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CLIENT ALERT

The Opportunity Zone (OZ): the Great and Powerful Tax Incentive?

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As investors and tax advisors have begun to digest the fundamental changes enacted as part of last December's Tax Cuts and Jobs Act, a less noticed benefit, designed to encourage investments in low-income communities, has come to the fore. While the potential for the OZ provisions to spur investments in Opportunity Zones may be hampered by uncertainties in the legislative language,[1] Treasury regulations may clear a path forward.

Tax Benefits (and Costs) at Four Stages

1. *Deferral*. A taxpayer can elect to defer gain from the sale or exchange of any property by investing such gain in a qualified opportunity fund ("QOF") within 6 months, and any such gain can be deferred through December 31, 2026 (or until an earlier sale). Note that gain from a sale or exchange after December 31, 2026 cannot be deferred. The requirements for QOFs are discussed below.

Unlike a section 1031 "like kind" exchange, gain from any type of property can be deferred, and only the gain, not the entire investment, must be reinvested. For example, assume that in January 2018 a taxpayer sells stock for $150 that was originally purchased for $50. The $100 gain is deferred by investing in a QOF, freeing up the original $50 investment

[1] The tax benefits appear in Section 1400Z-2 of the Internal Revenue Code of 1986, as amended ("Code"). Section 1400Z-1 contains rules on the designation of Opportunity Zones.

for other purposes. For deferral to be available under section 1031, the entire $150 would need to be reinvested (and then only if the original and replacement property are real estate).

2. *Elimination of 10% of deferred gain after 5 years, 15% after 7 years*. If the taxpayer holds the QOF investment for at least 5 years, 10% of the gain is eliminated; for at least 7 years, and an additional 5% of the gain (for a total of 15%) is eliminated. The elimination of gain is accomplished through an increase in basis. In the example above, the $100 invested in the QOF will initially have a $0 basis, which would increase to $10 after 5 years and to $15 after 7 years. As discussed below, the 7-year period can end no later than December 31, 2026, so investments must be made by December 31, 2019 to realize the full benefit.

3. *Deferred gain recognized on December 31, 2026*. Any deferred gain must be recognized on December 31, 2026 if not recognized sooner. The amount of gain recognized equals the difference between the amount of deferred gain (or, if less, the fair market value of the QOF on December 31, 2026) and the taxpayer's basis in the QOF investment. Continuing the example above, the taxpayer will recognize the remaining $85 of gain on December 31, 2026 ($100 deferred gain, reduced by $15 basis increase described above), assuming the QOF investment is worth at least $100 on that date. Gain must be recognized on December 31, 2026 even though the taxpayer receives no cash.

4. *After 10 years, permanent exclusion of new gain on QOF investment*. If the QOF investment is held for at least 10 years, the taxpayer can elect to increase the basis to its fair market value on the date of a sale or exchange. This is the most tantalizing benefit in these rules. Assume the taxpayer sells the QOF investment for $600 after 10 years (say, in 2029). As noted above, the taxpayer would already have recognized $85 of the deferred gain, and would have a $100 basis in the QOF interest ($15 of excluded gain plus $85 of recognized gain). All $500 of "new gain" — the increase in value from the original $100 investment to the current $600 value — would escape tax. This election would be available no matter how much new gain is realized.

It appears that the statute can provide a benefit for new gain even when there is no benefit for the "old" gain. For example, assume that in January 2026, the taxpayer sells stock for $150 that was originally purchased for $50 and, within 6 months, reinvests the $100 gain in a QOF. The deferral and basis increases described above would provide no benefit here, because the $100 of "old gain" would need to be recognized on December 31, 2026, the same year in which the sale occurs. By investing in the QOF, however, the taxpayer would ensure that any new gain — any appreciation in the value of the QOF over the initial $100 investment — would escape tax if held for at least 10 years.[2]

[2] The statute provides that gain from a sale or exchange after December 31, 2026 cannot be deferred. This appears to permit gain from a sale as late as December 31, 2026 to be invested in a QOF in order to obtain the exclusion benefit for new gain.

Sale of interest in QOF versus sales by QOF. The tax benefits described above attach to the investment in a QOF, but it is not clear how they will apply to investments made by a QOF. If the QOF in the example is treated as a partnership for tax purposes, the investor can realize all the tax benefits if the partnership buys and holds its investment(s) and the investor exits after 10 years by selling the partnership interest. If the partnership sells an investment along the way, however, it appears that gain would be allocated (and taxable) to the investor and the other partners under the normal partnership rules. Treasury is authorized to issue regulations providing for a reasonable period of time for a QOF to reinvest proceeds from property investments, and the return of capital from investments in underlying companies or partnerships (see discussion of "Qualified Opportunity Zone Property" below). Thus, regulations may allow QOFs to maintain deferral, at least in part, after an asset sale. It is also not clear how (if at all) the election to increase basis to fair market value after 10 years will apply to a QOF's sale of its assets. This benefit should be available to investors in a QOF that is taxed as a real estate investment trust ("REIT"), if the QOF sells its assets and then liquidates, based on the operation of the REIT rules. In other contexts, the answer is not clear. The success of the OZ rules will likely turn on whether the regulations can resolve these issues.

Qualified Opportunity Funds

To realize the benefits described above, a taxpayer must invest gain in a QOF. Note that the term "fund" in this definition is a bit misleading, because a QOF can easily be a special purpose vehicle holding a single investment and owned by a single investor or multiple investors. The challenges in organizing a QOF as a fund that holds multiple investments are discussed below. To qualify as a QOF, an entity must meet three requirements.

- *Organization*. A QOF is an investment vehicle organized as a corporation or partnership. There does not appear to be a policy reason against permitting a state-law limited liability company or trust that is treated as a corporation or partnership for tax purposes to qualify, but the statutory language may make this difficult.[3] However, it appears that a corporation electing to be treated as a REIT or an S corporation would qualify. Unlike entities under the new markets tax credit program, a QOF will self-certify by attaching a form to its tax return.

- *Purpose*. The QOF must be organized for the purpose of investing in qualified opportunity zone property other than another QOF. The 3 categories of qualified opportunity zone property — qualified opportunity zone business property, stock and partnership interests — are discussed below.

- *Investment*. The most vexing requirement is that the QOF must hold at least 90% of its assets in qualified opportunity zone property, based on the average of the amount invested on the last day of the first 6-month

[3] The new markets tax credit regulations permit a trust or limited liability company to qualify as a community development entity based on its tax qualification, but the relevant definition under those rules refers simply to a "corporation or partnership" and not to an entity "organized" as a corporation or partnership.

> period and on the last day of each taxable year of the QOF (the "90% test"). It is not clear whether cash held by a QOF pending investment will be treated as qualifying for some period of time or whether a delay in the QOF's deployment of cash will imperil the tax benefits of its investors. The statute provides for a monthly interest charge if a QOF fails to meet the 90% test, unless the failure is due to reasonable cause. The regulations may build on this to provide clarity and flexibility.

As noted above, to benefit from deferral under the OZ rules, an investor needs to invest gain within 6 months of a sale or exchange. A fund will make capital calls when the fund finds an investment opportunity. Because these two events may not coincide — a capital call may come before the investor is ready to sell or more than 6 months after the investor's sale — investors may be reluctant to invest in QOFs organized as multi-asset funds. It is also possible that capital commitments could be treated as non-qualifying fund assets, making satisfaction of the 90% test difficult for a multi-asset fund. A fund may be able to manage these timing issues, either on the investor or investment side, by funding investments with debt, to be repaid later with capital calls.

One possible solution to these issues is to structure participation in a QOF through a pledge fund or investment club. Investors would agree to general terms but would decide, on a deal-by-deal basis, whether to participate in any particular investment (each of which would be a separate QOF).

A single QOF may also be able to make multiple investments by using an open-end structure, similar to a hedge fund or mutual fund. In such a structure, investors purchasing interests at later closings would participate pro rata in all investments made until that date.[4] This would be possible only if the assets could be reliably valued so that the fund's net asset value could be determined for each closing. Cash invested at each closing would remain in the fund rather than being distributed to earlier shareholders, and the fund would thus need to be able to deploy the cash quickly enough to meet the 90% test every 6 months.

Qualified Opportunity Zone Property

There are 3 categories of qualified opportunity zone property: qualified opportunity zone business property ("Business Property"), qualified opportunity zone stock, and qualified opportunity zone partnership interests (together with qualified opportunity zone stock, "Equity Interests"). With either type of Equity Interests, the entity must be a "qualified opportunity zone business," which is also described below.

Business Property. Business Property is tangible property used in a trade or business of a QOF if (i) it is acquired by purchase from an unrelated party after December 31, 2017, (ii) its original use in the qualified opportunity zone

[4] Investors arriving too late would not benefit from the elimination of gain after 5 or 7 years.

commences with the QOF or the QOF substantially improves the property, and (iii) during substantially all of the QOF's holding period for the property, substantially all of the use of the property was in a qualified opportunity zone. The QOF will be considered to have substantially improved the property if, during the 30 months following acquisition, renovations add as much to its basis in the property as its original investment. It is not clear how purchase price allocable to land will be treated for this purpose or for the requirement that the property's original use commence with the QOF. Guidance is also needed on what period will constitute "substantially all" of the QOF's holding period or use of property.

Equity Interests. An Equity Interest is stock in a domestic corporation or a capital or profits interest in a domestic partnership if (i) acquired by a QOF after December 31, 2017, at original issue (directly or, in the case of stock, through an underwriter) solely in exchange for cash, (ii) at the time of issuance, the entity was, or was being organized for the purpose of being, a qualified opportunity zone business (as described below), and (iii) during substantially all of the QOF's holding period for such equity interest, the entity qualified as a qualified opportunity zone business. Although an Equity Interest does not include debt, it appears that it could include an interest with debt-like features, such as nonqualified preferred stock as defined in section 351(g)(2) of the Code. A profits interest could also permit flexibility. The requirement that the Equity Interest be acquired solely in exchange for cash appears to preclude the issuance of an interest, such as a carried interest, partially in exchange for services (although it may be possible to acquire an Equity Interest for cash and a separate class of interests for another type of consideration).

Qualified opportunity zone business. For a QOF's investment in Equity Interests to qualify, the entity must be a qualified opportunity zone business. This is a trade or business that meets the following requirements:

- substantially all of the tangible property owned or leased by the entity is Business Property under the demanding requirements described above: acquired by purchase from an unrelated party after 2017, originally used (or substantially improved) by the entity, and located in a qualified opportunity zone for substantially all of its use during substantially all of the entity's holding period;
- the entity does not operate or lease land to 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;
- at least 50% of the total gross income of the entity is derived from the active conduct of such business;
- a substantial portion of the intangible property of such entity is used in the active conduct of any such business; and
- less than 5% of the average of the aggregate unadjusted bases of the entity's property is attributable to nonqualified financial property (such as stock, partnership interests, options, etc.).

Opportunity Zones

The Treasury Department Community Development Financial Institutions ("CDFI") Fund is responsible for the nomination and designation of qualified opportunity zones. Information on the official list of designated zones is available at the CDFI Fund website.[5]

A qualified opportunity zone must be a low-income community ("LIC") as defined for purposes of the new markets tax credit. This is generally a census tract with a poverty rate of at least 20% or where the median family income does not exceed 80% of the statewide median (or the metropolitan area median family income, if greater). In addition, a non-LIC census tract can qualify if it is contiguous with an LIC that is designated as a qualified opportunity zone (even if in a different state) and the median family income of the non-LIC tract does not exceed 125% of the median family income of that contiguous LIC.

These designations are based on the 2010 census and will apply for 10 years.

State Tax Benefits

The tax benefits described above may also apply for state tax purposes. Many states base their income tax on federal income, so that the exclusions and basis adjustments described above would apply automatically — unless specifically reversed by state legislation.[6] State tax benefits may not be available in states that use their own tax base or conform only to specific provisions of the federal tax code (or only as of a specific date).

[5] https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

[6] *See, e.g.*, https://esd.ny.gov/opportunity-zones ("Generally, both the deferral and exclusion of the capital gains from federal income will flow through to New York State. This means those gains will also be deferred and excluded from New York taxable income.").

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