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Workshop 6

Opportunity Zones: Deferring, Reducing and Eliminating Capital Gains in Real Estate Transactions

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Introduction

The Qualified Opportunity Zone (QOZ) program was created in December 2017 as part of the 2017 Tax Cuts and Jobs Act (TCJA) to spur economic development in distressed areas throughout the United States. QOZ investors enjoy tax deferrals on their invested capital gains and favorable tax treatment upon the sale of the related QOZ property or business. No wonder that in the two plus years following the passing of the TCJA over $10 billion has been funded by your clients and other investors into QOZ funds (QOFs). However, the economic downturn and uncertainty triggered by the Covid-19 pandemic is causing investors to reevaluate QOF investments. Moreover, the economic downturn combined with the issues of policing and wealth disparities are compelling policy makers to amend and rethink the QOZ program. This seminar will explore, among other things, various strategies and considerations for QOF investments and the QOZ program generally during a time when social impact investing is especially needed and food deserts across the country persist.

1. Opportunity Zone Tax Primer

What are Qualified Opportunity Zones (QOZ)?

The 8,761 nationwide census tracts nominated by the states and approved by Treasury and located in low income communities or contiguous to low-income communities. Notice 2018-48 lists the population census tracks approved by Treasury as QOZs.

What is a Qualified Opportunity Fund (QOF)?

A QOF, in general terms, is a corporation or partnership that invests at least 90 percent of its assets in "qualified opportunity zone property," which is defined as "qualified opportunity zone business property," "qualified opportunity zone stock," and "qualified opportunity zone partnership interests." Qualified opportunity zone business property is tangible property used in a trade or business within a QOZ if, among other requirements, (i) the property is acquired by the QOF by purchase after December 31, 2017 from an unrelated person, (ii) either the original use

of the property in the QOZ commences with the QOF or the QOF "substantially improves" the property by doubling the basis of the property over any 30-month period after the property is acquired, and (iii) substantially all of the use of the property is within an QOZ. Qualified opportunity zone stock and qualified opportunity zone partnership interests are stock in a corporation or interests in a partnership acquired in a primary issuance for cash after December 31, 2017, provided "substantially all" of the tangible property, whether leased or owned, of the corporation or partnership is qualified opportunity zone business property during substantially all of the QOF's holding period for the stock or interest.

QOFs can be created by the taxpayer or an investor can invest in an established QOF. To become a QOF, an eligible corporation or partnership self-certifies by annually filing Form 8996 with its federal income tax return. See Form 8996 instructions. The data selected on the Form 8996 is key for triggering when capital investments may be taken in by the QOF, in addition to asset testing periods for satisfying the 90 percent asset test referenced above.

What are the Federal Tax Benefits of Opportunity Zones?

Investments in QOFs can qualify for three principal tax benefits: (i) a temporary deferral of capital gains that are reinvested in a QOF within 180 days after the recognition of such gains ("reinvested gain"), (ii) an exclusion of up to 15% of such reinvested gain, and (iii) a permanent exclusion of all gain, other than reinvested gain, realized on an investment in a QOF that is held for a ten-year period.

- *Deferral*. In general, all capital gains realized by a person that are reinvested within 180 days of the recognition of such gain in a QOF for which an election is made are deferred for U.S. federal income tax purposes until the earlier of (i) the date on which the investment is sold or exchanged and (ii) December 31, 2026. Under current Treasury Regulations, with respect to any capital gain recognized by a partnership and reinvested by a partner thereof in a QOF, the 180-day investment period would begin on the last day of the partnership's taxable year, though the partner could elect to commence the period on the date the partnership recognized the capital gain. Additional flexibility was provided for in the regulations to allow investments to be made until the entity's tax return is due to be filed.
- *Exclusion*. An investor's tax basis in a QOF for purposes of determining gain or loss is increased by 10 percent of the amount of reinvested gain if the investment is held for five years by December 31, 2026 and is increased by an additional 5 percent of the amount of reinvested gain (for a total increase of 15 percent) if the investment is held for seven years by December 31, 2026. This means for investors that invested in a QOF prior to the end of 2019, they should receive a 15 percent reduction to gain recognized; while investors that got in before the end of 2021 receive a 10 percent reduction to the gain when recognized.
- *Step Up in Basis.* The tax basis in an investment in a QOF attributable to reinvested gain and held for at least 10 years is increased to the fair market value of such investment on the date of the sale or exchange of such investment, effectively eliminating any gain (other than the reinvested gain) in the investment for U.S. federal income tax purposes. Importantly, if an investor sells its qualifying investment before the end of the ten-year period, that investor can roll it over into another qualifying investment. Furthermore, final regulations clarified that a QOF's sale of qualifying property should be exempt from tax due to the basis step-up with that treatment passing through to investors.

See Appendix A for a more detailed (but not exhaustive) presentation of select Opportunity Zone tax matters

2. IRS Provided Relief Needed due to COVID-19-Related Delays for Taxpayers

- *Generally*. The IRS released Notice 2021-10 providing additional relief for QOFs and their investors in response to the coronavirus (COVID-19) pandemic.. These extended time frames are detailed below.

- *Postponement of 180-Day Investment Period*. Generally, taxpayers may elect to exclude from gross income capital gains from the sale to, or exchange with, an unrelated person of any property held by the taxpayer invested in a QOF during the 180-day period beginning from the date of such sale or exchange. Notice 2021-10 provides that If the last day of the 180-day investment period within which a taxpayer must make an investment in a QOF falls on or after April 1, 2020, and before March 31, 2021, the last day of that 180-day investment period is automatically postponed to March 31, 2021.

- *90% Investment Standard for QOFs*. A QOF is required to hold at least 90% of its assets in qualified QOZ property, determined by the average of the percentage of QOZ property held by that QOF as measured (1) on the last day of the first six-month period of the tax year of the QOF, and (2) on the last day of the tax year of the QOF. Notice 2021-10 provides that in the case of a QOF whose (1) last day of the first six-month period of a tax year or (2) last day of a tax year falls within the period beginning on April 1, 2020, and ending on June 30, 2021, any failure by that QOF to satisfy the 90% investment standard for that tax year of the QOF is due to reasonable cause under section 1400Z-2(f)(3). Thus, any failure by that QOF to satisfy the 90% investment standard for that tax year is not taken into account for purposes of determining whether the QOF or any otherwise qualifying investments in that QOF satisfy the requirements of section 1400Z-2 and the section 1400Z-2 regulations for any tax year of the QOF

- *Extension of 30-Month Substantial Improvement Requirement.* Generally, QOFs have 30 months within which to substantially improve property to qualify as QOZB property. Notice 2021-10 provides that the 30-month substantial improvement period for property held by a QOF or a QOZB for the period beginning on April 1, 2020, and ending on March 31, 2021, is disregarded in determining any 30-month substantial improvement period. Consequently, the 30-month substantial improvement period is tolled during the period beginning on April 1, 2020, and ending on March 31, 2021.

- *Extension of 31-Month Safe Harbor for Working Capital*. As originally provided under the opportunity zone regulations, the working capital safe harbor allows a QOZB to treat any amount of working capital (if held in cash, cash equivalents, and/or debt instruments not exceeding 18 months) as reasonable for a period of up to 31 months, if:

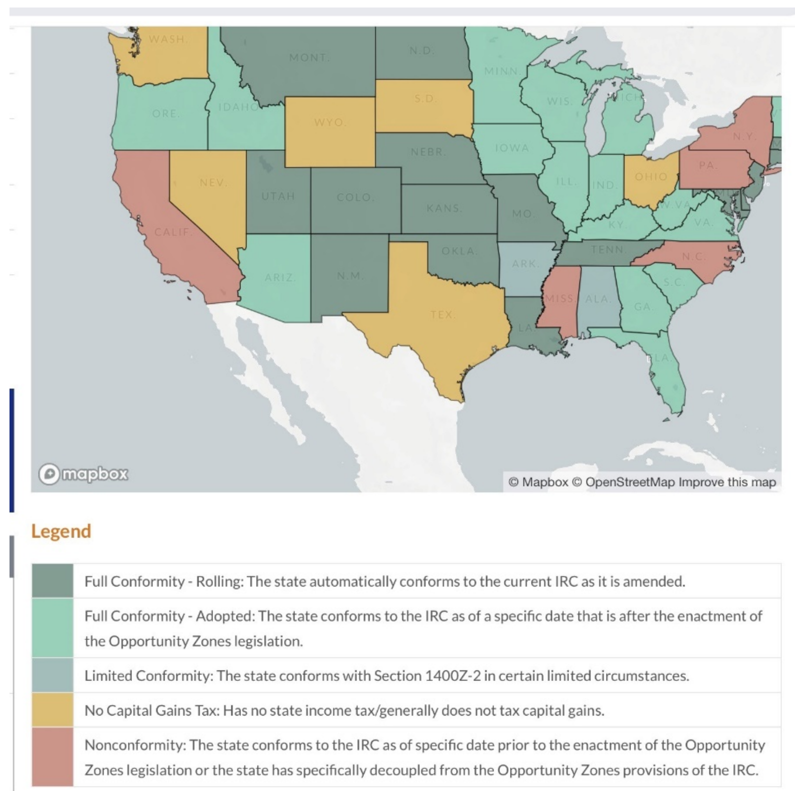
  - There is a plan that identifies the working capital as property intended to be used in a trade or business in the QOZ;
  - There is a schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital, and under that schedule, the working capital will be spent within 31 months of receipt; and,
  - The working capital is used in a manner that is substantially consistent with the schedule.

Notice 2021-10 provides that as a result of the federally declared COVID-19 emergency declaration, all QOZBs holding working capital assets intended to be covered by the working capital safe harbor before June 30, 2021, and if receive not more than an additional 24 months (including any relief provided under Notice 2020-39) qualify for a maximum safe harbor period of not more than 55 months total (not more than 86 months total for start-up businesses) in which to expend the working capital assets of the QOZB, provided all other opportunity zones rules are satisfied.

- *Extension of 12-Month Reinvestment Period*. If a QOF sells or disposes of some or all of QOZ property or if a distribution with respect to the QOF's QOZ stock is treated as a return of capital in the QOF's hands, and if the QOF reinvests some or all of the proceeds in QOZ property by the last day of the 12-month period beginning on the date of the distribution, sale or disposition, then the proceeds are treated as QOZ property for purposes of the 90% investment standard. This treatment is available to a QOF only to the extent that, prior to the reinvestment in qualified opportunity zone property, the reinvested proceeds are continuously held in cash, cash equivalents or debt instruments with a term of 18 months or less. Notice 2021-10 states that If any QOF's 12-month reinvestment period includes June 30, 2020, that QOF receives not more than an additional 12 months, including any relief provided under Notice 2020-39, for a maximum reinvestment period of not more than 24 months total, to reinvest in QOZ property provided that the QOF otherwise satisfies the opportunity zone rules and invests the proceeds in the manner originally intended before June 30, 2020.

3. State Tax Code Conformity – Corporate Income

A state's conformity with the federal opportunity zones provisions is an important factor investors should consider. Investors in states that do conform with the federal opportunity zones provisions may receive state tax incentives similar to those available at the federal level. Conversely, investors residing in nonconforming states may be unable to defer and reduce state taxation on the initial gains invested in opportunity zones. Investors in these nonconforming states may also be required to recognize gain for state tax purposes on their eventual sale of the opportunity fund investment. Notably, New York and California are among the States that have decoupled from opportunity zones. The below chart currently found at the following link which is maintained by Novogradac & Company (see https://www.novoco.com/resource-centers/opportunity-zone-resource-center/guidance/state-tax-code-conformity-corporate-income) but note that the laws change and the data may be stale.



4. What is Possibly Ahead Legislatively for Opportunity Zones.

There is a growing chorus supporting enhancements the OZ incentives. Earlier this year, President Biden advanced a narrative to: (a) push for more partnerships between qualified opportunity funds and nonprofit or community-oriented organizations, and the creation of community benefit plans for each investment, (b) to have the U.S. Department of the Treasury (Treasury) to review OZ benefits to ensure there are clear benefits to the community; and (c) require detailed reporting, along with public disclosure on OZ investments.

At the same time, there is a growing chorus for more accountability in the OZ program. Late last year, the U.S. Government Accountability Office (GAO), released a report entity "Opportunity Zones: Improved Oversight Needed to Evaluate Tax Expenditure Performance (see https://www.gao.gov/products/gao-21-30). The highlights of the GOA's findings were as follow:

- Compared to some other community development tax expenditures, OZ program generally has fewer limits on the project types that can be financed and fewer controls to limit potential revenue losses. While the OZ program can generally be used to support investment in any type of tangible asset class within a Opportunity Zone, some other tax expenditures, such as the Low Income Housing Tax Credit, are targeted at specific project types. The OZ program is also not subject to limits on the aggregate dollar amount that can be claimed, unlike the New Markets Tax Credit.

- Congress did not designate an agency with the responsibility and authority to collect data, evaluate, and report on OZ program performance. GAO has previously reported that the Department of the Treasury could be the most appropriate agency to evaluate any tax expenditures that do not have logical connections to program agencies. GAO has also previously reported that achieving complex outcomes can benefit from collaboration among agencies. A member of an interagency council has issued a report estimating the effects of OZ program, but the long-term future of this council, including any plans to continue evaluations over the duration of the tax expenditure, is uncertain.

- As a result of unclear statutory authority, there are insufficient data available to evaluate the OZ program performance. The Internal Revenue Service administers and collects data explicitly for tax compliance purposes. Some of these data, such as investment amounts, can be used to evaluate outcomes. Without additional data, however, only limited reporting on performance is possible. Additional data collection and reporting on OZ are necessary to evaluate outcomes. It would be beneficial for Congress to indicate what questions it would like such evaluations to address, such as what are OZ program's effects on employment and housing in the Zones.

There is bipartisan support for reporting and there has been numerous calls for the adoption of reporting requirements from both OZ supporters and critics. Several bills were introduced in the 116th Congress that would require reporting and impact assessment – most notably the IMPACT (Improving and Reinstating the Monitoring, Prevention, Accountability, Certification and Transparency of Opportunity Zones) Act introduced by Sen. Scott, who is widely considered the author of the incentive and has been instrumental in advancing the incentive from its inception, and seven co-sponsors. .

APPENDIX A
SELECT OPPORTUNITY ZONE TAX MATTERS

CAPITAL GAIN REQUIRED

- Eligible taxpayer includes individuals, C corporations (including RICs/REITS), partnerships, S corporations, and trusts and estates
- Triggering event is the realization of capital gain
- Must be treated as capital gain for Federal income tax purposes (short or long term)
- Capital gain must be from an unrelated party
- Ordinary gains do not qualify (e.g., §§ 475, 1221, 1245, 1250)
- Taxpayer will elect to defer gain on Form 8949 which will be filed with its tax return.
- Investment in a QOF must occur within 180 days of liquidation/disposition/sale to third party, except in the case of when gain is realized through pass-through entity and entity does not invest and make the deferral election. Investment deadline can go until entity's tax return due date.
- Taxpayers cannot invest in opportunity fund property directly – all investments must be made through QOF
- QOFs are self-certified and can be created by the taxpayer or you can invest in an established QOF – all investment must be through QOFs
- A QOF must be an "investment vehicle"
- If a QOF is organized in a US possession or territory, it must be organized for the purpose of investing in Opportunity Zone property where it is organized. This should be in organizational documents according to IRS guidance.

STOCK OR PARTNERSHIP INTEREST

- QOFs can acquire two types of Opportunity Zone property:
    - Tangible property such as building and equipment
    - Opportunity Zone stock or partnership interests in domestic operating business
- During substantially all of the holding period, the corporation or partnership must be a qualified Opportunity Zone business
- LLCs will qualify (must choose to be treated as a corporation or partnership), but not disregarded SMLLCs because these are not partnerships or corporations unless they elect to be a corporation.
- Pre-existing entities can be utilized if they otherwise meet the other requirements (including the requirement that substantially all tangible property was acquired after 2017)
- QOF cannot invest in another QOF (no tiers), but an investor could contribute its QOF interest to a master holding partnership in exchange for an interest in the master partnership. That master holding partnership may consist of QOF investments and other investments.

OPPORTUNITY ZONE BUSINESS PROPERTY

- Tangible property acquired by the QOF after 12/31/17
- Acquired from unrelated party (20% common ownership)
- Original use of the property commences with the business or the business substantially improves the property
- Substantially all (70%) of the tangible property use was in the qualified Opportunity Zone during substantially all (90%) of the QOF's holding period
- Original use and substantial improvement not applicable to ground-up development, vacant property and leased property.

OPPORTUNITY ZONE BUSINESS

- For a subsidiary to qualify it must be a trade or business for which substantially all (70%) of its tangible property (owned or leased) is qualified Opportunity Zone business property
- At least 50% of the business's total gross income must be derived from the active conduct of the business in the Opportunity Zone, measured based on time or compensation.
- A substantial portion (40%) of the business's intangible property is used in the active conduct of the business
- Non-qualified financial property (NQFP) must be less than 5% of the average of the aggregate unadjusted basis of the business's property (e.g., cash, debt, stock, options, warrants, partnership interests, futures contracts, etc.) – see working capital safe harbor
- "Sin" businesses are prohibited – sun tan parlors, horse tracks and casinos, golf courses, country clubs, massage parlors, hot tub facilities, liquor stores (defined as stores with the principal purpose of selling alcoholic beverages for consumption off the premises)

- Trade or business for purposes of the QOZ rules is a trade or business within the meaning of section 162
- Ownership and operation of real property, including leasing, is considered the active conduct of a trade or business
- Entering into a triple net lease is not enough
- Opportunity Zone businesses – examples that qualify
  - Retail stores
  - Grocery stores
  - Research facilities
  - Hotels
  - Restaurants
  - Office buildings
  - Manufacturing
  - Mixed use developments

ASSET TEST
- At least 90% of the assets must be invested in Opportunity Zone property
- Newly contributed investments made in the preceding six months are not included as part of the asset testing as long as the new assets are being held in cash, cash equivalents or debt instruments with a term of 18 months or less
- The 90% test is the average of the QOZ property (average at six months and year-end)
- The first test date will be the end of the first six months in the tax year that it is a QOF and the second test date will be the last day of the tax year
- If the QOZ start date is May then the first testing date is November 30 and the next is December 31
- If the QOZ start date is August (July through December), then the only testing date is December 31
- If the QOZ has applicable financial statements (typically audited financial statements), use the value of assets reported on those statements for the asset testing
- If there are no applicable financial statements, use the basis of assets on the date of acquisition for the asset testing
- Special rules permit the use of the most favorable method for businesses that are owned by multiple QOFs
- The calculation of the 90% test will be made annually on Form 8996
- Failing to meet the 90% will not result in termination
- Penalty is equal to the shortfall multiplied by the underpayment rate established under §6621(a)(2)
- Can avoid the penalty if failure due to reasonable cause

SUBSTANTIAL IMPROVEMENT
- QOF has a 30-month window (“any”) to improve the acquired Opportunity Zone property – not original use
- Basis of the property increases by an amount that exceeds the amount of the adjusted basis with respect to the property at the beginning of the 30-month period
- The substantial improvement requirement is made on an aggregate basis
- Rev. Rul. 2018-29 stated that land can never have original use; however, land will not be required to be substantially improved if it is used in an active trade or business
- General anti-abuse provision can be used to prevent “land banking”
- Example: Invest $2M in existing building and land ($1M relates to the land) – to meet the substantial improvement requirement would need to invest an additional $1 M plus $1 (not the $2M)

ORIGINAL USE
- Original use of an asset starts on the date when the property is first placed in service in the QOZ for purposes of depreciation or amortization
- Used property is original use if it has not been previously used or placed in service by any taxpayer in the QOZ
- A building or structure that was vacant for at least five years prior to being purchased by the QOF or QOZB will satisfy the original use requirement
- Leasehold improvements made by a lessee are treated as original use property

OPPORTUNITY ZONE BUSINESS – 50% GROSS INCOME TEST SAFE HARBORS

- At least 50 percent of the services performed for the business, measured by hours, is performed within the QOZ
- At least 50 percent of the services performed for the business, measured by amounts paid for such services, is performed by employees and independent contractors in the QOZ
- Both the tangible property of the business that is in a QOZ and the management or operational functions performed for the business in the QOZ are necessary to generate 50 percent of the gross income of the trade or business
- If the QOZB does not meet any of the safe harbors they may still meet the test relying on facts and circumstances

WORKING CAPITAL SAFE HARBOR – SUBSIDIARY

- Exclude from the NQFP limitation is a "reasonable" amount of working capital held in cash, cash equivalents, or debt instruments of 18 months or less
- Working capital will be considered reasonable if:
  - Amounts are designated in writing for the acquisition, construction, or substantial improvement of tangible property in the Opportunity Zone or expenditures used in the development of a trade or business in the QOZ
  - There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets – cash flow schedule
- Working capital must be spent within 31 months of receipt by the business
- Working capital safe harbor not violated if delay is due to government action (e.g., permits or other government approval)
- Maximum of 86 months taking into account all rules and extensions from IRS.

REGARDING LEASED PROPERTY

- Leased property may be treated as QOZB property
- Leased property must be acquired under a lease entered into after December 31, 2017
- Substantially all of the use of the leased property must be in a QOZ during substantially all of the period for which the QOZB leases the property
- No original use requirement
- No related party disallowance rule if lease meets the following requirements:
  - Lease must be at FMV
  - Lease cannot allow prepayments relating to a period of use exceeding 12 months
  - By the last day of the lease or 30 months (whichever comes first), the lessee must become the owner of the QOZB property whose value is at least equal to the value of the lease and there must be a substantial overlap of time using both the leased and acquired property
- There is a general anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement
- Leased properties have two methods of valuing leases:
  - Financial statement - Amount of an applicable GAAP financial statement – if leases are assigned a value
  - Alternative method – sum of the present value of all of the lease payments, calculated at the time the lease is entered into
  - Once a method is selected, it must be applied consistently to all leased tangible property for the taxable year

OTHER GUIDANCE

- If QOZ sells an asset before 10 years, there is a 12 month safe harbor to reinvest the cash – the regulations do not include a provision that would allow a QOF to sell assets without recognizing gain, so the sale is a taxable event
- QOFs organized as partnerships and S corporations may sell their assets and, assuming that the investor has held the investment in the QOF for more than 10 years, the investor will pay no tax on the gain – does not apply to C corporations
- Transfer of QOZ interest by gift ends the tax benefits, but transfer at death or to a grantor trust does not
- Carried interest does not receive the special tax treatment
- Debt financed distributions are not taxable unless they exceed the partner's basis in the partnership interest
- Substantial improvement is determined in the aggregate in certain cases

- Secondary purchase of a QOF interest is permitted
- Tiered partnerships are not permitted – taxpayer must invest capital gain into a QOF
- QOF stock is not stock for purposes of determining corporate affiliation
- QOF C corporation can be a common parent of a consolidated group, but not a subsidiary member of a consolidated group