



Opportunity Zones

November 29, 2018

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Background

As part of the recently enacted Tax Cuts and Jobs Act, new Code section 1400Z-2 provides for the temporary deferral of tax on capital gains that are reinvested in a “qualified opportunity fund,” the potential to receive partial exclusion on such gain if held for a minimal amount of time and the permanent exclusion from tax of the gains from the sale or exchange of an investment held for at least 10 years in a qualified opportunity fund.



DEFINITIONS

Qualified Opportunity Zone

- Low income census tract or a census tract contiguous with a low income census tract that has been nominated by the chief executive of a state or possession and certified by the Treasury Department
 - › All tracts have been certified by Treasury
- The designated Opportunity Zones are available here:

<https://www.cdfifund.gov/Documents/Designated%20QOZs.4.18.18.xlsx>

Qualified Opportunity Fund

- Corporation or partnership:
 - Organized for the purposes of investing in “qualified opportunity zone property”
 - As simple as establishing a new entity with dedicated bank account
 - Capital gains must be placed in Qualified Opportunity Zone within 6 months of realization
 - Gains must be deposited in Fund account, or at least a binding commitment to transfer cash is made
 - Fund must hold at least 90% of its assets in qualified opportunity zone property, measured twice (once 6 months into the taxable year, and once at the end of the taxable year), meaning capital proceeds must be invested within 6 months

Qualified Opportunity Fund

- Observations
 - > The 90% testing places time pressure on investments
 - > Observation: Since the 90% test is done six months into and at the end of the Fund's taxable year, Fund established on December 1 may have to deploy 90% of its cash by December 31
 - The Proposed Regulations provide a 31-month "working capital safe harbor"

Qualified Opportunity Zone Property

- Stock acquired by a Fund after December 31, 2017 (for cash) at its original issue in a corporation that is a qualified opportunity zone business
- A partnership interest acquired by a Fund after December 31, 2017 (for cash) in a partnership that is a qualified opportunity zone business
- Tangible property used in a trade or business of the Fund if the property was acquired after December 31, 2017 and the original use of the property in the qualified opportunity zone commences with the Fund or if the Fund substantially improves the property

Qualified Opportunity Zone Business

- A trade or business in which substantially all tangible property owned or leased by the business was acquired by purchase after December 31, 2017
- The original use of the property commences with the business or the business substantially improves the property
- Substantially all of the use of the property is in a qualified opportunity zone
- At least 50% of the total gross income of the business must be derived from the active conduct of the business

Qualified Opportunity Zone Business

- A substantial portion of the intangible property of the business must be used in the active conduct of the business
- Less than 5% of the average of the aggregate adjusted bases of the property of the business can be attributable to certain financial property (debt stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar properties)
 - The financial property does not include working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less or accounts receivable
- The property cannot be certain excluded property (golf courses, country clubs, massage parlors, hot tub facilities, tanning facilities, racetracks, gambling facilities or liquor stores)
- The phrase “substantially all” is not defined in the statute

Opportunity Zone Investments

- Investors cannot create own gain by selling property to related party
 - › But investors can maintain up to a 20% interest
- Substantial improvement means doubling your investment
 - › 30 month measuring period does not commence on Day 1
- Ability to structure investments is fairly open-ended
 - › GP and LP Opportunity Funds/AIVs
- One fund/one property structure provides most flexibility and administrative ease

Opportunity Zone Investments

- Opportunity Fund deals can be used with tax credits such as LIHTC, energy, or historic
- Proposed Regulations address issues such as carried interests and special allocations and the use of debt

Disposition of Investment

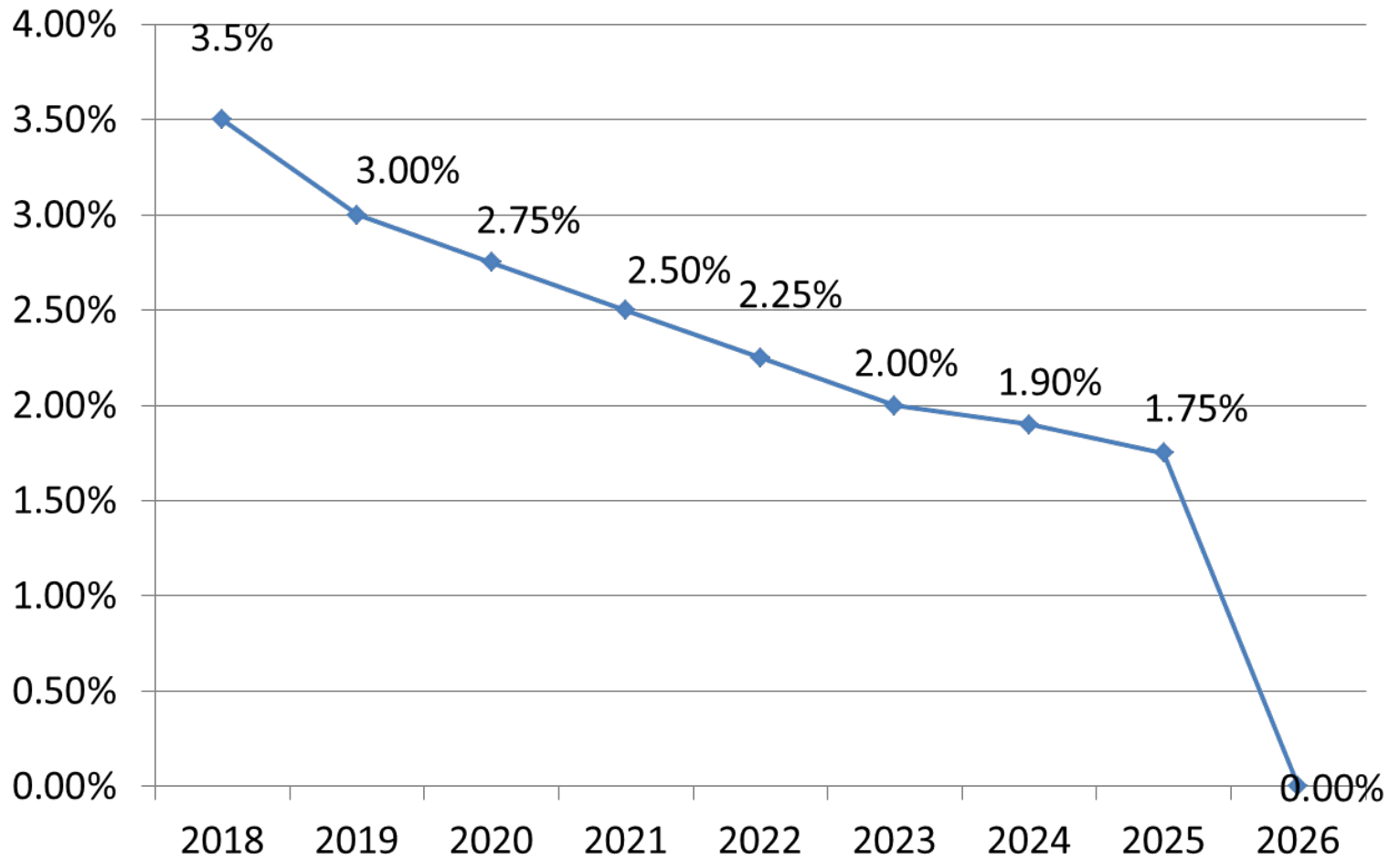
- Investor must sell the Fund interest and not the underlying property

BENEFITS

Deferral of Gain

- By election, a taxpayer can elect to have the gain from the sale or exchange of property excluded from gross income to the extent that the gain is invested in a Fund within 180 days from the date of the sale or exchange
- The election cannot be made for any sale or exchange after December 31, 2026
- The gain that is invested in a Fund is deferred until the investment in the Fund is sold or until December 31, 2026, whichever is earlier. I.R.C. § 1400Z-2(b)(1)
- Observation-the benefit of the statute lessens as the date of the investment gets closer to the end of 2026.

Declining Benefit of Investing in Fund



Stepped-Up Basis

- If a taxpayer holds an investment in a Fund for at least 5 years, the basis of the gain is increased by 10% of the original amount of gain deferred
- If the investment in a Fund is held for at least 7 years, the basis of the gain is increased by an additional 5% of the original amount of gain deferred
- Investors can get up to a 15% reduction in capital gains tax for investments held more than 7 years

Permanent Exclusion

- By election, gains from the sale or exchange of an investment in a Fund are permanently excluded from tax if the investment in the Fund is held for at least 10 years, so long as the investment in the Fund is sold or exchanged in an arm's length transaction
 - › The mechanism for the exclusion from tax is the step-up in basis of the investment to its fair market value upon disposition
 - › Thus, a sale of the investment to an affiliate may qualify for the exclusion so long as the sale price of the investment is consistent with the price that would be paid by an independent third party

Losses

- The legislative history makes it clear that taxpayers can continue to recognize losses associated with investments in Funds

PENALTIES

Penalties

- There is a penalty if the Fund fails to maintain the requirement that the Fund hold at least 90% of its assets in qualified opportunity zone property
- However, the reference in the statute to the 90% requirement is incorrect as it states, “the 90-percent requirement of subsection (c)(1)” when the 90% requirement appears in subsection (d)(1). Without a technical correction, it is unclear if the penalty can be imposed by the IRS
- The penalty is the excess of the amount equal to 90% of the Fund’s assets over the aggregate amount of qualified opportunity zone property held by the Fund, multiplied by the federal underpayment rate for the month
- For Funds that are partnerships, the penalty is taken into account as part of the distributive share of each partner of the partnership

FUND CERTIFICATION

Fund Certification

- The statute requires the Treasury Department issue regulations that include “rules for the certification of qualified opportunity funds” for the purposes of the statute
- For now, the Proposed Regulations, and a recently issued draft IRS Form allow Funds to “self certify” compliance with the statute

EXAMPLES AND APPLICATIONS

Investment in Fund is Held for at Least 10 Years

Assume a taxpayer has \$100 in gain from the sale of stock on June 1, 2018. Within 180 days from the date of the sale of the stock, the taxpayer invests the \$100 gain in a Fund, and makes the appropriate election. The \$100 gain is not subject to tax in 2018 (the year of the sale of stock), and is deferred until the investment in the Fund is sold, or December 31, 2026, whichever is earlier.

Further, assume that the taxpayer holds the investment in the Fund for 10 years. The basis in the deferred \$100 gain is increased by 15%, which reduces the taxable gain by \$15, making only \$85 of the gain subject to tax. Since the investment in the Fund was held for 10 years (i.e. at least 7 years), the \$85 gain is taxed in 2026.

Additionally, assume that the taxpayer sells his investment in the Fund in 2029 (at least ten years after the original investment in the Fund), for \$200, the fair market value of the investment, and makes the appropriate election. Since the basis of the investment in the Fund equals the fair market value of the investment on the date of the sale, no tax is paid on the \$100 of appreciation of the investment over the taxpayer's 11 year holding period.

Investment in Fund is Held for at Least 10 Years

The tax effect of holding the investment in the Fund for at least 10 years, compared to an ordinary investment, is as follows:

<u>At Least 10 Year Holding Period</u>		<u>Ordinary Investment</u>		<u>Difference</u>
Deferred Gain (taxed in 2026)	\$100.00	Gain (taxed in 2018)	\$100.00	
Basis Step-Up	\$15.00	Basis Step-Up	\$0.00	
<u>Taxable Gain</u>	<u>\$85.00</u>	<u>Taxable Gain</u>	<u>\$100.00</u>	
Tax (at 23.8%)	\$20.23	Tax (at 23.8%)	\$23.80	\$3.57
Gain on Investment	\$100.00	Gain on Investment	\$100.00	
Basis Step-Up	\$100.00	Basis Step-Up	\$0.00	
<u>Taxable Gain</u>	<u>\$0.00</u>	<u>Taxable Gain</u>	<u>\$100.00</u>	
Tax (at 23.8%)	\$0.00	Tax (at 23.8%)	\$23.80	<u>\$23.80</u>
				\$27.37 TOTAL

As a result of holding an investment in a Fund for 10 years, and making the proper elections, a taxpayer would save \$27.37 in tax, and would get the benefit of the deferral of tax on the gain that is invested in the Fund until 2026.

Investment in Fund is Held for at Least 7 Years

- Assume a taxpayer has \$100 in gain from the sale of stock on June 1, 2018. Within 180 days from the date of the sale of the stock, the taxpayer invests the \$100 gain in a Fund, and makes the appropriate election. The \$100 gain is not subject to tax in 2018 (the year of the sale of stock), and is deferred until the investment in the Fund is sold, or December 31, 2026, whichever is earlier
- Further, assume that the taxpayer holds the investment in the Fund for 7 years. The basis in the deferred \$100 gain is increased by 15%, which reduces the taxable gain by \$15, making only \$85 of the gain subject to tax. Since the investment in the Fund is held for 7 years, the \$85 gain is taxed in 2025.

Investment in Fund is Held for at Least 7 Years

The tax effect of holding the investment in the Fund for 7 years, compared to an ordinary investment, is as follows:

<u>At Least 7 Year Holding Period</u>			<u>Ordinary Investment</u>	<u>Difference</u>
Deferred Gain (taxed in 2025)	\$100.00		Gain (taxed in 2018)	\$100.00
Basis Step-Up	\$15.00		Basis Step-Up	\$0.00
<u>Taxable Gain</u>	<u>\$85.00</u>		<u>Taxable Gain</u>	<u>\$100.00</u>
Tax (at 23.8%)	\$20.23		Tax (at 23.8%)	\$23.80
				\$3.57

As a result of holding an investment in a Fund for 7 years, and making the proper election, a taxpayer would save \$3.57 in tax, and would get the benefit of the deferral of tax on the gain that is invested in the Fund until 2025.

Investment in Fund is Held for at Least 5 Years

Assume a taxpayer has \$100 in gain from the sale of stock on June 1, 2018. Within 180 days from the date of the sale of the stock, the taxpayer invests the \$100 gain in a Fund, and makes the appropriate election. The \$100 in gain is not subject to tax in 2018 (the year of the sale of stock), and is deferred until the investment in the Fund is sold, or December 31, 2026, whichever is earlier.

Further, assume that the taxpayer holds the investment in the Fund for 5 years. The basis in the deferred \$100 gain is increased by 10%, which reduces the taxable gain by \$10, making only \$90 of the gain subject to tax. Since the investment in the Fund was held for 5 years, the \$90 of gain is taxed in 2023.

Investment in Fund is Held for at Least 5 Years

The tax effect of holding the investment in the Fund for 5 years, compared to an ordinary investment, is as follows:

<u>At Least 5 Year Holding Period</u>			<u>Ordinary Investment</u>	<u>Difference</u>	
Deferred Gain (taxed in 2023)	\$100.00		Gain (taxed in 2018)	\$100.00	
Basis Step-Up	\$10.00		Basis Step-Up	\$0.00	
<u>Taxable Gain</u>	<u>\$90.00</u>		<u>Taxable Gain</u>	<u>\$100.00</u>	
Tax (at 23.8%)	\$21.42		Tax (at 23.8%)	\$23.80	\$2.38

As a result of holding an investment in a Fund for 5 years, and making the proper election, a taxpayer would save \$2.38 in tax, and would get the benefit of the deferral of tax on the gain that is invested in the Fund until 2023.