Opportunity Zones

Internal Revenue Code Section 1400Z-2

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Opportunity Zone Program

- Enacted as part of TCJA on December 22, 2017
- First round of proposed regulations issued on October 19, 2018
- Second round of proposed regulations issued on April 17, 2019
- The regulations generally take a taxpayer favorable approach intended to facilitate economic development in Opportunity Zones

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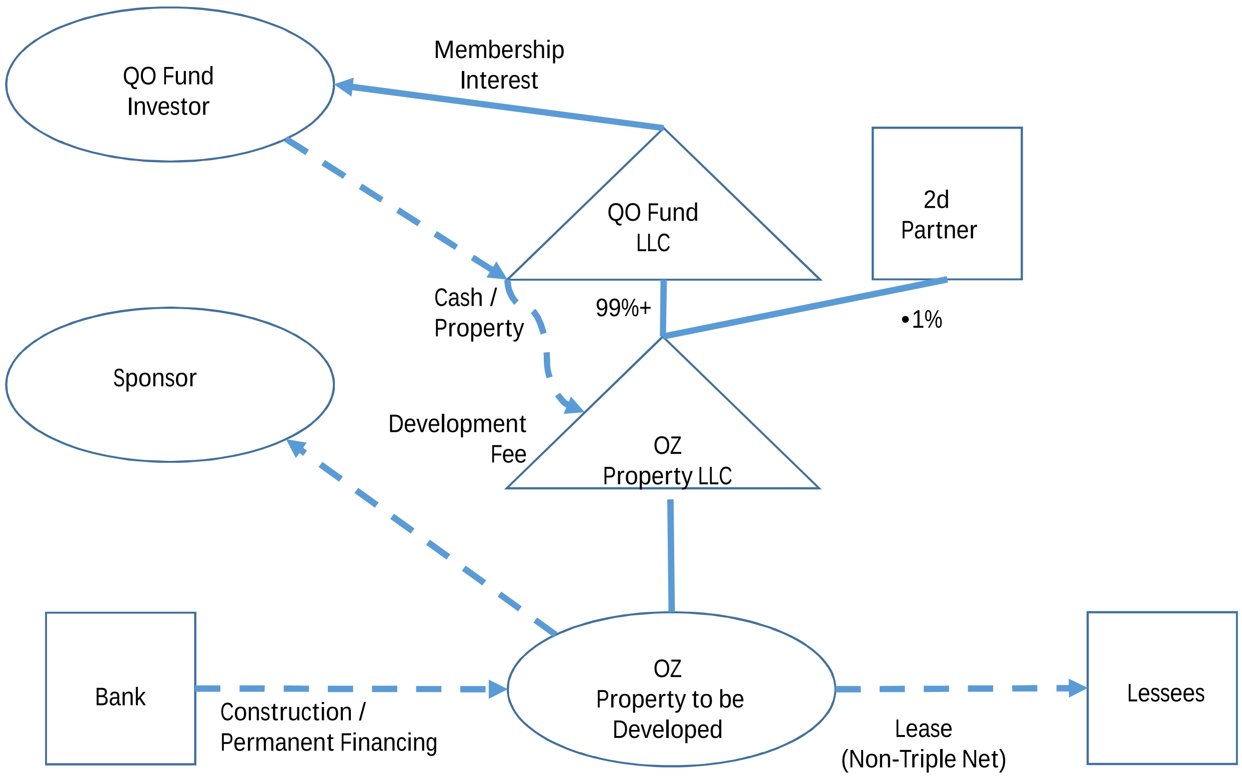
What is an Opportunity Zone?

- Designated low income census tracts that can be developed through investments in Qualified Opportunity Funds (QO Funds)

- 161 opportunity zones in Missouri, 41 in St. Louis
  - Downtown, Cortex, The Grove, North Riverfront

  - For a map of opportunity zones in Missouri, see: https://opportunitydb.com/location/missouri/

Sample Structure



- QO Fund Investor must invest amount equal to capital gain within 180 days
  - Investment provides significant tax benefits
- QO Fund LLC must certify 90% of assets are OZ Property
  - Exclude new capital raised by QO Fund in last 6 months
  - Exclude sales proceeds reinvested within 12 months
- OZ Property LLC acquires or substantially improves property in OZ and is engaged in OZ Business
  - Active trade or business
    - Leasing OK, but not triple net lease
  - At least 50% of gross income from active trade or business
  - Less than 5% of business assets are non qualified financial assets subject to safe harbor
  - No sin business
  - At least 70% of owned or leased assets are OZ Property
  - Original use in OZ or substantially improved

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Three Significant Tax Benefits for QO Fund Investors

- Temporary deferral of capital gain until the earlier of (1) the sale of the investment or (2) December 31, 2026

- Elimination of tax on 10% or 15% of the rollover gain if a 5-year or 7-year holding period is satisfied, respectively
  - Must invest by December 31, 2021 for 5-year holding period
  - Must invest by December 31, 2019 for 7-year holding period and maximum tax benefit (although there are proposals to extend the deadline)

- Elimination of gain on appreciation in the QO Fund investment in excess of the built-in rollover gain if a 10-year holding period is satisfied
  - There should be no depreciation recapture

Making Qualifying Investments in a QO Fund

- Tax benefits available only for "qualifying investment" in QO Fund
- Investors must own an equity interest in QO Fund from contribution of cash or property, not services
  - Can acquire equity interest from existing investor rather than making a contribution
  - Initial basis $0 for purposes of QO Fund rules
- Must invest amount equal to gain to be deferred in QO Fund within 180 days
  - Only capital gains (including net Section 1231 gains) are eligible for deferral
  - Tax attributes on deferred gain preserved (e.g., short-term or long-term capital gain)
  - Special timing rule for partnerships, other pass-throughs and net Section 1231 gain

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Organizing / Designating the QO Fund

- QO Funds are easy to organize
  - Must be a corporation (including a C corporation, S corporation or a REIT) or tax partnership formed for the purpose of investing in OZ Property
    - Entities treated as trusts or disregarded entities for tax purposes not permitted to be QO Fund
  - Most QO Funds for development projects will be organized as tax partnerships
  - Can be organized by sponsor, developer, or any other person
  - No advance ruling/certification from IRS required
    - Designation made by filing Form 8996 with tax return for year
    - Can designate the first month in which will be treated as a QO Fund

Types of Funds

- Purposes
  - Real estate and infrastructure development
  - Funding new businesses
- Investment Strategy
  - Single project funds
  - Multiple project funds
  - Blind pool funds
- Relationship with Other Incentives
  - Combine with other incentives to increase return

Qualification Requirements for a QO Fund

- 90% Test: QO Fund must hold at least 90% of its assets in OZ Property (defined below)
  - Measured every 6 months by self-certification
  - Cash received less than 6 months prior to a testing date is ignored for this test
    - This allows for multiple rounds of financing in a real estate development project

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How is a QO Fund Affected if it Sells an Investment

- QO Funds have up to 12 months to reinvest sales proceeds from dispositions of investments in OZ Property
  - So long as the QO Fund reinvests the proceeds within 12 months, the cash will not cause the QO Fund to fail the 90% Test
  - Gain from the sale is still taxed to investors if the holding period is less than 10 years
  - Should not trigger inclusion of deferred gain

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Qualified Opportunity Fund

- 3 types of “OZ Property”
  - OZ Stock
  - OZ Partnership Interest
  - OZ Business Property

- A QO Fund may not invest in another QO Fund

OZ Stock / Partnership Interest

- OZ Stock / OZ Partnership Interest acquired by the QO Fund after 12/31/17 at original issue for cash

- At issuance, entity must be engaged in an OZ Business

- During 90% of the QO Fund's holding period, the entity must qualify as an "OZ Business"

OZ Business

- 70% of all business property owned or leased is OZ Business Property

- No “sin” businesses, such as:
  - Golf courses
  - Liquor stores
  - Tanning salons
  - Spas

- Unclear if marijuana businesses included

OZ Business

- At least 50% of gross income from "active trade or business"
- Three safe harbors under Proposed Regulations
  - 50% of the services performed (based on hours) for the OZ Business are performed within the Opportunity Zone
  - 50% of the services performed (based on amounts paid for the services performed) for the OZ Business are performed in the Opportunity Zone
  - The tangible property of the OZ Business in an Opportunity Zone and the management or operational functions performed for the OZ Business in the Opportunity Zone are each necessary to generate 50% of the gross income

OZ Business

- Active trade or business requirement
  - Rental real estate leasing is expressly treated as a trade or business for this requirement
  - A triple net lease arrangement, however, is specifically excluded from qualifying as a trade or business
  - Some active management of the properties is likely necessary

OZ Business

- Less than 5% of business assets may be invested in "nonqualified financial property"
- Working capital exception:
  - Written plan identifying property as held for the acquisition, construction or substantial improvement of tangible property or the development of a trade or business in an Opportunity Zone
  - Written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets within 31 months of the receipt by the business of the property (time frame may be extended if delay is attributable to waiting on government action)
  - The OZ Business substantially complies with the written plan
- Each round of financing should qualify for a new 31-month window if the requirements are satisfied

OZ Business Property

- Used in active trade or business
- Located in the OZ during 90% of the QO Fund's holding period
- Tangible property purchased from an unrelated person after 12/31/2017
- Originally used in OZ Business or "substantially improved"
  - "Original use" can mean vacant for at least 5 years prior to acquisition or property was never placed in service
  - Property is substantially improved if its basis increases by 200% within 30 months
  - Raw land not counted for substantial improvement

OZ Business Property

- Real property straddling an Opportunity Zone

- Property is located in an Opportunity Zone if:
  - Amount of real property based on square footage located within the Opportunity Zone is substantial as compared to the amount of real property based on square footage outside of the Opportunity Zone
  - Real property outside the Opportunity Zone is contiguous to part or all of the real property located inside the Opportunity Zone

- Substantial improvement outside Opportunity Zone?

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OZ Business Property

- Leased Property can be OZ Business Property
  - Acquired by the QO Fund or the OZ Business under a lease entered into after 12/31/2017
  - Substantially all of the use of the leased tangible property must be in an Opportunity Zone during substantially all of the lease period
  - Terms of the lease must be market rate (arms-length terms) at the time the lease was made
  - Leased tangible property does not need to be substantially improved and improvements to leased property by lessee satisfy “original use” requirement

OZ Business Property

- Related Party Leases have additional requirements
  - Lessee cannot make a prepayment for more than 12 months
  - For leased tangible personal property, during the period beginning on date lessee takes possession and ending on the earlier of (i) the last date of the lease term or (ii) 30 months after the lessee takes possession, lessee must become owner of tangible property that is OZ Business Property having a value equal to or greater than the value of the leased tangible personal property
  - Both the leased tangible personal property and acquired OZ Business Property must be used substantially in the same Opportunity Zones

Two-Tiered Structure

- Benefits
  - Working capital safe harbor only available at OZ Business level
  - Allows for more flexibility and fewer assets in an Opportunity Zone
    - 90% at QO Fund level and 70% at lower-tier level

- Disadvantages
  - Exclusion of capital gain on sale of asset only applicable at the QO Fund level
  - In the case of a lower-tier partnership, requires an outside partner

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QO Fund Operational Issues

- Debt-financed distributions
  - Generally should be tax-free assuming distributions do not exceed basis
  - Can potentially be used to provide liquidity for tax on deferred gain due in April 2027
- Inclusion events
  - Sale of a QO Fund interest prior to 10 year holding period triggers recognition of deferred gain
  - Interim income distributions
  - Certain transfers of an interest in a partnership that owns a QO Fund
  - Gift of a QO Fund interest

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QO Fund Exit Strategy

- Asset sales and equity sales are viable exit strategies
  - Appreciation in an "investment" in a QO Fund is tax-free if the investor has held the investment for 10 years and makes the proper election
- Investors can make an election to exclude their allocable share of capital gain on the sale of each capital asset held by the QO Fund
  - This favorable rule should allow large real estate funds with multiple investments to operate QO Funds
- This rule is only applicable at the QO Fund level
  - In a two-tier structure where a QO Fund owns an OZ Business, this exclusion is not available for assets sold by the OZ Business

Comparison with §1031 Exchanges

- Rollover gain does not need to be from or invested in realty
- Only rollover gain needs to be invested instead of all sales proceeds
- Under §1031, post-acquisition realty improvements are difficult to qualify for deferral compared to 30-month substantial improvement timeline
- No 45-day ID or deposit of proceeds with qualified intermediary is needed for replacement property
- Replacement property need not be like-kind
- Sale to related parties is not possible, as opposed to simply adding a 2-year holding period under §1031(f)