



OPPORTUNITY ZONES AND COMMERCIAL REAL ESTATE 2019

January 23, 2019

John Balboni

Sullivan & Worcester
One Post Office Square
Boston, MA 02109
jbalboni@sandw.com

Daniel Ryan

Sullivan & Worcester
One Post Office Square
Boston, MA 02109
dryan@sandw.com

Ben Armour

Sullivan & Worcester
One Post Office Square
Boston, MA 02109
barmour@sandw.com

SULLIVAN &
WORCESTER

Background

As part of the Tax Cuts and Jobs Act, 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, a 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 at least 70% of the 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)

Opportunity Zone Investments

- Investors cannot create their 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
 - > Importantly, this does not include basis allocable to land, which provides a planning opportunity
- 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
- Statute creates the need for creative exit strategies when investors want to sell after 10 years
 - > One Opportunity Fund, one investment or property
 - > Buyouts

BENEFITS

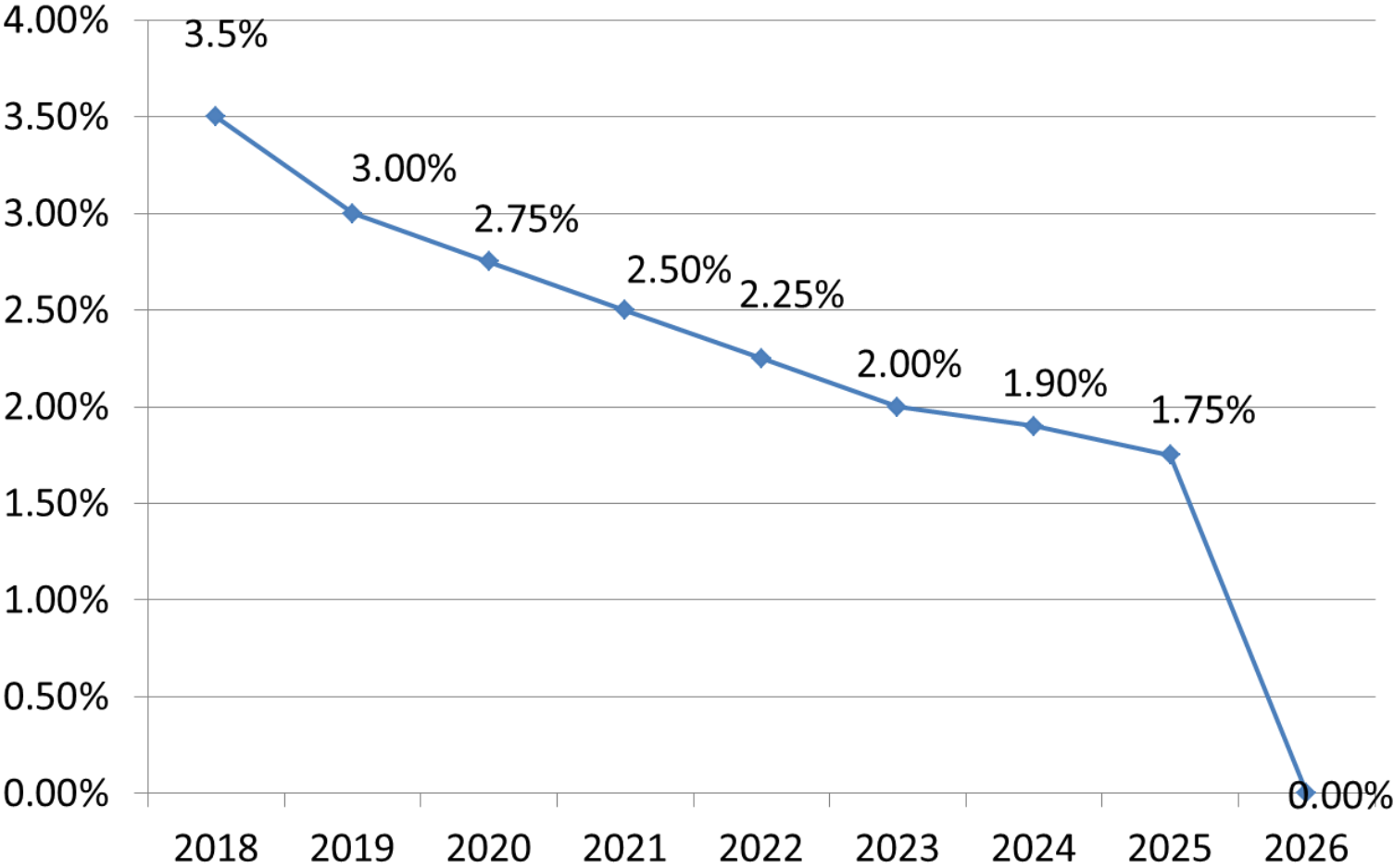
Deferral of Gain

- By election, a taxpayer can elect to have the gain from the sale or exchange of property (both long and short term gain) 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
 - For partnerships, partners are able to invest their allocable share of the partnership gain in a fund. In such a case, the partners have 180 days from the end of the tax year, which gives additional time to invest
- 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

Deferral of Gain *(cont.)*

- Tax rate on capital gains due in 2026 is based on the short- or long-term classification at the time of the original gain
- There can be “mixed funds” where gain and non-gain dollars are invested in an Opportunity Fund, but only the gain dollars qualify for the tax benefits
- Money is fungible, but the capital gain invested in a Fund must be identified

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
 - > Investors have until December 31, 2047 to dispose of an interest in an Opportunity Fund and receive the permanent exclusion from tax

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

Other Pitfalls

- The statute and proposed regulations are filled with precise timing requirements which must be followed, at an investor's peril
- Additionally, there are other specific requirements that can also jeopardize an Opportunity Fund investment
 - > The original use requirement
 - > The post-2017 requirement
 - > The "sin businesses"
 - > Active trade or business
- While establishing an Opportunity Fund can be simple, there are numerous factors that need to be considered to ensure that an investor receives the tax benefits
- The failure of an Opportunity Fund to qualify will lead to an investor owing additional tax, interest, and penalties and investors will not receive the exclusion after 10 years

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 10 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

Other Benefits and Applications

- An Opportunity Zone investment can be combined with federal tax credit programs, such as low income housing, new markets, or historic
- Many states offer incentives for investments in Opportunity Zones
 - Tax abatements
 - State credits
 - Grant programs

Operating Businesses

- While the focus has been on real estate investments, an investment in an operating business also can qualify for Opportunity Zone benefits
 - Generally, business must be in an Opportunity Zone
 - The business must have tangible personal property in the Zone
- Operating businesses could include service businesses such as restaurants or tech start-ups

State Tax Considerations

- Not all states adopted the Tax Cuts and Jobs Act, so these states will not have Opportunity Zone benefits for investors
- Investors concerned with state tax consequences must consult with a tax advisor to see if their state offers the benefits
- Other states are seeking to have state-level programs modeled after the federal Opportunity Zone program

John G. Balboni



Partner

Sullivan & Worcester
One Post Office Square
Boston, MA 02109
T 617-338-2438
jbalboni@sandw.com

John is a partner in our Boston-based Real Estate and Corporate Practice Groups. John is a member of the firm's Management Committee and co-leader of the firm's Real Estate Group, focusing on debt and equity transactions. His practice in real estate and finance law includes private/preferred equity investing, structured real estate transactions, syndicated real estate projects, real estate crowdfunding, lending matters and fund formation. His clients include hedge funds, insurance companies, family offices, developers, investment banks, local, national and international banks, REITs and other institutional investors.

Bar & Court Admissions

- Connecticut
- Massachusetts

Education

- B.A., College of the Holy Cross
- J.D., *cum laude*, Suffolk University Law School

Daniel P. Ryan



Partner

Sullivan & Worcester
One Post Office Square
Boston, MA 02109
T 617-338-2457
dryan@sandw.com

Dan is a partner in the Tax Department of our Boston office. His practice focuses on representing taxpayers in federal and state tax litigation and controversies as well as transactional planning involving corporate, franchise, personal income and sales/use tax matters. Prior to his employment at Sullivan & Worcester, Dan was an attorney at the Internal Revenue Service Office of Chief Counsel, where he represented the Internal Revenue Service in litigation before the United States Tax Court and served as a Special Assistant United States Attorney for the District of Massachusetts.

Bar & Court Admissions

- Massachusetts
- New York
- U.S. District Court, District of Massachusetts
- U.S. Tax Court

Education

- LL.M., Taxation, Boston University School of Law
- J.D., *magna cum laude*, Catholic University, Columbus School of Law
- B.A., Boston College

Benjamin J. Armour



Partner

Sullivan & Worcester
One Post Office Square
Boston, MA 02109
T 617-338-2423
barmour@sandw.com

Ben Armour is a partner in the Corporate Department of our Boston office. His practice focuses on corporate and securities law, representing public and private companies in complex transactions, including mergers and acquisitions, capital markets transactions, real estate investment trust (REIT) conversions, SEC reporting and other general corporate and securities matters. Ben counsels clients through all stages of the corporate life cycle – from initial formation and financing through successful initial public offering or acquisition. He also plays an active role in the firm’s blockchain initiative, and advises companies with respect to blockchain and related technologies, virtual currencies and digital token sales, and related securities laws and regulatory matters. In addition, Ben is a leader of the firm’s Opportunity Zones practice group, and he advises a range of clients in forming private investment funds, partnerships, joint ventures and other investment structures to take advantage of the U.S. Tax Cut and Jobs Act of 2017’s Opportunity Zone Program.

Bar & Court Admissions

- Massachusetts
- New York

Education

- J.D., Boston University School of Law
- B.A., cum laude, Amherst College

S&W's Opportunity Zone Team

Sullivan & Worcester has created a multi-disciplinary team consisting of lawyers from our **Tax, Real Estate, Affordable Housing** and **Corporate** practice groups. We work closely with clients across the country to analyze how they might implement this new legislation into their business strategy.

More specifically, we advise clients on the following:

- Fund Formation and Structuring
- Tax Compliance and Related Tax Matters
- Real Estate Acquisitions
- Asset, Property Management and Operational Issues
- Financing Components (Senior, Mezzanine and Preferred Equity)
- Affordable Housing and Tax Credit Matters
- Business Start-Ups

Sullivan & Worcester's Info-Zone blog features insight and analysis about Opportunity Zones, written by our multi-disciplinary team of lawyers from our [Tax](#), [Real Estate](#), [Affordable Housing](#) and [Corporate](#) practice groups.

blog.sandw.com/info-zone