Opportunity Zone Overview

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Introduction

- Background
  - Created through the Tax Cuts and Jobs Act and codified in Internal Revenue Code Sections 1400Z-1 and 1400Z-2.
  - Designed to incentivize long-term investments in economically distressed communities designated by the IRS as Opportunity Zones.
  - All Opportunity Zones have been designated. There are over 8,700 zones.
  - Taxpayers receive preferential tax treatment for investing capital gain in Opportunity Zones through investment vehicles called Opportunity Funds.
- Update
  - On October 19, 2018, the IRS published proposed regulations (REG-115420-18), a revenue ruling (Revenue Ruling 2018-29), and an update to its FAQ page clarifying key aspects of Opportunity Zone tax benefits.
  - Comments on the proposed regulations were due on December 28, 2018.
  - A public hearing on the proposed regulations will be held on January 10, 2019.

Capital gain

- Receiving any Opportunity Zone tax benefits begins with investing capital gain into an Opportunity Fund.
- The capital gain must stem from a sale or exchange with an unrelated party that occurred within the previous 180 days.
- Investing other money alongside capital gain is permissible, but only the capital gain portion of the investment will give rise to tax benefits.

Step 1: Realize capital gain

Taxpayer realizes capital gain from a capital gain triggering event (e.g., taxpayer sells corporate stock).

Step 2: Invest capital gain

Taxpayer creates (or finds) an Opportunity Fund and invests capital gain into the Opportunity Fund within 180 days.

Opportunity Funds

- Opportunity Funds are investment vehicles organized as corporations or partnerships, created for the purpose of investing in Opportunity Zones.
- Opportunity Funds must be self-certified.
- Opportunity Funds must hold at least 90% of their assets in Opportunity Zone Property, calculated by averaging the percentage invested at the mid-point and end-point of the Opportunity Fund's fiscal year.

Step 3: Opportunity Fund invests in Opportunity Zone Property

Taxpayers cannot invest in Opportunity Zone Property directly. All investments must be through Opportunity Funds.

Opportunity Zone Property

- Opportunity Funds can acquire three types of Opportunity Zone Property:
  - Opportunity Zone Business Property
  - Opportunity Zone Stock <u>or</u> Opportunity Zone Partnership Interest
- Opportunity Zone Business Property
  - Must be tangible property, such as real estate or equipment, acquired from an unrelated party after December 31, 2017.
  - During "substantially all" of the Opportunity Fund's holding period, the property must be used within an Opportunity Zone.
  - Either the "original use" of the property in the Opportunity Zone must be with the Opportunity Fund or the Opportunity Fund must "substantially improve" the property within 30 months.
- Opportunity Zone Stock or Opportunity Zone Partnership Interest
  - Must be stock or a partnership interest in a domestic company, acquired with cash after December 31, 2017.
  - Upon acquisition and during "substantially all" of the Opportunity Fund's holding period of the investment, the company must be an Opportunity Zone Business.

Tax benefits

- Upon investment of capital gain into an Opportunity Fund, the invested gain is deferred from inclusion in the taxpayer's gross income until the earlier of the taxpayer selling the Opportunity Fund investment or December 31, 2026.
- When the deferral period expires, if the Opportunity Fund investment was held for 5+ years, the gain included in gross income is reduced by 10%; If the investment was held for 7+ years, the gain included in gross income is reduced by 15%.
- When the taxpayer eventually exits the Opportunity Fund, if the Opportunity Fund investment was held for 10+ years, the taxpayer is permanently exempt from paying capital gains tax on gain realized from the sale of the Opportunity Fund investment.

Step 4: Tax deferral

Investment of capital gain → tax bill deferred until 12/31/2026 at the latest.

Step 5: 10% tax reduction

Taxpayer holds Fund investment for 5+ years → 10% tax bill reduction.

Step 6: 15% tax reduction

Taxpayer holds Fund investment for 7+ years → 15% tax bill reduction.

Step 7: Tax exemption

Taxpayer holds Fund investment for 10+ years → No taxes on capital gain from appreciation of Fund investment.

Select Issues from the Proposed Regulations

Opportunity Fund Formation and Certification

- Eligible taxpayers
  - Individuals, C corporations, regulations investment companies (RICs), real estate investment trusts (REITs), partnerships, S corporations, trusts and estates are all “eligible taxpayers” for investment into Opportunity Funds.
- Formation and Certification
  - Opportunity Funds do not need to have a traditional “fund” structure. An “eligible taxpayer” can create its own Opportunity Fund.
  - Must be “organized as a corporation or a partnership”; A limited liability company (LLC) that chooses to be treated as a corporation or partnership can be an Opportunity Fund.
  - The IRS has released draft Form 8996 for Opportunity Fund certification and annual compliance.
- Operations
  - If an Opportunity Fund is organized in a US possession, it must operate within the possession where it is organized.

Investment Timeline and the Working Capital Safe Harbor

- Taxpayers have 180 days to invest capital gain into an Opportunity Fund.
- Opportunity Funds must acquire Opportunity Zone Property order to meet the 90% asset test. This window to deploy capital will be 6 months or less.
- For most real estate projects, the Opportunity Fund will acquire stock or a partnership interest in an Opportunity Zone Business, rather than directly acquiring Opportunity Zone Business Property. Thus, most real estate deals will have a two-tier structure.
- Why a two-tier structure?
  - The proposed regulations provide a “working capital safe harbor,” specifying that an Opportunity Zone Business can hold financial property for up to 31 months so long as the business has a written plan and schedule for using the capital to acquire, construct, or substantial improve property in an OZ. The business must substantially comply with the plan and schedule.
  - The proposed regulations provide that the “substantially all” requirement for tangible property owned or leased by an Opportunity Zone Business is 70%.
- Opportunity Zone Business Requirements:
  - (1) “Substantially all” of the business’s owned or leased tangible property must meet the requirements for Opportunity Zone Business Property; (2) At least 50% of the business’s total gross income must be derived from “active conduct” in an Opportunity Zone; (3) A “substantial portion” of the business’s intangible property must be used in “active conduct” in an Opportunity Zone; (4) Less than 5% of the average bases of the business’s property is attributable to nonqualified financial property (e.g., stocks); and (5) Cannot be a “sin business.”

Substantial Improvement

- Overview
  - Tangible property must be “substantially improved” unless its “original use” in an Opportunity Zone is with the Opportunity Fund or Opportunity Zone Business.
  - Substantial improvement requires that additions to basis must exceed the adjusted basis of the property within 30-months.
- Recent Guidance on Land
  - Due to the inherent nature of land, its “original use” in an Opportunity Zone cannot commence with an Opportunity Fund or an Opportunity Zone Business. However, land does not need to be substantially improved.
  - For example, if an Opportunity Fund acquires a building located on land in an Opportunity Zone, substantial improvement will be measured based on the adjusted basis of the building alone. The Opportunity Fund should not include the land’s basis in the substantial improvement calculation.
  - There is ambiguity regarding the treatment of vacant land. Many comment letters on the proposed regulations request clarification on this issue.

Opportunity Zones – Comparison to 1031

Sec. 1031 Like-Kind Exchanges	**Opportunity Zones**
• Requires re-investment of 100% of proceeds to defer gain	• Requires re-investment of gains only to defer gain (do not need to invest 100% of gain)
• No exclusion benefit; deferral only	• Original gain is deferred and may be permanently reduced up to 15%
• No separate tax benefit for gains on the “new” investment	• All appreciation on the “new” investment is permanently excluded from taxable income
• Replacement property must be like-kind; no rollover for gain on personal property	• Replacement property need not be like-kind, but must be located in an Opportunity Zone

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