March 13, 2019

Opportunity Zones: What Are They and Why Should We Care?
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The 2017 Tax Cuts and Jobs Act (the "Act") introduced a federal income tax program that has received much attention and could be an excellent tool for the development of properties within areas of our community designated as Opportunity Zones (OZs).

Treasury Secretary Mnuchin has repeatedly stated that OZs will attract $100 billion in capital gain investments. These types of statements, along with the announced formation of dozens of Qualified Opportunity Funds (QOFs) to attract capital gain dollars for investment highlight the potential opportunity this program represents for distressed communities.

In October 2018, the IRS provided some initial guidance about OZs. While the IRS is expected to issue further guidance during 2019, certain developments already can qualify for OZ tax benefits. The following is not intending to be an exhaustive review but provides information for a basic understanding that can be further explored based on specific arrangements

A. GENERAL COMMENTS.

Who should be interested in OZs?

- Businesses already located in OZs that plan to expand.
- Projects within an OZ that seek equity investments.
- Individuals and businesses that have or are expecting to cash out of capital gain investments and are interested in OZ development. The reason for the investment can be for a possible solid return, for civic minded reasons, or both.
- Investment funds to be formed to accumulate capital gains dollars from investors to be used towards OZ projects.
- Lenders who will provide additional financing for OZ development and want to understand how OZ tax requirements impact lending terms.

What tax benefits are available for qualifying OZ investments?

The Act provides federal income tax benefits to taxpayers who invest their capital gains from the sale of properties into OZ projects and, in exchange, receive an equity interest through a qualifying structure. The potential tax benefits apply to the (1) capital gain amounts invested in OZ projects and (2) tax free future appreciation of the OZ investment. The main points are:

1. For capital gains that are timely and properly invested through a QOF structure, the tax on such capital gain is deferred through no later than 2026.

2. If the equity interest in the QOF received for the invested capital gain is held for at least 7 years (but with a 2026 hard stop), 15% of the deferred capital gain is excluded from the applicable tax in 2026. If the equity interest in the QOF is held for at least 5 years (but with a 2026 hard stop), a maximum 10% of the deferred capital gain is excluded from the applicable tax in 2026 or when sold, if earlier.

3. If the equity interest in the QOF is held for 10 years or more, any taxable amount on the sale of such QOF interest is tax free. Accordingly, appreciation in the value of the QOF assets are tax free. In the right circumstances, this can be a powerful incentive for investors.

Other more common incentives might also be available through the State of Georgia and municipalities in connection with developments within these designated communities.

Are there risks associated with OZ investments?

Any investment entails risks, and investments in a financially distressed area can be particularly risky. Some of the risks associated with OZ investments include:

1. Tax Rate Risk--Taxation of the capital gain amount used in OZ investments is deferred and subject to tax no later than 2026. Tax rates are subject to change from time to time, and the tax rates in effect in the future year will apply to determine the tax cost relating to the deferred gain. An increase of approximately 5 percentage points from the current tax rates would eliminate the tax benefit associated with the deferred capital gain and related income exclusion, depending on the discount rate used. However, the benefit associated with post-investment tax free appreciation would continue to be available.

While purely speculative at this point, the hope is that lobbying efforts would push for transitional relief from any increased tax rates that would be applicable to the deferred gain for prior OZ investments.

2. Liquidity in 2026 to Pay Income Taxes on Deferred Capital Gains. Because most of OZ investments will be held past the 2026 year, consideration needs to be given to having liquidity in 2026 to pay the tax on the deferred gain. There is a hard stop on the tax deferral with respect to the invested capital gain in 2026, even though the taxpayer continues to hold the OZ investment.

3. Economic Risk—As with any investment, the potential future appreciation of the development can be an important driver. If the investment does not significantly appreciate in value (or even loses value), the tax benefit of tax free appreciation has limited value.

Are there reasons for waiting to make investments in an OZ?

For projects under consideration within an OZ—particularly real estate projects—there is no reason to wait to evaluate whether the development can satisfy the tax requirements or restructure the arrangement to meet the requirements. Under existing guidance, some projects might not be eligible for the tax benefits because they do not satisfy certain requirements. Further IRS guidance in the next few months might be positive with respect to these open points. It is beyond this summary to list the open points.

Besides the statute that was enacted in 2017, what additional government action has been issued to provide guidance?

- October 2018 IRS Proposed Regulations.
- February 14, 2019 Hearing on IRS Proposed Regulations.
- April 2019 Second Separate Set of IRS Guidance Expected.
- December 2019 Third Set of IRS Guidance Expected.
- December 2018 President Issues Executive Order to Have 13 Federal Agencies Focus on Distressed Areas, including OZs.

B. STRUCTURAL POINTS AND EXAMPLE OF TAX BENEFITS.

Does the IRS guidance to date favor any particular OZ investment?

To date, the IRS OZ guidance has focused on real estate development. Retention of cash amounts for extended periods is a limitation applicable to OZ investments A special rule allows cash to be used towards real estate development for a 31 month period. Without this special rule, there are limitations on having the entity build up cash in excess of 5% of the initial project amount.

Additional flexibility is expected with respect to the development of vacant or underutilized buildings in the second set of IRS guidance.

EXAMPLE: Assume that an individual has $1 million of long term capital gain from the sale of stock, real estate, or the sale of a business. For simplicity, assume that the individual originally invested $200,000 and the sale value is now $1.2 million, resulting in the $1 million capital gain. How do the tax benefits apply?

In 2019, the individual (and a second person) form a LLC as the QOF and the individual invests the $1 million capital gain dollar in exchange for an equity interest in the QOF (assume 99% interest), and the QOF contributes the capital gain dollars to a newly-formed LLC operating company (OpCo) in exchange for an equity interest in the OpCo (assume 99% interest), which is used toward the purchase of land and development of rental property. OpCo also borrows $2 million, which is used toward the development.

In 2029 (after holding the QOF equity interest for 10 years), the individual sells the equity interest in the QOF when the net value of the interest is $4.2 million. What are the resulting tax consequences?

85% of the $1 million deferred gain that was invested in the QOF is recognized ($850,000) in 2026, and taxed at the long term capital gain tax rates in effect in 2026. The 2026 year is a hard stop for the deferral and taxation of the capital gain dollars invested in the QOF. The tax on the deferred gain is payable in 2026, even though the individual continues to retain the QOF interest for an additional three years through 2029.

The $1.2 million of additional appreciation ($4.2 million sale price less the aggregate $1 million capital gain investment and $2 million financing) is recognized tax free.

It would also seem that any LLC losses that flow through to the individual from early depreciation and interest deductions during such ten-tear period avoid being recaptured on the sale of the QOF interest. This is an additional benefit that seems available and could be confirmed by future IRS guidance.

If the QOF interest is sold in 2027 (rather than 2029), the 15% exclusion of the deferred capital gain still applies and the $850,000 is taxed in 2026, but the additional $1.2 million appreciation (and possible LLC losses that flowed through to the individual) are taxed because the QOF interest is held for less than 10 years.

If the QOF interest is sold in 2025 (after a six-year holding period), then the exclusion applicable to the $1 million deferred gain is 10% (rather than 15%) and the $900,0000 deferred capital gain is taxed at the capital gain rates in effect in 2025.

If the QOF interest is sold in 2023 (after a four-year holding period), then the full $1 million deferred capital gain is recognized at that time at the capital gain rates in effect for 2023. There is no exclusion because the QOF interest has been held for less than five years.

What if the investment of the capital gain dollars into a QOF occurs in 2020, 2026, or after 2026?

A 2020 investment of capital gain dollars through a QOF that is held for ten years allows the deferred capital gain invested to be eligible for a 10% exclusion in 2026. The 10% deferred gain exclusion is linked to holding the QOF investment for six years.

An investment of capital gain dollars through a QOF in 2022-2026 that is held for ten years is eligible for a deferral of the capital gains amount but no exclusion applies to such deferred gain. No exclusion applies because the QOF investment would be held for less than five years.

In both cases, the post-investment appreciation of the invested dollars in the QOF will be eligible for total exclusion from taxation.

Under current rules, the OZ program is not available for investments after 2026.

Can OZ investments be used in startup tech businesses located within an OZ, with the funds applied primarily towards operations (e.g., licensing and compensation costs) and much less towards real estate development?

Currently, there are limitations with expanding a startup business' operations. One limitation stems from the requirement that cash reserves be spent relatively quickly. Based on the level of comments submitted to the IRS, it is expected that this limitation will be addressed, with the question being whether all of the limitations will be removed. In many situations, this is an area where it might be worthwhile to wait for additional guidance in the next few months.

What is the timing of guidance that will result from the President's Executive Order to have 13 federal agencies address distressed areas?

The order includes time periods (of up to one year) for the issuance of recommended changes to best implement the development of distressed areas, including OZs.

Is there a preferred structure for implementation of the OZ provisions?

Yes. A multi-person owned LLC (with as few as two persons) is formed and designated as a QOF and such entity forms a second two person LLC entity with the QOF owning a 99% interest and the second LLC acting as the operating entity (OpCo).

The investors contribute capital gain dollars into the QOF in exchange for equity interests, and then the QOF contributes the same dollars to the OpCo in exchange for an equity interest. Any borrowing is made at the OpCo level. The OpCo purchases (or leases) the property to be developed and applies the capital gains dollars and the borrowed funds toward real estate development over a 31-month period.

How does an LLC get designated as a Qualified Opportunity Fund?

The LLC elects QOF status with its first income return tax by filing an IRS Form 8996 with a checked box, the selection of an effective date that coincides with when the capital gain investments were made, and reflecting that the QOF properly invested within a 6-month period. The simplest method for the QOF to meet the 6-month investment requirement is to have the capital gains transferred as equity into a second LLC that will act as the operating entity (OpCo) to develop real property.

At this point, there is no additional qualifying approval from or reporting required to any federal or State agency. This same form is attached annually to each income tax return.

It is expected that the QOF (and the OpCo) will need to report their investments and possible operations in some manner, but this point is still in a development stage.

Does the LLC that elects QOZ status need to have any special provisions in its organizational or operating agreement?

The LLC organizational document should include a statement that its purpose is to invest in qualified opportunity zone property and a description of the qualified opportunity zone business(es).

While not required, consideration could be given to including provisions that the QOF and the OpCo will not engage in certain prohibited activities and not hold any "nonqualified financial property," a defined term which would reference that cash amounts will be distributed in a manner to prevent impermissible cash accumulation. It is not necessary that the documents contain such provisions but only that these OZ requirements are met in operation.

There is a lot of talk of QOFs that are expected to hold large amounts of capital gain dollars for investments. Must these specific QOFs be used in some manner for the use of the OZ provisions?

No. There are two types of QOFs.

First, there are QOFs formed and owned by a few persons who have a specific targeted project. These persons use their own capital gains towards the project through the use of the QOF/OpCo structure described above.

Second, there are QOFs funded through capital gains contributed by a diverse investor group, where the investors are not involved in the selection or development of projects, and that task is left to the QOF manager.

This second group of QOFs is a potential source of equity funds that can be used by a developer towards a project. The expected returns by each QOF must be explored. Counsel for investors who contribute capital gains in exchange for an equity interest in these QOFs must be aware of what protections the Fund uses to assure that qualifying investments are made and what exit procedures are available.

C. LENGTH OF TIME TO HOLD INVESTMENT TO OBTAIN TAX BENEFITS.

How long must an investment in a QOF be held to achieve post-investment tax-free appreciation?

Investments in QOF must be held at least 10 years to potentially maximize the federal income tax benefits available.

Can investments in a QOF be held more than 10 years and, if held more than 10 years, is any additional tax benefit available?

Yes, investments in a QOF can be held through 2047 and all appreciation from the time of the QOF investment through such time can be tax free.

Must the QOF interest be sold in 2047?

Under current rules, a sale is required between the ten-year investment date and 2047 to have the benefit of tax-free appreciation. The IRS is considering whether to allow for a step-up in tax basis in the QOF interests in 2047 to the then current value without the need for a disposition of the QOF interest.

What happens if an investor sells its equity interest in a QOF before 10 years?

If the equity interest in the QOF is sold within ten years, any post-investment appreciation in the QOF interests will be taxed on the sale date. However, the investors still have the deferral of the taxation of the capital gains used to invest in the QOF through the sale date (but not past 2026) and can exclude up to 15% of the deferred capital gain associated with the investment in the QOF if the QOF equity interest was held for at least 7 years, or up to 10% of the deferred capital gain associated with the investment in the QOF equity interest if such interest was held at least 5 years. As stated above, there is a hard stop of the deferral and 15%/10% gain exclusion in 2026.

Can the QOF sell the interests in the OpCo, or can the OpCo sell the property interest, within the ten year investment period and reinvest the sale proceeds in a manner so as to continue the potential tax free appreciation and the deferred capital gain benefits?

Possibly. To be determined by future IRS guidance.

D. EXAMPLES OF QUALIFYING INVESTMENTS.

What are examples of qualifying OZ investments?

Example #1 Capital gain dollars and additional financing used by OpCo (that is primarily owned by QOF) towards the purchase of land within an OZ from an unrelated person and construction of new building that is leased as rental property.

Example #2 Capital gain dollars and additional financing used by OpCo (that is primarily owned by QOF) with $300,000 used towards the purchase (from an unrelated person) of land and $500,000 allocated toward the purchase of existing building within an OZ. An additional $1 million is used towards the renovation of the building, which is then leased as rental property.

Example #3 Existing business owner within OZ plans to expand existing facility. Assume that the business owner (rather than the business) has capital gains to invest. Individual uses the structure described in Example 1 or 2 to develop property to lease to the existing business. Need to confirm that use of separate entity does not create tax inefficiencies.

Example #4. If the business in example #3 has capital gain from the sale of a business unit or otherwise, then the existing business can form a QOF that owns an OpCo to construct an expanded facility.

Example #5. Individuals can use capital gain dollars and additional financing through a QOF/OpCo structure to purchase homes within an OZ from an unrelated person, "substantially improve" the homes, and continue as rental property.

Example #6. Hopeful that Future Guidance Will Allow. Capital gain dollars and additional financing used through typical QOF/OpCo structure towards the purchase of an equity interest in a biomedical or software business with a portion of the invested dollars used towards the expansion of the physical location and the primary use of the dollars towards licensing costs and employee compensation. The appreciation in value of the OpCo is linked to the development of intangible technology property which is licensed throughout the world.

Are there are any businesses that cannot be operated by a QOF or an OpCo in which a QOF owns an interest?

Yes, no portion of the business can consist any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

Are all real estate leasing activities by a QOF or an OpCo permissible?

No, while subject to future guidance, consideration needs to be given to avoiding triple net lease arrangements. The OZ provisions require the active conduct of a business. The meaning of an active conduct can limit the use of triple net leasing arrangements and the meaning of business can limit the use of development of property for a quick resale as dealer property.

Is there a certain period that the invested cash and additional financing must be used?

Yes, the OpCo is permitted to hold cash for the acquisition, construction, and substantial improvement of tangible property within n OZ for up to 31 months.

Can non-capital gains dollars be invested in the QOF or in the OpCo in exchange for an equity interest?

Yes, but such dollars would not be eligible for any of the OZ tax benefits and would dilute the tax benefits available to the capital gain investors.

Can the QOF or OpCo own both properties within an OZ and properties outside an OZ?

From a practical perspective, no. There is some flexibility to this point but some practical considerations should prevent this.

E. MECHANICS OF CAPITAL GAINS INVESTMENTS IN QOF.

How long does a person have to invest capital gains into a QOF?

180 days from when the capital gain is recognized, which typically (but not always) means from the closing date.

Can the capital gain result from a sale to a related person?

No. The sale that triggers the capital gain eligible for investment in a QOF must be to an "unrelated person."

If a taxpayer owns public company shares that were purchased for $20,000 and sells for $100,000, what is the amount that can be contributed through a QOF structure to be eligible for the federal income tax benefits?

$80,000 capital gain amount representing the difference of $100,000 less $20,000. If the taxpayer contributes an amount in excess of $80,000 for an equity interest, the additional amount is not eligible for the tax free appreciation and would dilute the equity percentage interest owned by the taxpayer eligible for the tax free appreciation. For example, if the taxpayer in this example contributed the full $100,000 for a 99% QOF equity interest, then approximately 80% of the post-investment QOF appreciation is available for tax free benefit and the remaining 20% is not eligible for the benefit.

If the taxpayer in the above example invests only $50,000 in a QOF structure, then the additional $30,000 capital gain is immediately recognized.

Is there a dollar limit on how much capital gain can be invested through a QOF structure and be eligible for the federal income tax benefits?

No. However, the terms of a third-party QOF can impose minimum and maximum thresholds on the amounts that can be contributed.

How does a taxpayer report to the IRS that the Opportunity Zone tax provisions are being used?

Following the Instructions to IRS Form 8949, an election is made to defer the recognition of the capital gain invested in a QOF.

A second election must be made on the income tax return for the year that the QOF interest is sold to take advantage of the tax free appreciation.

If the value of the QOF equity interest declines by 2026 or the earlier sale date, what is the deferred gain amount to take into income?

If, as of the December 31, 2026 date, the value of the QOF reinvestment has declined to less than the deferred gain amount, then only a portion of the deferred gain is recognized on that date equal to the value of the QOF interest. If the QOF equity interest appreciates in value thereafter and the property continues to be held for at least 10 years, then all additional appreciation following December 31, 2026 escapes taxation. The pass through of operational losses must be taken into account to determine the deferred gain recognized in the situation where the property value has declined.

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