QUICK AND DIRTY: OPPORTUNITY ZONE PROGRAMS

A small piece of legislation within a large package of tax reform has major implications for commercial real estate.

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Recently, U.S. Treasury Secretary Steven Mnuchin predicted that $100 billion in capital would be invested into "Opportunity Zones." If you're not familiar with the term "Opportunity Zone," consider this your invitation to catch up on the latest tax incentives from Uncle Sam.

The Opportunity Zone program is a federal tax program established under the 2017 Tax Cuts and Jobs Act to encourage long-term capital investments in low-income communities.

Under this program, investors may defer tax — and if additional requirements are satisfied, avoid a portion of the tax altogether — on an unlimited amount of income treated as capital gains. This includes gains from sales of stocks or other securities, business assets and certain other property — business or personal — but only if the gain is reinvested in an "Opportunity Zone."

Where Are They?

Certain geographic areas or census tracts located in all 50 states, the District of Columbia and certain U.S. possessions have been designated as Opportunity Zones. Texas alone has 628 census tracts located across 145 counties designated as Opportunity Zones.

The majority of these designated Opportunity Zones are located in Harris County, which has 105 designations, followed by Bexar County with 24, Hidalgo County with 23, Travis County with 21 and Dallas County with 18. A map of designated Opportunity Zones is available at *www.cims.cdfifund.gov*

Tax Incentive Benefits

There are three tax incentives to investing in an Opportunity Zone. The first incentive allows a taxpayer that reinvests his/her capital gains income

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into a qualified opportunity fund ("QOF") to elect to defer tax on that rollover gain until December 31, 2026 or when the QOF is sold, whichever comes earlier.

The second incentive is a partial exclusion from tax on the rollover gain of up to 15 percent if the taxpayer satisfies certain holding period requirements. Finally, a taxpayer that owns the QOF for 10 years or more can elect to avoid tax on all appreciation in the QOF investment — but not the original investment rolled over into the QOF — upon exit therefrom.

As you would expect from any tax incentive, there are some tedious rules, requirements and deadlines, not to mention the tax jargon and acronyms. While a review of all of the Opportunity Zone rules is beyond the scope of this article, we will address some issues relevant to the real estate industry.

The QOF Investment

As noted above, rolled-over capital gain income must be invested in a QOF. This investment must constitute an equity interest in order to qualify — debt or other non-equity investments are not eligible for the benefits provided under the program.

Although a QOF is defined under the program as a "fund," any entity structured as a corporation or as a partnership for federal tax purposes, including an LLC that elects to be treated as such, may qualify as long

as

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as certain conditions are met.

The entity must be organized for the purpose of investing in "qualified opportunity zone property," and hold at least 90 percent of its assets in qualified opportunity zone property. This is commonly referred to as the "90 Percent Test."

Qualified Property

Qualified opportunity zone property generally includes qualified opportunity zone business property (i.e., tangible property held by and used in a trade or business that is located in an Opportunity Zone and the original use of which began with the QOF or which is substantially improved by the QOF); and a qualified opportunity zone business interest (i.e., generally an equity interest in an entity structured as a partnership or corporation for federal tax purposes (including an LLC that elects to be treated as such) that operates a qualified opportunity zone business).

Qualified Business

A business constitutes a qualified opportunity zone business if substantially all of its tangible property constitutes qualified opportunity zone business property and certain other tests are satisfied, including the active business requirement noted below.

Original Use Requirement

Because of its permanent nature, the original use requirement noted above is problematic in the context of land investments. Fortunately, the IRS has provided guidance in the context of a QOF or qualified opportunity zone business acquiring land and an existing building.

In either such case, if the QOF substantially improves the existing building by making capital expenditures in excess of the purchase price attributed to the building (without regard to the purchase price attributed to the land), both the land and the building should satisfy the substantial improvement test.

Unfortunately, the IRS has not provided guidance on land in the context of a ground-up development involving either unimproved land or land with improvements/structures that will not be part of the new development. Although this remains an open issue, we anticipate future guidance will confirm that a similar analysis will be applied in such case — and which may also address underutilized or abandoned property.

Active Business Requirement

When a QOF operates through a subsidiary "qualified opportunity zone business," that subsidiary must be an active business. However, the rules do not define what constitutes the active conduct of a trade or business.

We expect most activities that constitute a trade or business for federal income tax purposes will be considered the active conduct of a business, with the possible exception of triple-net leases. Although some skeptics raised questions about the eligibility for multifamily residential rental projects, most practitioners expect this activity to qualify.

Construction Projects

The Opportunity Zone program contains a number of restrictions on a QOF or qualified opportunity zone business holding working capital or nonqualified financial property. Because, as described below, the rollover gain must be invested in a QOF within 180 days, the working capital restriction can cause problems for new development construction projects.

Fortunately, the proposed regulations provide a working capital safe harbor for a QOF subsidiary operating a qualified opportunity zone business. Note that this safe harbor does not appear available to a QOF investing directly in qualified opportunity zone business property.

Under the safe harbor, working capital can be held for a period of up

This map shows the location of some of the opportunity zones (highlighted in blue) that exist throughout the DFW metroplex.

to 31 months. However, this assumes there is a written plan identifying the working capital as held for the acquisition, construction or substantial improvement of tangible property in an Opportunity Zone and that a schedule of expenditures and the plan has been identified and planned.

Timing Considerations

There are a number of timing requirements that must be met in order to obtain these new tax incentives. First of all, as a threshold matter for all Opportunity Zone incentives, a taxpayer must reinvest the rollover gain into a QOF within 180 days of the sale or of the disposition event that gives rise to the original capital gain.

To qualify for a partial exclusion on the rollover gain, a taxpayer must meet the holding period requirements described below by December 31, 2026.

A taxpayer who holds a QOF investment for at least five years is eligible for a 10 percent exclusion from tax on the rollover gain. A taxpayer who holds a QOF for at least seven years is eligible for a 15 percent exclusion.

So, to be eligible for the 10 percent exclusion, a taxpayer must invest in a QOF by December 31, 2021. Eligibility for the 15 percent exclusion requires investment by December 31, 2019.

A taxpayer investing in a QOF after 2021 but before December 31, 2026 will still be eligible to defer the rollover gain and remain eligible to avoid tax on the appreciation in the QOF investment — provided the QOF investment is held for 10 years or more — but will not be eligible for a partial exclusion on the original investment of rollover gain.

Conclusion

The Opportunity Zone program is favorable to investors and the proposed regulations provide significant guidance to encourage Opportunity Zone investment. The U.S. Treasury has stated that additional proposed guidance should be released during the last quarter or 2018 or the first quarter 2019.

Although open issues remain, the proposed guidance provides taxpayers with enough clarity to confidently undertake Opportunity Zone investments in qualifying ventures. It is important to remember that these tax incentives may not, by themselves, make any particular investment financially rewarding.

Opportunity Zone incentives should be viewed as a bonus that could make a difficult project viable or a good project better. A potential investor in an Opportunity Zone project should still undertake all customary due diligence to evaluate the merits of the project.

More Information

This article is intended as a quick-reference guide for brokers, developers, investors and lenders in the real estate and financial industries and their advisors. The information provided is general in nature. Various points that could be important in a certain case have been condensed or omitted in the interest of readability.

The content is subject to the statutory and regulatory language behind the incentive in its entirety. Professional advice should be obtained before applying this information to a case. ■

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