified opportunity zones”.
- In June, the Department of the Treasury announced the final round of Opportunity Zone designations, with qualified areas in all 50 states, the District of Columbia, and the five United States possessions.
- On October 19, the Department of the Treasury released draft guidance regarding rules and regulations for Opportunity Funds and Opportunity Zone businesses.

OPPORTUNITY ZONES PROGRAM

Background:

In 2016 and 2017, Senators Tim Scott (R-SC) and Cory Booker (D-NJ) and Congressmen Pat Tiberi (R-OH) and Ron Kind (D-WI) introduced the bipartisan Investing in Opportunity Act in the House and Senate, [H.R. 5082](#) and [S. 2868](#). The bill sought to revitalize low-income communities by establishing incentives for investors to reinvest unrealized capital gains into such communities.

The bill would have allowed investors to temporarily defer capital gains recognition from the sale of an appreciated asset by reinvesting the gains into qualified opportunity zones, removing the tax disincentive of realizing those gains. Similarly, the bill would have allowed investors to receive the same tax benefits by contributing capital gains to Opportunity Funds. This would have allowed investors to pool resources and mitigate risks, while increasing the scale of investments to underserved areas. These funds would have been required to invest in qualified opportunity zones. Under that legislation, governors would have been able to designate no more than 25 percent of such census tracts as qualified opportunity zones. However, the bills stalled in the 114th Congress and never received committee or floor votes.

Current Developments:

As part of H.R. 1, the *Tax Cuts and Jobs Act*, Congress included language similar to the bipartisan Investing in Opportunity Act. H.R. 1 establishes the opportunity zones program in *Sec. 13823* and enables states to create Opportunity Zones where investors are able to defer capital gains as long as they invest in existing or new businesses. Opportunity Zones must have a poverty rate of at least 20 percent, or, for rural areas have a median family income that does not exceed 80 percent of the statewide median. Designated zones in metropolitan areas must have a median income that does not exceed 80 percent of the metro area's median income, or be a census tract adjacent to a low-income area as long as the median income does not exceed 125 percent of the area's median income. Opportunity Zones also cannot exceed 25 percent of the low-income qualified census tracts in the state.

When President Trump signed the *Tax Cuts and Jobs Act* into law on December 22, it set the 90-day clock for governors to designate low-income communities as qualified opportunity zones. However, governors were able to request a 30-day extension from the Secretary of the Treasury while awaiting guidance on selecting areas for the designation. By mid-June, Treasury had received and approved all submissions for the designated Opportunity Zones, ending the designation process for the program.

On October 19, Treasury released additional draft guidance for Opportunity Funds and Opportunity Zone businesses. The guidance, consisting of a Notice of Proposed Rulemaking, a Revenue Ruling, and draft tax form for Opportunity Funds, provides greater clarification for Opportunity Funds and Opportunity Zone businesses.

The [proposed regulations](#) clarify that almost all capital gains qualify for deferral. This includes capital gains from a partnership, and allows either a partnership or its partners to elect deferral. Similar rules would apply to other pass-through entities. Generally, to qualify for deferral, the capital gains must be invested in a Qualified Opportunity Fund (QOF), which is an entity treated as a partnership or corporation for federal tax purposes and organized in any of the 50 states, District of Columbia, or five U.S. territories for the purpose of investing in qualified opportunity zone property. The QOF must hold at least 90 percent of its assets in qualified Opportunity Zone property.

Investors who hold their QOF investment for at least 10 years may qualify to increase their basis to the fair market value of the investment on the date it is sold. Specifically, investment benefits include deferral of tax on prior gains as late as 2026. The benefits also include tax forgiveness on gains on that investment if the investor holds the investment for at least 10 years. Opportunity Zones retain their designation for 10 years, but under the proposed regulations, investors can hold onto their investments in QOF through 2047 without losing tax benefits.

The proposed regulations also provide that if at least 70 percent of the business property owned or leased by a trade or business is qualified opportunity zone business property, the requirement that “substantially all” of such business property is qualified opportunity zone business property can be satisfied if other requirements are met. If the property is a building, the proposed regulations provide that “substantial improvement” is measured based only on the basis of the building, not of the underlying land. The revenue ruling, [Rev. Rul. 2018-29](#), provides guidance for taxpayers on the “original use” requirement for land purchased after 2017 in qualified opportunity zones. The draft tax form, Form 8996, is what investment vehicles will use to self-certify as QOFs.

Key Provisions from H.R. 1, The Tax Cuts and Jobs Act:

- Sec. 13823
 - Sec. 1400Z – 1
 - This subsection lays out the criteria for a low-income community's designation as a qualified opportunity zone, including the actions a governor must take to nominate such communities. A governor must notify the Secretary of the Treasury of the

nomination of an eligible community within 90 days of the bill's passage, although the governor may request a 30-day extension. The Treasury Secretary has 30 days to certify or reject a governor's nomination.

- The number of census tracts designated as qualified opportunity zones may not exceed 25 percent of the low-income communities in a state. Census tracts that are contiguous with low-income communities may also be designated as qualified opportunity zones under certain conditions laid out in this section.
 - The designation of a qualified opportunity zone remains in effect for 10 years after it is certified by the Treasury Secretary.
- Sec. 1400Z – 2
 - This subsection lays out rules for capital gains invested in opportunity zones and opportunity funds, including the tax treatment of such invested capital gains.

Next Steps:

Treasury and IRS have asked state and local leaders to comment on the proposed regulations issued on October 19, with a 60-day comment period available once published in the Federal Register. However, Treasury and IRS are encouraging investors to start working immediately and are offering a grace period to any who begin under the draft rules in case there are any changes. Treasury also noted that more guidance is expected later this year, containing another tranche of regulations addressing additional questions regarding Opportunity Funds.

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NGA will continue to track the Opportunity Zones program and provide updates as information becomes available. If you have questions or need additional information, please contact EDC staff: Caroline Sevier (csevier@nga.org), Neil Ohlhausen (nohlhausen@nga.org), or Richard Lukas (rlukas@nga.org).