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Investing in Qualified Opportunity Zones:

Background on the Law and Application of the Law to a Hypothetical Project

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Tax Cuts and Jobs Act of 2017

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act of 2017, Pub. L. 115-97 (the "TCJA"). Comprising the most aggressive tax reform legislation since the Tax Reform Act of 1986, TCJA has been criticized by some as a partisan giveaway and praised by others as a pro-growth proposal. Yet, perhaps lost in the wake of the political banter and posturing related to TCJA's more prominent features (the restructuring of tax brackets and the repeal of certain state and local tax exemptions), is a new economic development tool known as Opportunity Zones, added as §§1400Z-1 and 1400Z-2 of the Internal Revenue Code. Designed to encourage private investment and economic growth throughout many of our country's most economically distressed areas, §1400Z-1 allows for the creation and designation of qualified opportunity zones, while §1400Z-2 allows for a number of favorable tax incentives in the form of temporary deferrals and a possible exclusion from annual income of certain capital gains. The purpose of this article is to highlight recent guidance proposed by the Treasury Department intended to clarify what gains qualify for deferral and potential exclusion, which taxpayers and investments are eligible to receive these benefits, and the parameters for the establishment of an opportunity funds. This article will also provide a "real world" hypothetical to illustrate how the rules under the TCJA are applied in practice.

Opportunity Zones

Opportunity Zones represent a new take in a line of federal tax incentive initiatives designed to expand economic development and long-term private investment in distressed communities.[1] Included in TCJA as The Investing in Opportunity Act (the "Act"), the program proposal garnered significant bipartisan support in an otherwise politically contentious bill.[2] Pursuant to the Act, which has now been codified as 26 U.S.C. §§1400Z-1 and 1400Z-2, each states' governor is able to designate up to 25 percent of their state's low-income community census

[1] Created in the Community Renewal Tax Relief Act of 2000, Pub. L. 106-554, Empowerment Zones ("EZ") and Renewal Communities ("RC") are designated distressed rural and urban communities where qualified business operating in such designated areas are eligible for employment credits (up to $3,000.00 annually for each employee who resides within that EZ or RC.

[2] The Act was introduced by Senator Tim Scott (R-SC) and Senator Cory Booker (D-NJ) in the United States Senate, and by Representative Pat Tiberi (R-OH) and Representative Ron Kind (D-WI) in the United States House of Representatives.

tracts to be designated by the Department of the Treasury as an "Opportunity Zone."[3] Low-income community census tracts are generally defined as places with poverty rates of at least 20 percent or median family incomes no greater than 80 percent of the surrounding area. As of the date of this article, the Department of the Treasury has approved Opportunity Zones in all 50 states, the District of Columbia, and five U.S. Territories totaling over 8,000 community census tracts. According to testimony given in front of the U.S. Senate Committee on Small Business and Entrepreneurship by John Lettieri, the President and CEO of the Economic Innovation Group, a bipartisan research and advocacy organization based in Washington, D.C., more than 31 million Americans live within Opportunity Zones, where the median household income in the average tract is only 59 percent of its state or regional median.

Being designated an Opportunity Zone has the potential to generate an influx of capital in each designated community. Pursuant to 26 U.S.C. § 1400Z-2, taxpayers who choose to invest their capital gains through December 31, 2026 may take advantage of three separate tax benefits. First, the taxpayer is able to temporarily defer the inclusion in taxable income for capital gains reinvested in an Opportunity Zone or Opportunity Fund (discussed below). Second, the taxpayer will be granted a "step-up" in basis for capital gains reinvested in an Opportunity Zone or Opportunity Fund. The basis is increased by 10% if the investment is held by the taxpayer for at least 5 years and by an additional 5% if held for at least 7 years, thereby excluding up to 15% of the original gain from taxation. These tax benefits are limited to those taxpayers who invest in an Opportunity Zone at least 5 or 7 years prior to December 31, 2026. Third, the taxpayer may permanently exclude from its taxable income capital gains from the sale or exchange of its initial investment in an Opportunity Zone or Opportunity Fund if the investment is held for at least 10 years. This exclusion only applies to gains accrued on the initial investment by the taxpayer in an Opportunity Zone or Opportunity Fund. It should be noted that there are two categories of "capital gain" – (1) capital gain from the sale/disposition of the unrelated property which is effectively rolled over into an investment into the Opportunity Zone and (2) capital gain from taxpayer's investment in the Opportunity Zone.

Unlike a traditional 1031 exchange[4], the tax benefits associated with investment in an Opportunity Zone or Qualified Opportunity Fund (sometimes referred to herein as a "QOF") may be from capital gains generated from the sale of any investment – not just capital gains from the sale or disposition of real property. Additionally, the Act only requires that capital gains be invested in an Opportunity Zone or Qualified Opportunity Fund to receive a benefit – as opposed to a traditional 1031 exchange which requires that all proceeds from a sale be reinvested. For example, in 2018, an individual investor sells 1,000 shares of Apple stock they purchased in 2015 for $100,000.00. The sale, at $250.00 per share, results in a $150,000.00 capital gain. Instead of

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[3] Title 26, U.S.C. §§1400Z-1

[4] Section 1031 of the Internal Revenue Code provides an exception that allows a property owner to defer payment of capital gains taxes upon the sale of a business or investment property upon the property owner reinvesting the proceeds of the sale in a similar property through a like-kind exchange.

paying federal capital gains tax on this sale, the investor may invest his or her $150,000.00 gain into an Opportunity Zone or a QOF with a plan to either sell or liquidate the fund in 2028 (thereby deferring paying taxes on the investor's initial $150,000.00 original capital gain, reducing the eventual tax payment on the $150,000.00 original capital gain by 15%, and a complete exclusion from taxes on any additional capital gains generated in connection with the investor's investment into the Qualified Opportunity Fund).

It has been recently publicized that U.S. investors currently hold approximately $6 trillion in unrealized capital gains, indicating a substantial untapped resource for economic investment, job creation, and community development throughout our nation's most underserved communities[5]. As a result of the Act structuring its tax incentives to become more favorable the longer an investment remains in an Opportunity Zone or Qualified Opportunity Fund, policy makers hope the creation of Opportunities Zones will encourage an investment mentality of sustainable capital investment rather than that of a quick "flip."

Qualified Opportunity Funds

It is clear that the objective of the Act was designed to help alleviate poverty, reduce unemployment, and boost economic activity in distressed communities by attracting new capital into those areas, and while an individual investor can reinvest his/her personal capital gains in "Qualified Opportunity Zone Property" (which can include real property and issued stock, partnership interests, or business property in an Opportunity Zone), the authors of the Act had the forethought to create a new investment vehicle allowing multiple investors to pool and deploy significant amounts of reinvestment capital – the "Qualified Opportunity Fund."

Pursuant to Section 1400Z-2(e)(4) of the Code, any taxpayer that is a corporation or partnership for tax purposes may elect to self-certify as a QOF by submitting Form 8996 along with the taxpayer's Federal income tax return for the relevant tax year to be certified by the Treasury Department. To retain its tax benefits, the QOF must also hold at least 90% of its assets in Qualified Opportunity Zone Property, and must further, within 30 months of acquiring the Qualified Opportunity Zone Property, substantially improve any Qualified Opportunity Zone Property by an amount equal to or greater than the adjusted basis of portion of the Qualified Opportunity Zone Property allocated to investments at the beginning of the 30 month period. It is also important to note that the Act does not penalize investments in Qualified Opportunity Zone Property from being coupled with other community development tax incentive programs – Low Income Housing Tax Credits, tax benefits earned pursuant to the Community Renewal Tax Relief Act of 2000, Pub. L. 106-554 (EZ's and RC's), or other local, county, or state programs.

Due to the ease of creating a QOF, and the diversity in kind and class of investments that meet the standard definition of Qualified Opportunity Zone Property, fund managers, real estate

[5] https://www.forbes.com/sites/jenniferpryce/2018/08/14/theres-a-6-trillion-opportunity-in-opportunity-zones-heres-what-we-need-to-do-to-make-good-on-it/#7a8d30296ffc

investors, brokers, developers, and asset managers, are well positioned to take advantage of the tax incentives offered under the Act. It is important, however, that investors contemplating participation in a QOF carefully evaluate various approaches and options, including alternative investment structures that have the potential to maximize the financial, tax, and social benefits presented by the Opportunity Zones.

October 2018 Guidance and Practical Application

Although certain aspects of the Act were clear and discernable, many aspects required clarification potentially delaying investments during the 2018 taxable year. In October 2018, the Treasury Department released illustrative guidance relating to: (i) the type of gains that may be deferred by investors; (ii) the time by which corresponding amounts must be invested in Qualified Opportunity Zone Property; and (iii) the manner in which investors may elect to defer specified gains. The guidance document also contained proposed regulations applicable to QOFs (including rules for self-certification, valuation of QOF assets, and guidance on what may constitute Opportunity Zone businesses). The next section provides a summary of the key benefits and rules for investing in Opportunity Zones with the guidance provided to date.

Summary of Key Benefits and Basic Rules of Investing in Opportunity Zones

1. Gain deferral – Capital gain in connection with the unrelated property are deferred until earlier of December 31, 2026 or earlier sale.

2. Partial exclusion – 10% of gain is forgiven on property held for five (5) years and additional 5% for property held for seven (7) years.

3. Exclusion of gain on appreciation if the Opportunity Zone investment is held for ten (10) years or more:

    a. There is total forgiveness of any appreciation

    b. There is an increase in basis of the investment equal to its fair market value on the date the investment is sold or exchanged

    c. The Proposed Regulations provide that a taxpayer must sell a qualified opportunity zone investment by December 31, 2047, after holding it for at least 10 years in order to make the election to pay no tax on the gain recognized on such a qualified opportunity zone investment

4. A QOF is an investment fund organized as a corporation or partnership for the purpose of investing in a Qualified Opportunity Zone Property (QOZP). There is a distinction between QOZP and Qualified Opportunity Zone Business Property (QOBP) as both are defined terms.

5. A QOF must hold 90% of its assets in QOZP or QOBP. Tested six months after QOF status is effective and at end of first tax year. For applying the 90% asset test,

the QOF uses the asset values that are reported on the QOF's applicable financial statement for the taxable year (as defined in § 1.475(a)-4(h)) or the asset should be valued at cost if the QOF does not have financial statements.

6. Three types of business property are eligible as QOZP: (a) original issue stock of a QOF corporation, (b) interest in a QOF partnership (it can be an LLC), and (c) tangible property which includes construction or substantial renovation of improvements on real estate. In general, the original use of property must begin within the OZ with the applicable opportunity zone business to qualify as QOBP or if the original use of the property within the opportunity zone did not begin with the opportunity zone business, then it may still qualify as QOBP if you meet this "substantially improvement" rule.

7. The QOF can also directly invest in a Qualified Opportunity Zone Business ("QOZB"). A QOZB is a trade or business conducted by an entity in which "substantially all" of the tangible property owned or leased by the business is property that is acquired by purchase after December 31, 2017.

8. Construction or rehabilitation of real property must occur within the 30-month period beginning after the date of acquisition. When building or renovating, additions to basis with respect to such property held by a QOF must be in an amount equal to the adjusted basis of the existing improvements. Land cost is not included in determining the amount that must be expended during the 30-month period.

9. In addition, in order to be a QOZB, the trade or business of a zone entity must meet the following requirements:

   a. "Substantially all" of the tangible property owned or leased by the entity must constitute zone business property.

      (i) If at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property, the trade or business is treated as satisfying the <u>substantially all</u> requirement.

      (ii) Since the QOF must meet the 90% asset test and a QOZB needs to meet a 70% safe harbor, it appears that, in combination, the QOF and QOZB may need to only hold 63% of their assets in QOZ property.

   b. At least 50% of the gross income of the entity must be from the active conduct of the QOZB. For purposes of IRC 1400Z-2, in order for an entity in which a QOF invests to be a QOZB, 50% of the total gross income of such entity must be derived from the active conduct of such business.

   c. A substantial portion of the intangible property of the entity must be used in the active conduct of the QOZB.

d. Less than 5% of the average of the aggregate unadjusted bases of the entity's property can be attributable to "nonqualified financial property," such as debt, stock, partnership interests, options, future contracts, forward contracts, swaps, annuities, and similar property (excluding reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or ordinary course trade or business notes receivable)

10. A QOZB that ceases to be a QOZ business property shall continue to be treated as such for five years or until no longer held (if earlier).

11. Investments cannot include "sin businesses" which include:

    a. Commercial golf course or country club

    b. Massage parlor

    c. Hot tub facility

    d. Suntan facility

    e. Racetrack or other facility for gambling

    f. Off-sale liquor store

12. What is reasonable working capital for a QOZB?

    a. The Proposed Regulations provide a safe harbor for QOZBs that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in an opportunity zone.

    b. For projects that are being constructed, the Proposed Regulations provide that "working capital" includes cash (as well as cash equivalents and debt instruments with a term of 18 months or less) maintained by the QOF for up to 31 months after acquiring the qualified opportunity zone property for the purpose of acquiring, constructing or rehabilitating the property if:

        (i) There is a written plan that identifies such cash as being held for this purpose,

        (ii) There is a written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months, and

        (iii) The business substantially complies with the schedule.

13. What key questions remain to be answered?

a. If an entity acquires existing property already within an Opportunity Zone with a plan to construct or rehabilitate, is the property a QOBP while it is waiting for construction or when it is being constructed/rehabilitated?

b. Timing of investments needs to be clarified. While the working capital exception provides some relief, QOFs may be unable to accept funds from taxpayers within the 180-day requirement if QOF investments are not identified and ready to close. Also, if investors need to obtain land use/zoning approvals, the time periods may be too short.

c. What does "Substantially all" mean when the TCJA states that "substantially all" of the tangible property owned or leased by the entity must constitute zone business property? "Substantially all" is used in several other sections of the statute and is to be addressed in the additional proposed regulation to be published in the "near future."

d. What happens if capital is invested in installments? In real estate projects, capital is typically invested in stages. How will that work?

e. Can a business that consists of leasing residential rental property qualify as an opportunity zone business? The TCJA appears to be a great way to attract capital for the development of affordable housing. Residential rental property is not listed in IRC § 1400Z-2, however, Rev. Rul. 2018-29 describes a residential rental project so seems to indicate that direct ownership of a residential rental property by a QOF qualifies.

f. Does a return of a portion of the partner's cash (not to exceed the partner's basis in its QOF interest) as a result of a refinancing of the asset owned by the QOF constitute a sale or exchange that triggers the end of the tax deferral period?

g. The TCJA does not specifically exclude businesses selling cannabis products. Does this mean they can be QOZB's? Or, are cannabis businesses excluded because they are deemed illegal under Federal law?

Those interested in investing in either an Opportunity Zone directly or through an Opportunity Zone Fund should familiarize themselves with the TCJA and all guidance. Below is a description of a hypothetical project created to illustrate how the basic rules apply when investing in Qualified Opportunity Funds.

Hypothetical Opportunity Zone Project

In 2010, Sergio, a real estate developer, purchased a painting for $1,000,000.00. Sergio discovered that his new painting was in-fact an original Picasso. In November 2018, Sergio decided to sell the Picasso at auction. The Picasso sells for $11,000,000.00 so Sergio has a capital gain of $10,000,000.00.

Sergio has heard about Opportunity Zones from his attorney. Rather than paying the capital gains tax on his $10,000,000.00 capital gain, Sergio chooses to invest his entire capital gain in a Qualified Opportunity Zone. To do so, on January 1, 2019, Sergio forms a Florida limited liability company called S&C LLC. Sergio makes the election to have S&C LLC be taxed as a partnership and files a Form 8996 to self-certify as a QOF when he files the tax return for S&C LLC. Sergio capitalized the newly formed QOF with his capital gains.

Sergio discovered a perfect vacant parcel of land in a Qualified Opportunity Zone designated for multi-family use. The property is located within 1,000 feet of a major public transportation node and rumor has it that the City's Major League Soccer team plans to construct its new state of the art stadium a few blocks away. Sergio enters into a contract to purchase the property for $5,000,000.00.

Since there is a severe shortage of affordable housing in the area, Sergio intends to develop a 20-story mixed-use project consisting of 375 residential apartment units and commercial retail on the ground floor. Since Sergio likes beer, he also intends to operate a microbrewery in one of the commercial spaces on the ground floor of the project since he has learned that his capital gains can also be invested in operating businesses located within Opportunity Zones. Sergio estimates that the total project will cost approximately $50,000,000.00 - $45,000,000 to complete the construction of the building and $5,000,000 to build-out and equip the microbrewery.

Sergio now plans to raise an additional $5,000,000.00 in equity. Lucky for Sergio, his college roommate, Chuck, just sold his luxury beachfront condominium for $15,000,000.00 in December 2018. Chuck made a $10,000,000.00 capital gain on the sale of his condo unit, and chooses to invest $5,000,000.00 in Sergio's Qualified Opportunity Fund on January 2, 2019. With a total of $10,000,000 in cash equity and the value of the land ($5,000,000), Sergio and Chuck are confident they can secure a $35,000,000 construction loan to fund the remaining project costs. After Chuck invests his $5,000,000 in S&C LLC, he holds a 33.33% interest in the venture and Sergio holds a 66.66% interest.

Sergio and Chuck decide that they want the real estate project and the microbrewery to be held in separate entities so they form RE LLC to hold title to the real estate project and MB LLC to hold the assets of the microbrewery business. Sergio then assigned the purchase contract for project land to RE LLC. Each of RE LLC and MB LLC must qualify as a Qualified Opportunity Zone Subsidiary so they each need to be taxed as either a corporation or partnership. In order to qualify for partnership taxation, each LLC must have at least two members. As such, Sergio and Chuck decide to form S&C Corp. and elect to have it taxed as a Sub-S corporation. S&C Corp. will hold a 1% membership interest of each of RE LLC and MB LLC in order to accomplish the two-member requirement. S&C LLC will hold 99% of the membership interest of each of RE LLC and MB LLC. Sergio will hold a 66.66% membership interest in S&C LLC and 66.66% of the stock of S&C Corp. Chuck will hold a 33.33% membership interest in S&C LLC and 33.33%

of the stock of S&C Corp. An organizational chart illustrating the ownership of the entities is attached as Schedule 1.

Sergio and Chuck purchased their interests in S&C LLC and their shares of S&C Corp for cash and S&C LLC and S&C Corp each acquired their respective interests in the two LLC's for cash after 2017 and both of the new LLC's will be engaged in Qualified Opportunity Zone Business. On January 31, 2019, RE LLC closes on the purchase of the project land for $5,000,000. Initially, RE LLC holds the land worth $5,000,000 and $8,000,000 in cash and MB LLC holds $2,000,000 in cash.

Sergio and Chuck engage an architect and GC, enter into construction contracts and commence the project by June 30, 2019 and the project is completed by June 30, 2021. MB LLC signs an agreement to purchase custom made brewing equipment and tanks on June 15, 2019 and delivers a $500,000 deposit to the manufacturer. MB takes delivery of the brewery equipment in June 2021 and pays the balance owed under the contract in the amount of $1,000,000. MB uses the remaining $500,000 to purchase the FF&E necessary to operate the brewery and restaurant. MB commences operations in July 2021 in the commercial space they lease at the project.

In 2027, Sergio and Chuck received an offer from a large beer company to sell MB LLC for $10,000,000. Sergio and Chuck agreed to sell MB and the sale of the LLC interest of MB LLC closed in June 2027.

Sergio and Chuck received a great offer to sell the whole project to a pension fund in 2030 for $75,000,000 so they decided to sell the project and retire. The sale closes in June of 2030.

<u>Analysis of Hypothetical Project</u>[6]

<u>Asset Test</u>: Within 6 months of the filing of the Form 8996 and at December 31st of each year each QOF must pass a semi-annual asset that requires that 90% of the QOF's be Qualified Opportunity Zone Property ("QOZP"). The first test date for the LLCs in the hypothetical is June 30, 2019.

S&C LLC satisfies the test so long as the property held by RE LLC and MB LLC is QOZP. A partnership interest in a partnership that owns QOZP qualifies as QOZP. As described above, RE LLC and MB LLC both qualify as partnerships since they have two members.

As of June 30, 2019, RE LLC holds land in an OZ valued at $5,000,000 and $8,000,000 of cash. The land qualifies as QOZP. The cash is to be used to pay hard and soft costs of the project pursuant to a plan and construction contract so it also qualifies as QOZP under the working capital safe harbor.

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[6] Thanks to Carol Surowiec, Partner, Cherry Bekaert in Coral Gables, Florida for her assistance with the creation of the hypothetical and advice regarding the application of the law to the facts of the hypothetical project.

As of June 30, 2019, MB LLC holds $1,500,000 in cash and is under contract to purchase the brewery equipment to be used in the business. The cash will be used to pay the balance owed when the brewery equipment is delivered and to purchase the FF&E so the cash qualifies as QOZP under the working capital safe harbor. More than 70% of MB LLC's assets will be used in the business. Also, once the brewery is operational, 100% of its gross receipts will be generated by the brewery and restaurant business.

It should be noted that there is a possibility that the microbrewery business could be considered a "sin business" as it involves the sale of liquor. However, since the microbrewery will also serve food, it may qualify as an acceptable business. Perhaps future clarification will be provided by the IRS.

As of December 31, 2019 and all subsequent testing dates each of the LLC's can demonstrate that they comply with the asset test based on the above.

<u>Payment of Capital Gains Tax</u>: In 2026, Sergio and Chuck are required to recognize their capital gains they made in 2018. Each of Sergio and Chuck have held their interest in their QOF for seven years, so 15% of their capital gain is forgiven.

Sergio must pay $1,700,000 in capital gains tax in 2026, calculated as follows: $10,000,000, less 15% or $1,500,000 equals $8,500,000 (the amount subject to tax), multiplied by 20% equals $1,700,000.

Chuck must pay $850,000 in capital gains tax in 2026, calculated as follows: $5,000,000, less 15% or $750,000 equals $4,250,000 (the amount subject to tax), multiplied by 20% equals $850,000. Note that in 2018, Chuck had to pay the capital gains tax on the $5,000,000 he elected not to invest in S&C LLC.

<u>Sale of MB LLC in 2027</u>: The portion of the total capital gain invested by Sergio and Chuck invested in MB is $2,000,000. Upon the sale of MB LLC, the basis on the MB LLC interest is $2,000,000 since the basis includes 85% of the capital gain recognized ($1,700,000), plus the 15% step up in basis as a result of holding the investment for at least 7 years ($300,000). As such, a capital gain of $8,000,000 was realized when MB LLC was sold for $10,000,000 in 2027. Sergio must pay the tax on 66.66% of the gain as the holder of a 66.66% membership interest in S&C LLC and Chuck must pay the tax on 33.33% of the gain as the holder of 33.33% of the membership interest in S&C LLC. Consequently, Sergio pays $1,066,656 (66.66% of $8,000,000 equals $5,333,280, multiplied by the 20% capital gain rate). Chuck pays $533,328 (33.33% of $8,000,000 equals $2,666,640, multiplied by the 20% capital gain rate).

<u>Sale of the Project in 2030</u>: RE LLC sells the entire project in 2030. The basis is equal to the fair market value of the project in 2026 which is approximately $70,000,000. However, since S&C LLC has held the interest in RE LLC for over 10 years, under Section 1400Z-2(c), S&C LLC (Sergio and Chuck) do not recognize any capital gain on the sale. At this point, the project cash

flows reduced the construction mortgage to $30,000,000. After paying off the mortgage and closing expenses of $1,500,000, RE LLC distributes $43,500,000 to S&C LLC. S&C distributes $28,999,710 to Sergio and $14,499,855 to Chuck – tax-free!

SCHEDULE 1

ORGANIZATIONAL CHART