BROWN BROTHERS HARRIMAN

In Focus –

Opportunity Zones and Qualified Opportunity Funds

The US Tax Cuts and Jobs Act (TCJA) of December 2017 created the Opportunity Zones program to increase investment in certain low-income communities throughout the country. The program aims to accomplish this by providing benefits to US investors in the form of deferred and reduced capital gains tax treatment for investments in these regions.

In this edition of *In Focus*, we aim to clarify the requirements of the program for US-based funds and investors hoping to take advantage of the associated tax benefits.

What is an Opportunity Zone?

Opportunity Zones are designated economically-distressed communities. In order to be included within the program, the zones must be nominated for inclusion in the Opportunity Zone program by the state in which they are located and then certified by the federal government. The tax incentives described below are intended to spur economic development in real estate and businesses within these distressed communities. A list of designated Opportunity Zones can be found here.

How can I invest in an Opportunity Zone to take advantage of these benefits?

Perhaps the most accessible way for investors to avail themselves of the tax advantages is to invest in a Qualified Opportunity Fund (QOF).

What is a Qualified Opportunity Fund?

A QOF is an investment entity formed for the purpose of investing in Opportunity Zone properties and businesses. The fund must meet certain requirements in order to qualify for the status. For example, at least 90% of the QOF's assets must be invested in the Opportunity Zone.

What are the benefits of investing in a QOF?

Investment in a QOF can delay or reduce capital gains tax liability. US investors who reinvest capital gains in exchange for equity in a QOF within 180 days may elect to defer recognition of the gain until they sell their interests or until December 31, 2026, whichever is earlier.

Additional benefits are also available depending upon the holding period of the investment:

- If the QOF investment is held for 5 years, the investor may exclude 10% of the deferred gain.
- If the QOF investment is held for 7 years, the investor may exclude an additional 5% (for a total of 15%) of the deferred gain.
- If the QOF investment is held for 10 years, the investor is eligible for stepped-up basis in the equity of the QOF, equal to the fair market value (FMV) at the time of sale.

What are the risks and other considerations of such an investment?

US investors and funds considering investments in QOFs and Opportunity Zones should consider not only the benefits of such investments, but also the practical considerations such as the long holding periods requirements and the uncertainty in the proposed regulations governing QOF investment and testing. Additionally, state and local tax treatment of the deferred gains and other benefits may not be consistent with federal treatment, and the location of the zone itself may trigger potential state filing requirements.

Is it possible to pool investments in a QOF by using a feeder fund?

While it might seem efficient to pool investments in a QOF through feeder funds, both to fund managers and investors, there is uncertainty as to whether this sort of structure would be allowed based upon the regulatory requirement that deferred gains must be invested in the QOF by the taxpayer.

Investments in Opportunity Zones and QOFs offer investors and fund managers interesting and valuable tax benefits while also economically benefiting communities in need. BBH has extensive experience servicing investment partnerships and can leverage these capabilities to serve QOFs. The Investor Service Fund Administration teams are available to meet your needs.

Opportunity Zone Investment Timeline

Today

Traditional investment sold with a gain to the investor

Proceeds reinvested in Qualified Opportunity Zone fund

Gain on sale of investment deferred

+5 Years

QOF investment held for 5 years

10% of deferred gain can now be excluded from income

+7 Years

QOF investment held for 7 years

Additional 5% of deferred gain (for a total of 15%) can now be excluded from income

+10 Years

QOF investment held for 10 years

Investor is eligible for stepped-up basis in the equity of the QOF, equal to the FMV at the time of sale

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