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OPPORTUNITY ZONES: MORE THAN A PRIMER

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AGENDA

- Why invest in an Opportunity Zone fund?
- Where are the Qualified Opportunity Zones?
- How did Opportunity Zones come to be?
- Steps in the Opportunity Zone process.
- Opportunity Zone property.
- “Substantial improvement.”
- Some of the things to think about.
- Questions and (hopefully) answers.

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WHY INVEST IN AN OPPORTUNITY ZONE FUND?

- The short answer . . . If the investor meets the requirements (of which there are many):
- Defer federal income tax on recognized capital gains,
- Have a portion of that deferred gain forgiven, and
- Avoid federal income tax on gain from the Opportunity Zone investment.

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WHERE ARE THE QUALIFIED OPPORTUNITY ZONES?

- *Notice 2018-48*, 2018-18 IRB 9.
- Listed by State, county and census tract.
- Interactive map: Treasury's Community Development Financial Institutions Fund website.
- https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml
- Some of the locations may pleasantly surprise folks . . .

HOW DID OPPORTUNITY ZONES COME TO BE?

- Creation of the Tax Cuts and Jobs Act of 2017.

- Goal is revitalization of economically depressed geographies.

- Attempt to implement lessons learned from prior efforts . . .
  - Requisite long term investment to maximize benefits.
  - Attempt principally to capture investor's gains from other successful investments.
  - Broad – but not unlimited categories of qualifying investments.
  - To fully benefit from the Opportunity Zone provisions, the taxpayer needs to make astute opportunity zone investments.

STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 1: A taxpayer realizes and recognizes any capital gain.
  - Shares of stock.
  - Real estate.
  - Partnership interest that result in capital gain.
  - Other property.
- Step 2: The taxpayer invests the gain dollars in an “Opportunity Zone Fund.”
  - Timing: Investment within 180 days for realization/recognition event.
  - Taxpayer cannot invest directly in property, even if in opportunity zone.
  - The fund can self-certify.

STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 2: The taxpayer invests the gain dollars in an “Opportunity Zone Fund.” (continued).
  - Fund must be “organized as a corporation or partnership.”
- Step 3: Opportunity Zone Fund invests in “opportunity zone property.”
- Step 4: Opportunity Zone Fund must hold 90% of its assets in opportunity zone property.
  - Twice annual testing.
  - Penalty for failure to comply.

STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 5: If the taxpayer holds its opportunity zone fund interest for 5+ years, the taxpayer receives an increase in his/her adjusted basis of 10% of the deferred gain.
- Step 6: If the taxpayer holds its opportunity zone fund interest for 7+ years, the taxpayer receives an increase in his/her adjusted basis of 5% of the deferred gain.

STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 7: On 12/31/2026, there is a “deemed disposition,” so that all the deferred gains related to the investment in the opportunity zone fund ends and gain is recognized.
  - The gain is the lesser of:
    - The original deferred gain, or
    - The FMV of the taxpayer’s Opportunity Zone Fund investment
  - Reduced by the taxpayer’s basis in his/her Opportunity Zone Fund investment.

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STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 7 (continued): Putting the "deemed disposition" rule in context . . .
  - The deferred gain is the building block for the tax on the deemed disposition.
  - So, protecting the cash on sale attributable to the adjusted basis from the originating transaction is paramount.
  - The basis adjustment (up to 15%) essentially is free . . .
  - Taxpayer has interest-free use of the adjusted basis dollars until, say, April 15, 2027.
  - What is the value of free use of that cash on a discounted present value?

- Step 8: If the taxpayer holds the Opportunity Zone Fund investment for 10+ years, the taxpayer is permanently exempt from capital gains from the sale of his/her Opportunity Zone Fund.

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OPPORTUNITY ZONE PROPERTY

- Category 1: Opportunity Zone Property.
- Tangible property.
  - Real property.
  - Land and improvements to real property.
  - Equipment and other personal property.
- That tangible property needs to be in the opportunity zone during "substantially all" of the Opportunity Zone Fund's holding period.

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OPPORTUNITY ZONE PROPERTY

- Category 2: Opportunity Zone Stock or Partnership Interests.
  - So, the Opportunity Zone Fund is not limited to direct ownership of real estate.
  - The stock or partnership interest can be an investment in a domestic operating business.
  - “Substantially all” of the business tangible property must be:
    - Acquired by purchase from unrelated third parties after 2017, and
    - Used in the Opportunity Zone during “substantially all” of the business’s holding period.
  - Among other things, at least 50% of the business’s gross income comes from the “active conduct” of the business.
  - A “substantial portion” of the intangible property of the entity is used in the active conduct of the trade or business.
    - Thus, no sheltering IP companies . . .

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OPPORTUNITY ZONE PROPERTY

- Category 2: Opportunity Zone Stock or Partnership Interests.

- The balance sheet cannot contain too much financial property, which would imply the business's focus is investment speculation, rather than economic development.
  - Less than 5% of average aggregate unadjusted basis is "nonqualified financial property."

- By statute, certain businesses don't qualify (golf courses, country clubs, massage parlors, hot tub or sun tan facilities, race tracks, gambling, package liquor stores).

"SUBSTANTIAL IMPROVEMENT"

- An Opportunity Zone Fund has a 30-month window to improve property.
- Amount of improvements must exceed acquisition basis in the property.
- When does 30-month period start?
- Must land be "substantially improved"? Does the basis allocable to land count?
- How does this apply to operating businesses?

SOME OF THE THINGS TO THINK ABOUT

- Does this make sense for a given investor or gain?
  - Incremental benefit.
  - Comparative after-tax returns.
- State law conformity/nonconformity.
- Who is the taxpayer?
  - S corporations and/or their shareholders?
  - Partnerships or their partners?
- Mixed fund investments.

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SOME OF THE THINGS TO THINK ABOUT

- How does an investor think about opportunity fund investment versus a like-kind exchange?
- Does deferred gain mean roll-over investors start with an adjusted basis of $0?
  - Investor’s allocable share of annual tax loss?
  - Taxation of operating cash flow distributions?
- Does partnership-level nonrecourse borrowing solve all the problems?
- What is the tax result from a distribution of refinance proceeds?
- In a mixed fund, can the partnership make special allocations?

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SOME OF THE THINGS TO THINK ABOUT

- How best to structure funds with multiple properties? How does the fund structure an exit?

- How should developers and sponsors think about the related party rules?
  - Can/should the Fund purchase of assets owned by the developer?
  - Can the Fund pay the developer property management or asset management fees?

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Q+A