As the novelty of the Tax Cuts and Jobs Act (the “Act”) wears off, attention is turning to some of the less high-profile aspects of the Act and the opportunities they present. The opportunity fund falls squarely within the framework of obscure and potentially promising. The opportunity fund is the modern version of a classic tax policy strategy — matching economic need with private investment for mutual benefit. In short, the new special rules for gains invested in opportunity funds are intended to incentivize private investment in areas of economic need through tax benefits.

QUALIFIED OPPORTUNITY ZONES

New Subchapter Z of the Internal Revenue Code provides for the designation of certain low-income community population census tracts as qualified opportunity zones. The Department of Treasury and the Internal Revenue Service have certified designated areas in all 50 states, the District of Columbia, and five U.S. possessions, including Puerto Rico, as opportunity zones. For a complete list of approved Opportunity Zones see: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

In designating opportunity zones, particular consideration was to be given to areas that:

- are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity;
- have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and
- have recently experienced significant layoffs due to business closures or relocations.

The designation of a qualified opportunity zone remains in effect for ten years.¹

QUALIFIED OPPORTUNITY FUNDS GAINING MOMENTUM

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QUALIFIED OPPORTUNITY FUNDS GAINING MOMENTUM

It is estimated that close to 35 million Americans live in qualified opportunity zones. The data on the need is compelling:

<table>
<thead>
<tr>
<th></th>
<th>Qualified Opportunity Zones</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty Rate</td>
<td>The poverty rate in qualified opportunity zones is 32 percent, compared to 17 percent for the average U.S. census tract</td>
</tr>
<tr>
<td>Median Family Income</td>
<td>Opportunity zone median family income is on average 37 percent below the area or state median</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>Opportunity zone unemployment rate is nearly 1.6 times higher than the average U.S. census tract</td>
</tr>
</tbody>
</table>

POTENTIAL TAX BENEFITS FOR INVESTORS

The Act provides three main tax incentives to encourage investment in qualified opportunity funds:

- First, it allows for the temporary *deferral* of inclusion in gross income for gains that are reinvested in a qualified opportunity fund.
- Second, it allows for *exclusion* of up to 15 percent of the gain on the original investment that is deferred by the investment in the qualified opportunity fund if held for seven years.
- Third, the taxpayer may elect to *exclude* from gross income the post-acquisition gains on investments in qualified opportunity funds that are held for at least ten years.²

The rules are nuanced and additional guidance is needed. At its core, the strategy is intended to work as illustrated in the following example:
QUALIFIED OPPORTUNITY FUNDS GAINING MOMENTUM

EXAMPLE

Investor holds stock in company A that has appreciated. She purchased the stock for $200,000 and it is now worth $300,000.

- In Year 1, Investor sells the stock and within 180 days she invests the $100,000 gain in a qualified opportunity fund. Her original basis in the investment in the fund is zero.
- After Year 5, her basis in the investment in the fund is increased by 10 percent of the gain she deferred, or $10,000.
- After Year 7, her basis in the investment in the fund is increased by an additional five percent of the gain she deferred, or $5,000. Her basis in the fund now is $15,000.
- If she sells the investment in the fund before December 31, 2026, she will include her deferred gain in her income, using the applicable basis. If she holds the investment in the fund on December 31, 2026, under the Act, the lesser of the current value of the fund or her deferred gain will be included in her income, again, using the applicable basis.
- After 10 years, at a minimum it is expected that any further gain in the investment in the fund itself will be excluded from her income.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Year 5</th>
<th>Year 7</th>
<th>December 31, 2026</th>
<th>Year 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000 investment in fund; deferred gain; zero basis in investment in the fund</td>
<td>$10,000 basis in investment in the fund</td>
<td>Additional $5,000 basis in investment in the fund; total basis $15,000</td>
<td>Deemed recognition of deferred gain</td>
<td>Basis in investment in the fund equal to fair market value, if Investor files a timely election</td>
</tr>
</tbody>
</table>

Additional tax considerations include the following:

- If an investment is made with mixed funds (part deferred gain and part other), the investment is treated as two separate investments in the fund. The new tax rules only apply to the deferred gain portion of the investment.
- In the case of a decedent, amounts recognized, if not properly included in the gross income of the decedent, will be included in gross income of the decedent’s estate as income in respect of a decedent.

In sum, the maximum amount of the deferred gain from the original investment is equal to the amount invested in a qualified opportunity fund by the investor during the 180-day period, beginning on the date of sale of the original investment. The initial basis in the deferred gain portion of an investment in a fund is zero. Part or all of the deferred gain (depending on how long the investment in the fund has been held) will be deemed recognized December 31, 2026. After 10 years, it is expected that any further gain in the investment in the fund itself will be excluded from income.
QUALIFIED OPPORTUNITY FUNDS GAINING MOMENTUM

OPPORTUNITY ZONE INVESTMENT VEHICLES

What is a qualified opportunity fund?
A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund). The fund must hold at least 90 percent of its assets in qualified opportunity zone property. Opportunity funds become qualified by self-certification, with no required approval or action by the Internal Revenue Service. At the time of this publication, the form for certification was expected to be published.

If a qualified opportunity fund fails to meet the 90 percent requirement (and unless the fund establishes reasonable cause), the fund is required to pay a monthly penalty of the excess of the amount equal to 90 percent of its aggregate assets over the aggregate amount of qualified opportunity zone property held by the fund, multiplied by the underpayment rate in the Internal Revenue Code. If the fund is a partnership, the penalty is taken into account proportionately as part of each partner’s distributive share.

What is qualified opportunity zone property?
Qualified opportunity zone property includes any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property.

CAUTION IN THE FACE OF OPPORTUNITY

The special Subchapter Z gain deferral election is not available for sales or exchanges after December 31, 2026. In addition to the sunset, the nuances of the implementation and enforcement of Subchapter Z are in development, with guidance forthcoming periodically from Treasury and the Internal Revenue Service. This is a changing area and monitoring emerging guidance is recommended. All persons interested in qualified opportunity funds should confer with their legal and tax advisors regarding their particular circumstances.

FOR MORE INFORMATION

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