IRS Announces First Wave of Opportunity Zone Designations

by Adam S. Wallwork

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In this article, Wallwork discusses Treasury's first round of designations of qualified opportunity zones.

On April 9 and April 18, Treasury and the IRS designated qualified opportunity zones (QOZs) for 20 states, Puerto Rico, the U.S. Virgin Islands, the Northern Mariana Islands, and American Samoa under a new tax incentive program for low-income census tracts established by the Tax Cuts and Jobs Act (P.L. 115-97). As amended by the Bipartisan Budget Act of 2018 (P.L. 115-123), the TCJA authorizes states, the District of Columbia, U.S. possessions, and Puerto Rico (collectively, "states") to designate as many as 8,762 population census tracts nationwide as QOZs. Designations last for at least 10 years, beginning on the date that Treasury designates the population census tract as a QOZ and ending at the close of the calendar year ending on or after the 10th anniversary of the designation. For more than 55 percent of the QOZs eligible to be designated nationwide, which were part of Treasury's first round of QOZ designations, that designation period apparently will last from April 2018 until December 31, 2028.

The targeted tax incentives available for investors in QOZs allow a taxpayer to defer — and in some cases permanently exclude — qualified gain from a sale of property (including stock, partnership interests, real estate, or personal property) to, or an exchange of property with, an unrelated person. The sale or exchange must be completed before the end of 2026, and, within 180 days of the sale or exchange, gains realized must be reinvested in a self-certified investment vehicle known as a qualified opportunity (QO) fund.[1] The QO fund must then directly invest at least 95 of its assets in qualified businesses or tangible business property within a QOZ.

In a recent report, Linda B. Schakel and I detailed the nomination process for states and described the benefits of investing in a QO fund.[2] In general, states had until March 21 to submit their nominations of population census tracts for QOZ designation by Treasury. From the time it received a state's nomination, Treasury had 30 days to certify and designate the nominated tracts as QOZs. Treasury's period to designate QOZs nominated by states on the March 21 statutory deadline expired April 19. However, because states had the option of requesting a 30-day extension of the nomination period, many states had until April 20 to make their nominations. Although this staggered nomination timeline means that nearly 45 percent of QOZs nationwide have not been designated, Treasury's first round of designations, published April 9, provides investors and prospective fund managers clarity on the location of more than 55 percent of the nation's eligible QOZs.

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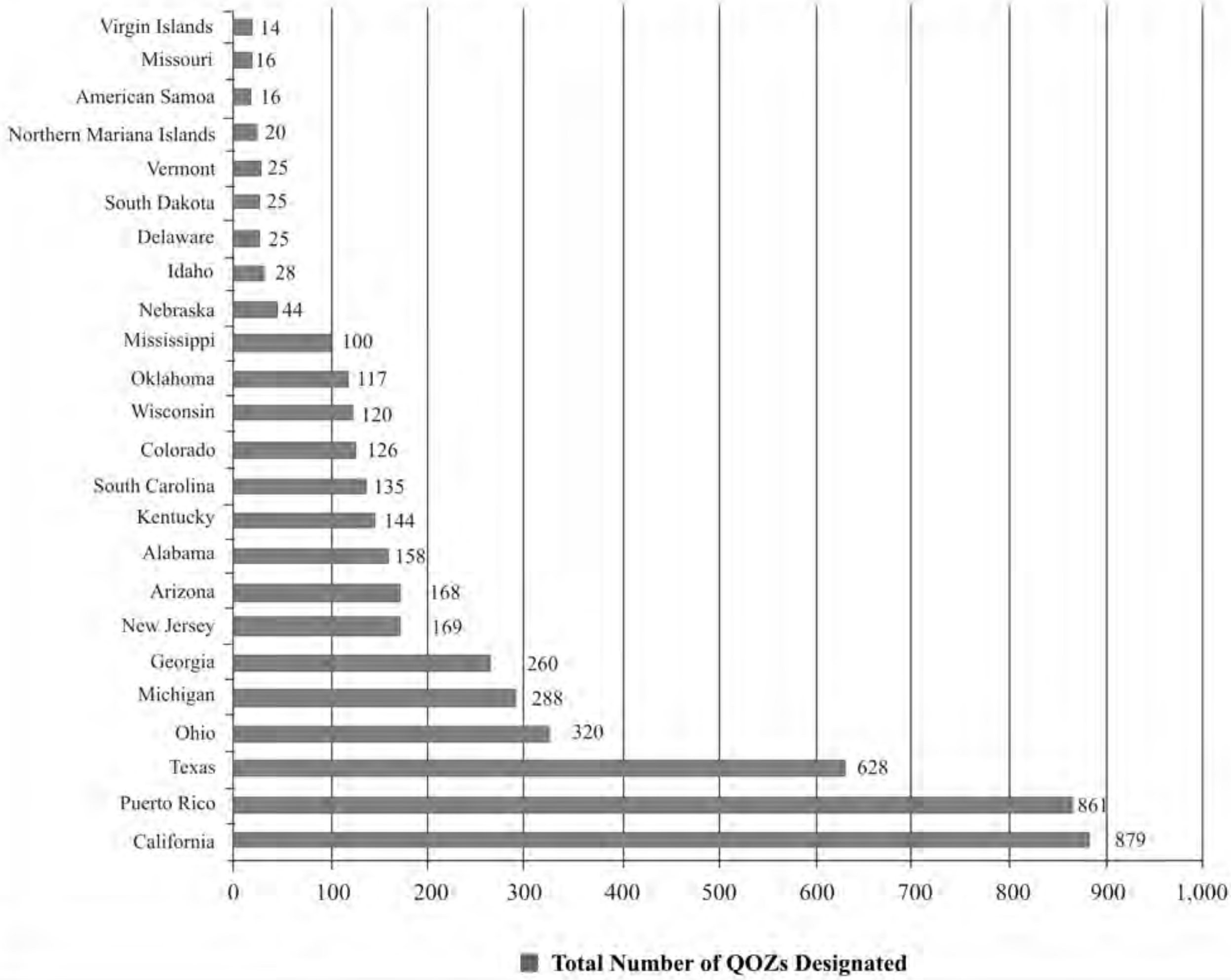
[1] The IRS published "Opportunity Zone Frequently Asked Questions" on April 24, 2018, which clarified that eligible taxpayers will "self-certify" QO funds by completing a form, which will be released in the summer of 2018 and must be filed with the taxpayer's return.

[2] Adam S. Wallwork and Schakel, "Primer on Qualified Opportunity Zones," *Tax Notes*, May 14, 2018, p. 945.

Figure 1. Total Number of QOZ Designations by State, Possession, and Territory, April 2018



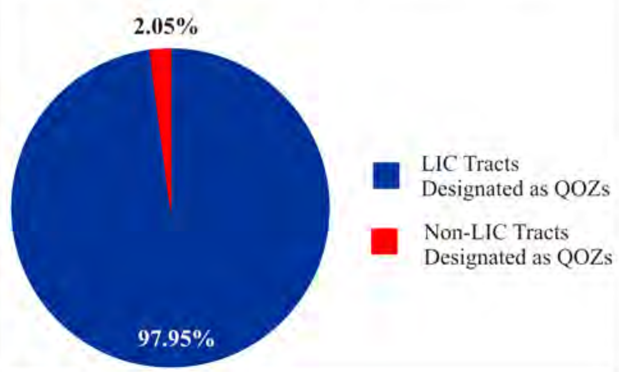
The primary beneficiaries of the QOZ program are population census tracts that meet one of the following five low-income thresholds, which are similar to the thresholds that apply for the new markets tax credit (NMTC) under section 45D[3]:

1. the poverty rate for the tract is at least 20 percent;
2. for a tract not in a metropolitan area, the median family income for the tract does not exceed 80 percent of the statewide median family income;
3. for a census tract in a metropolitan area, the median family income for the tract does not exceed 80 percent of the greater of (a) the statewide median family income or (b) the metropolitan area median family income;
4. the tract (a) has a population of less than 2,000, (b) is in an empowerment zone, and (c) is contiguous with a low-income community (LIC) that has a poverty rate of at least 20 percent or a median family income at least 20 percent below the statewide median (or, if relevant, the metropolitan area median family income); or

[3]The new opportunity zone provisions under section 1400Z-1 expressly incorporate section 45D(e)'s definition of a low-income community (LIC) for NMTCs. However, as a practical matter, targeted populations (including low-income individuals and groups of individuals not defined by geographic boundaries), which are LICs for NMTC purposes, are effectively excluded from QOZ designation because they do not fit within Treasury's safe harbor list of census tracts eligible for nomination as QOZs under Rev. Proc. 2018-16, 2018-9 IRB 383.

5. the tract (a) is in a high-migration rural county with a net outward migration of at least 10 percent of the county's population during a 20-year period ending with the year in which the most recent census was conducted, and (b) the median family income for the tract does not exceed 85 percent of the statewide median family income.

Figure 2. Low-Income and Non-Low-Income Tracts Designated in the First Round of QOZ Designations



The TCJA permits 5 percent of a state's designated QOZs to be non-LIC tracts that are contiguous with an LIC tract that has been nominated as a QOZ. The non-LIC tract must have a median family income that does not exceed 125 percent of the median family income for the contiguous LIC tract. If the contiguous LIC tract qualifies as low-income because its median family income is no more than 80 percent of the applicable statewide or metropolitan area median, the non-LIC tract will necessarily have a median family income that cannot exceed the applicable median family income (that is, 125 percent of 80 percent of the applicable median family income equals 100 percent of the applicable median family income).

However, because some LICs with median family incomes exceeding 80 percent of the applicable statewide or metropolitan area median may still qualify as LICs because they satisfy a different low-income threshold (for example, because the tract's poverty rate is at least 20 percent), some qualifying non-LIC tracts may have median family incomes that substantially exceed 100 percent of the applicable median. California, in particular, appears to have taken advantage of that fact by nominating several tracts in downtown Los Angeles. Among them are one LIC and one non-LIC contiguous tract that have been designated as QOZs despite median family incomes of approximately $108,000 and $92,000, respectively.[4]

Each of the 24 states and possessions included in the first round of designations nominated the maximum number of tracts allowed by law, for a total of 4,831 census tracts designated as QOZs. This includes 4,732 LICs (97.95 percent of all designated QOZs) and 99 non-LIC contiguous tracts (2.05 percent of the designated QOZs). The 24 nominating jurisdictions thus nominated fewer than half of the 182 non-LIC contiguous tracts that could have been designated as QOZs under the statute. All the tracts designated by Georgia, New Jersey, Texas, and Wisconsin as QOZs met at least one of the five low-income thresholds for NMTCs, and less than 1 percent of California's 879 QOZs were non-LIC census tracts, although, as discussed above, California took full advantage of the relatively high median incomes in its major cities. All this could point to local political considerations that might be pressuring states to select far fewer than 5 percent of their QOZ nominations from among the eligible contiguous non-LIC tracts.

The earlier charts and the table that follows show the results of Treasury's first round of QOZ designations, as well as how each state chose to allocate its designations among LIC and non-LIC tracts.

[4]The non-LIC tract that has a median family income equal to 143.71 percent of the Los Angeles metropolitan area median family income is listed in the QOZ database as tract 06037206081, and the LIC tract with a median family income of 173 percent of the Los Angeles metropolitan area's median is tract 06037207900. Median family income for the Los Angeles metropolitan area is derived from statistics available at DataUSA.

State-by-State Data on QOZ Designations (LICs and non-LIC tracts)

State	LIC Tracts Designated as QOZs	Non-LIC Tracts Designated as QOZs	Total Number of QOZs Designated	Percentage of Non-LIC Contiguous Tracts Designated as QOZs
Alabama	153	5	158	3.16%
American Samoa	16	0	16	0%
Arizona	160	8	168	4.76%
California	871	8	879	0.91%
Colorado	119	7	126	5.556%
Delaware	24	1	25	4%
Georgia	260	0	260	0%
Idaho	26	2	28	7.14%
Kentucky	139	5	144	3.472%
Michigan	283	5	288	1.736%
Mississippi	95	5	100	5%
Missouri	153	8	161	5%
Nebraska	43	1	44	2.273%
New Jersey	169	0	169	0%
Northern Mariana Islands	20	0	20	0%
Ohio	317	3	320	0.938%
Oklahoma	114	3	117	3%
Puerto Rico	835	26	861	3.02%
South Carolina	128	7	135	5.19%
South Dakota	23	2	25	8%
Texas	628	0	628	0%
Vermont	23	2	25	8%
Virgin Islands	13	1	14	7.14%
Wisconsin	120	0	120	0%
Total	**4,732**	**99**	**4,831**	**2.05%**

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