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Opportunity Zones – an Overview of the Benefits and Requirements

The opportunity zone statute that was enacted as part of the Tax Cuts and Jobs Act allows all taxpayers to avail themselves of tax benefits that include temporary tax deferral and the possibility of complete and permanent exclusion of some taxable income. The statute required guidance from the IRS to make the statute usable, and the IRS issued its first set of guidance in late 2018. Below is a very brief summary of benefits of the program and what someone wanting to benefit from the program would need to know.

Tax benefits that are available for investing in a "Qualified Opportunity Fund"

- Any gain that is treated as capital gain and realized by any taxpayer can be deferred until the tax year in which December 31, 2026 falls (or, if earlier, the year in which the interest in the Qualified Opportunity Fund is sold). Note that this includes Section 1231 gain, which is gain on the sale of depreciable or other investment property (although not gain that is recaptured as ordinary income).
- As long as the investment in the Qualified Opportunity Fund is held for at least five years before December 31, 2026, 10% of the gain that was deferred is permanently excluded from taxable income.
- As long as the investment in the Qualified Opportunity Fund is held for at least seven years before December 31, 2026, another 5% (for a potential total of 15%) of the gain that was deferred is permanently excluded from taxable income. Note that this can be achieved only by investing in a Qualified Opportunity Fund on before December 31, 2019.
- As long as the interest in the Qualified Opportunity Fund is held for at least ten years, complete exclusion of 100% of the gain realized on the sale of the interest.

The Opportunity Zone Act is structured to incentivize investments in certain economically depressed areas

- In order to qualify, money from a gain must be invested after December 31, 2017 in an "Opportunity Zone" under certain conditions.
- An "Opportunity Zone" is one of the census tracts that have been designated as an "Opportunity Zone" under the Opportunity Zone Act.
- A map and a search tool to find opportunity zones is at the following URL: https://esrimedia.maps.arcgis.com/apps/View/index.html?appid=77f3cad12b6c4bffb816332544f04542

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Who Can Benefit from the Opportunity Zone Act

- Any taxpayer desiring to invest capital gain in order to obtain tax deferral and potential tax-free returns.
- A company or business already located or planning to locate in an opportunity zone that is looking for equity investment.
- Syndicators or sponsors looking to create funds for themselves and others to invest.
- Any party that owns real estate in an opportunity zone and is looking for an opportunity a marketing advantage and/or to cash out.

In order for a particular taxpayer to obtain all of the benefits of the opportunity zone statute, the following must happen:

- The taxpayer must have a gain treated as capital gain that is realized prior to January 1, 2027.
    - For a pass-through entity that realizes a gain, the pass-through entity itself can invest in a Qualified Opportunity Fund to defer the gain.
    - If a pass-through entity does not elect to defer gain by investing in a Qualified Opportunity Fund, an individual member or shareholder can do so by investing in a Qualified Opportunity Fund within 180 days after the last day of the tax year of the pass-through entity in which the gain was realized.
- Within 180 days after the closing of the transaction that resulted in the gain, proceeds of the transaction must be invested in a "Qualified Opportunity Fund."
    - Note that the taxpayer does not need to invest all of the proceeds to qualify for deferral.
    - If the taxpayer receives $5 million of proceeds and $3 million of gain, the taxpayer can invest only $3 million and still defer the entire gain.
    - Note that this is very different from a like-kind exchange under Section 1031, in which that same taxpayer would immediately need to recognize $2 million of income.
- While the taxpayer *can* invest *more* than the amount of the gain in the Qualified Opportunity Fund if the taxpayer wishes, the taxpayer is not required to do so.
    - Down side: The taxpayer does *not* receive any additional tax benefit for the amount invested in the qualified opportunity fund in excess of the amount of deferred gain.

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What Qualifies as a Qualified Opportunity Fund?

- A Qualified Opportunity Fund is a partnership or corporation[1] that invests 90% or more of its assets either directly in a property located in an opportunity zone or in one or more entities that operate a "qualified opportunity zone business."
- At the time of the investment in the entity that is a Qualified Opportunity Fund, it must already have an election in place to be a Qualified Opportunity Fund.
    - The entity certifies itself to the IRS as a Qualified Opportunity Fund by filing Form 8996.
    - The form will specify the first month and year that the entity will be a Qualified Opportunity Fund.
    - The investment with the Qualified Opportunity Fund must be made after the election is effective.
- In order to be a Qualified Opportunity Fund, at least 90% of the assets of the entity must be invested in Qualified Opportunity Zone Property.
    - The 90% test is tested based on the entity's financial statements. If the entity does not have financial statements, it is based on the cost of each asset.
    - This is tested twice per year, and the average must be at least 90%.
    - If the test is not met, a penalty is assessed to the Qualified Opportunity Fund.

Qualified Opportunity Zone Property

Qualified Opportunity Zone Property can be any of the following:

- Qualified Opportunity Zone Business Property
- Qualified Opportunity Zone Stock
    - Stock in a qualifying corporation acquired after December 31, 2017.
    - The corporation is a "qualified opportunity zone business" – meaning generally that it invests at least 70% of its assets in qualified opportunity zone business property.

[1] As of the date of this description, it is uncertain whether an S corporation can qualify as a Qualified Opportunity Fund (QOF). In all events, only a very narrow list of types of taxpayers can be shareholders of an S corporation -- only U.S. citizens and resident individuals, certain trusts and estates, and tax-exempt corporations. That means an S corporation cannot have even one shareholder who is a partnership or a corporation or any individual who is a non-resident alien. That means that large categories of otherwise potential investors in a QOF would be barred from investing in the QOF. That generally would make an S corporation a less than optimal choice for a QOF.

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- Qualified Opportunity Zone Partnership Interest
    - The partnership interest must be acquired after December 31, 2017.
    - The partnership or LLC is a "qualified opportunity zone business" – meaning generally that it invests at least 70% of its assets in qualified opportunity zone business property.

Qualified Opportunity Zone Business Property is the key to a qualified investment. To be qualified opportunity zone business property, the property must be:

- Tangible property that is acquired by the Qualified Opportunity Fund, by purchase for cash, after December 31, 2017, from an "unrelated party."
    - Note that an entity is "unrelated" as long as there is common ownership of 20% or less, after applying constructive ownership rules.
    - That means an owner of property in an opportunity zone can sell to a qualified opportunity fund and invest in that fund as long as the seller owns 20% or less of the fund.
- Either (i) the original use of the property within the opportunity zone must begin with the business, **or** (ii) the Qualified Opportunity Fund must substantially improve tangible personal property.
    - Improving existing property within an opportunity zone can qualify as long as, within 30 months after purchasing the property, the business spends more to improve the property than the tax basis of the property immediately before the improvements were made. For the purpose of making this calculation, the value of the land can be excluded.
    - Used tangible property (e.g., machinery) can qualify as long as the machinery was used outside of the opportunity zone (and is only now being used in the opportunity zone for the first time).
- During substantially all of the business's period of ownership of the property, the property is used within an opportunity zone.
- Note that the property does not need to be used in the active conduct of a trade or business by the Qualified Opportunity Fund.
    - This allows a Qualified Opportunity Fund to just perform large-scale improvements to a property and then lease it to an active business.
    - ***That also means a sale-leaseback within an opportunity zone is one very good way to utilize the opportunity zone.***

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Qualifying as a Qualified Opportunity Zone Business

- 70% percent of the property owned or leased by the business is qualified opportunity zone business property.
- The definition of qualified opportunity zone business property requires three elements:
  - The property must be purchased after December 31, 2017.
    - This requirement seems to expressly conflict with the general statement that 70% of the property "owned or leased" is qualified opportunity zone business property.
    - That leaves it very unclear whether property that is leased and improved can be used to qualify an entity as a qualified opportunity zone business.
  - Either the original use of the asset is by the business, or the business "substantially improves" the property (meaning the tax basis of the new improvement work is at least equal to the tax basis of the improvements before the work).
  - Substantially all of the use of the property is within the opportunity zone.
- At least 50% of the income is from the active conduct of a trade or business.
- A substantial portion of the intangible property of the entity is used in the trade or business.
- Less than 5% of the property of the entity consists of any of certain financial assets, excluding cash and cash equivalents, accounts receivable, and working capital that is to be used within 30 months.
- The following businesses are expressly excluded: golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or other gambling facility, or a store the primary business of which is the sale of alcohol for off-premises consumption (note that a bar does not fall within the prohibited category and can be a qualified opportunity zone business).

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