OPPORTUNITY ZONES GAIN TRACTION ... AND OPPOSITION

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Created to encourage economic growth and investment in low-income and economically distressed communities, the Tax Cuts and Jobs Act[1] created a new tax incentive for investors to consider – Qualified Opportunity Funds (QOF). QOFs work such that taxpayers are able to defer paying tax on capital gains by investing those capital gains into a QOF, which in turn invests those funds within a Qualified Opportunity Zone (QOZ).[2] A QOZ is a population census tract in a low-income community that is formally designated as such by the U.S. Treasury Department.[3] (The complete list of such designated areas can be found at https://www.irs.gov/pub/irs-drop/n-18-48.pdf.)

While the interest level from taxpayers wanting to defer recognition of capital gains was expectedly high at the onset, so was the uncertainty. However, with the issuance of the initial proposed regulations in October 2018[4] and the proposed regulations in April 2019[5], many of those uncertainties (though not all) have been lifted. As a result, financial advisors, developers and taxpayers have begun the machinations necessary to create the investments envisioned by Congress when it enacted the program.

Since January 2019, QOF investments have grown almost six-fold.[6] The U.S. Economic Development Administration (EDA) added QOZs as an "investment priority" with the intent of increasing the number of QOZ-related projects that it can fund to spur greater public investment in QOZs.[7] In fact, as of December 2, 2019, the EDA has invested close to $342 million in almost 250 projects since the OZF incentive was created.[8]

QOFs have a series of timelines and thresholds, including a sunset date of December 31, 2026.[9] (December 31, 2019[10] was a sunset date insofar as one of the tax-favored features is concerned.) But first, here is a brief summary of the program.

Opportunity Zones

Eligible taxpayers can, within 180 days of a sale or exchange generating an eligible gain, elect to reinvest all or a portion of such a gain into a QOF, deferring its recognition until December 31, 2026, or, if earlier, the date the taxpayer sells or exchanges the QOF interest.[11]

Eligible taxpayers include individuals, C corporations, S corporations, partnerships, and trusts and estates. Eligible gains are those treated as "capital" gains, to the extent such gains do not arise from a sale or exchange with a related party, and include short-term and long-term, unrecaptured 1250 gain, and net section 1231 gain. Any depreciation recapture as ordinary income under sections 1245 and 1250, however, is not eligible gain.

Opportunity Zone Tax Benefits

There are three types of tax benefits that investors can attain from investing in a QOF – an investment vehicle organized either as a corporation or a partnership mainly for investing in QOZ property. The QOF is deemed to be conducting business in a QOZ either directly, by holding QOZ business property, or indirectly, by holding QOZ stock or a QOZ partnership interest of a corporation or a partnership, respectively, conducting business within a QOZ. (There are timelines and quantitative thresholds that must be met, which will be covered in detail later.)

In general, investments in QOZs may permit investors to:

- Defer the tax on any eligible capital gain until December 31, 2026, if that gain is invested by the taxpayer in a QOF within 180 days of the date the gain was recognized;
- Reduce up to 15% of eligible gains invested in a QOZ depending on the investor's holding period, namely 10% if the investor holds the qualifying investment for at least five years and an additional 5% if the investor holds the investment for an additional two years; and
- Increase the tax basis of their interest in a QOF to fair market value on the date of sale if they hold their interest in the fund for at least 10 years, meaning that the investor should not recognize gain on the sale of its qualifying investment.

Thus, for example, if an eligible taxpayer has $100 of capital gains and timely invests this into a QOF and holds the investment for 10 years, this taxpayer would be able to:

- Defer the tax owed on the original $100 of capital gains until 2026;
- Increase the basis of the underlying asset by 15%, thereby effectively reducing the $100 of taxable capital gains to $85; and
- Owe NO capital gains tax on its appreciation.

Assuming the $100 investment grows 7% annually, the after-tax value of the original $100 investment after 10 years would be $176, the sale of which would not be subject to any additional tax.

Meeting the Requirements

As detailed above, an eligible taxpayer may elect to defer a capital gain if, within 180 days of the sale or exchange, some or all of the gain is reinvested into a QOF. A QOF is an entity with a specific purpose that acts as a conduit towards achieving the legislative intent of ensuring

that the amounts represented by deferred capital gains are ultimately deployed in a qualified opportunity zone business (QOZB).

With respect to the 180-day requirement, if the taxpayer yielding the capital gain is a pass-through entity, it will have a choice as to when the measurement date begins. The pass-through may elect to defer that gain at the pass-through level or it may pass the gain through its partners (in the case of a partnership), who then can make their own decision as to deferral. If the distributees hold the power to elect, their measurement date would begin on the last day of the pass-through entity's tax year, as opposed to on the date of sale.

A QOF may be organized as a corporation or partnership (including an LLC) and may be a newly formed or even a pre-existing entity. While a QOZB must operate within a QOZ (more on this later), a QOF need not be located in a QOZ.

A QOF must have at least 90% of its assets invested in QOZ property, measured as the average of the "QOZ property" held in the QOF on the last day of the first six-month period of the QOF's taxable year and on the last day of the QOF's taxable year. Failure to meet this test will result in a penalty for each month that it fails to meet the threshold (based on the underpayment rate for a particular month).

To the extent such assets are held by the QOF in the form of cash, cash equivalents or short-term debt instruments, any cash or cash equivalents received by the QOF in the preceding six months as a contribution to capital are not taken into account in measuring the 90% test. This provision will provide operational relief in that QOFs need not hastily deploy contributed capital into QOZ property.

As mentioned previously, "QOZ property" can be one of three things:

- QOZ stock;
- QOZ partnership interests; and
- QOZ business property.

The last option permits a QOF to directly operate a QOZB that utilizes qualified opportunity zone business property (QOZBP), as long as at least 70% of such property is used within a QOZ for at least 90% of the time that the QOF owned the property. Such business property includes the following, if acquired after December 31, 2017:

- Machinery and equipment;
- Furniture and fixtures;
- Tenant improvements; and
- Land acquired.

In addition, the original use of the business property in the QOZ must commence with the QOF, or alternatively, improvements equaling at least 100% of the adjusted basis of the subject property must be made to the property during a 30-month period following acquisition.

Alternatively, a QOF may indirectly meet the 90% threshold by conducting a QOZB through a subsidiary by holding QOZ stock or a QOZ partnership interest. Under either indirect method:

- The QOF must have acquired the stock or partnership interest after December 31, 2017;
- The underlying corporation or partnership is, or is organized to be, a QOZB;
- During 90% of the time that the QOF holds the stock or partnership interest, the underlying entity is a QOZB with at least 70% of its business property being used within a QOZ;
- At least 50% of the business's total gross income is derived from the "active conduct of a trade or business;"
- At least 40% of the business's intangible property is used in the "active conduct of a trade or business;"
- Less than 5% of the aggregate unadjusted bases of the property of the trade or business is attributable to nonqualified financial property; and
- The QOZB cannot be a "sin" business, namely private or commercial golf courses, country clubs, massage parlors, gambling facilities and any establishment at which the primary business is the sale of alcohol.

There is a series of "loaded" terms in the quantitative tests applicable to a QOF investing through a corporation or partnership, namely (1) "50% of gross income," (2) "active conduct of a trade or business," and (3) "nonqualified financial property."

The proposed regulations released in April 2019 provide three safe harbors and a broad facts and circumstances test for determining whether the "50% of gross income" test is met, meaning that this test will be deemed to be satisfied if:

- At least 50% of the services performed (based on hours) for the business by its employees and independent contractors (and employees of independent contractors) are performed within the QOZ;
- Based on amounts paid for the services performed, at least 50% of the services performed for the business by its employees and independent contractors (and employees of independent contractors) are performed in the QOZ;
- The tangible property located in, and management or operational functions performed in, the QOZ are each necessary for the generation of at least 50% of the gross income of the trade or business; and
- Based on the facts and circumstances, at least 50% of the gross income of a trade or business is derived from the active conduct of a trade or business in a QOZ.

Statistics show that investments in QOFs are on the rise.

"Active trade or business" is not defined in the statute or in the proposed regulations. Ostensibly, IRC §162 and the vast body of authoritative guidance thereunder provides the roadmap for how this should be interpreted in the QOZ context. Importantly, the proposed regulations make clear that the operation (including leasing, but only if not solely triple net leasing) of real property is deemed to be the "active conduct of a trade or business."

The reader will recall that no more than 5% of the aggregate unadjusted bases of the property of the trade or business can be attributable to "nonqualified financial property," which includes debt, stock, partnership interests, options, futures, forwards, warrants, swaps, etc. However, it does NOT include "reasonable amounts" of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less. These are categorically called "Working Capital Assets."

Under the regulations, "working capital assets" will be deemed to be held in "reasonable amounts" if:

- The working capital assets are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ or the development of a trade or business in the QOZ;
- There is a written spending schedule that is consistent with the ordinary start-up of a trade or business;
- The working capital assets are spent within 31 months of the receipt by the business of such assets; and
- The working capital assets are actually used in a manner consistent with the written designation and the spending schedule.

Gain Recognition

As mentioned above, gain is recognized on the earlier of the date that the QOF investment is sold or exchanged, or December 31, 2016. "Sold or exchanged" includes any transaction that reduces the QOF investor's equity interest, including:

- A taxable disposition of the qualifying investment;
- Except in certain limited cases, a transfer by a partner of an interest in a partnership that itself directly (or indirectly solely through other partnerships) holds a qualifying investment;
- A transfer by gift of a qualifying investment; and
- Certain nonrecognition transactions, including (i) a disposition of qualifying QOF stock in a section 332 liquidation of the QOF corporation that issued such stock and (ii) a transfer of qualifying QOF stock in a section 351 transaction to the extent the transfer would reduce the transferor's direct interest in the QOF.

However, neither the transfer of the qualifying investment to a decedent owner's estate nor the distribution by the estate to the decedent's heir will be considered an inclusion event.

There are several watershed dates in the QOZ regime, of which December 31, 2019 was one. The reader will recall that one of the tax benefits of investing in a QOZ is a deferment on recognition of the tax on any eligible capital gain until December 31, 2026 and that such investors may eliminate up to 15% of eligible gains if they hold the qualifying investment for at least seven years. (Plotting this against the calendar means that an eligible investment needed to have been made on or before December 31, 2019 to attain the full 15% haircut.)

Addressing the Uncertainties

Granted, unanswered questions remain. For example, "merely entering into a triple net lease" is not the active conduct of a trade or business. But what definition of a triple net lease is applicable? What if a lessor pays one of the three – is this sufficient to avoid the rule? Or does the lessor need to meaningfully participate in the management or operations?

Nonetheless, investors, developers and financial advisors have been gaining confidence that there are more knowns than unknowns. Like any other significant investment, all parties with a stake in the successful outcome will, as they should, fully vet the business aspects of the underlying "deal" so that the tax benefits add the proverbial "cherry on top."

Most recently, the QOF program has come under criticism for benefiting wealthy donors, with several articles in *The New York Times* and *ProPublica* questioning the allocation of Opportunity Zone tracts. At the opposite end of the QOF spectrum, Congresswomen Rashida Tlaib (MI-13) and Pramila Jayapal (WA-07) introduced legislation to repeal QOFs from the United States tax code.[12]

Notwithstanding the sluggish start, the statistics show that investments in QOFs are on the rise. Full transparency and constant communication between the investor, QOF and developer are the keys towards ensuring that the flow and use of funds comply with the many thresholds and safe harbors contained in the rules to avoid penalties.

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FOOTNOTES:

[1] Tax Cuts and Jobs Act, §13823, Pub. L. No. 115-97, 131 Stat. 2054, 2184 (2017)
[2] 26 U.S.C. §1400Z-2 (2017)
[3] 26 U.S.C. §1400Z-1 (2017)
[4] REG-115420-18, 83 F.R. 54279 (10/29/18)
[5] REG-120186-18, 84 F.R. 18652 (5/1/19)
[6] NES Financial Opportunity Zone database. *Aggregated inflows from January – August 2019.*
[7] U.S. Economic Development Administration, (2019, June 12). *U.S. Economic Development Prioritizes Applications for Projects Located in Opportunity Zones* [Press Release]. Retrieved from https://www.eda.gov/news/press-releases/2019/06/12/opportunity-zones.htm
[8] U.S. Economic Development Administration, (2019, December 5). *EDA Grants Supporting Opportunity Zones* (Downloadable Excel Spreadsheet). Retrieved from https://www.eda.gov/opportunity-zones/
[9] 26 U.S.C. §1400Z-2(a)(2)(B) (2017)
[10] 26 U.S.C. §1400Z-2(b)(2)(B)(iv) (2017)
[11] Except as may be noted in subsequent endnotes, the authority for the authoritative statements hereinafter are 26 U.S.C. §§1400Z-1 and 1400Z-2 (2017) and/or REG-115420-18, 83 F.R. 54279 (10/29/18) and/or REG-120186-18, 84 F.R. 18652 (5/1/19).
[12] The Repeal Opportunity Zones Act of 2019, H.R. 5252, 116th Cong. (2019).