Obtaining Capital Gain Tax Savings Through Investment in Opportunity Zones

The 2017 tax reform package contained a provision that received little attention at the time, but is now recognized as an attractive means to defer, reduce and in some cases even eliminate the taxation of capital gains on certain qualifying investments.

The key is to invest capital gains in a qualified fund ("Qualified Fund" or "QOF") that is a U.S. entity that will hold equity interests in qualified business property ("Qualified Business Property") that qualifies due to its location in a designated Opportunity Zone ("Zone" or "QOZ"). Such a Zone must meet criteria as a census tract containing economically distressed areas.[1]

Benefits of QOF Investment

There are a number of important benefits that a taxpayer can realize through investment of a capital gain in a Qualified Fund:

- Only the gain ("Original Gain") must be invested in the Qualified Fund.[2] The portion of the sale proceeds constituting basis need not be reinvested and can be retained untaxed.
- Any taxpayer subject to capital gain taxation can defer such tax by investing the Original Gain in a Qualified Fund. The deferral lasts until the investment is sold or December 31, 2026, whichever is earlier.
- After an investment in a Qualified Fund is held for five years, there is a 10 percent step-up in basis, meaning that only 90 percent of the Original Gain is thereafter subject to tax upon the end of the deferral.
- After another two years (for a total of seven), there is another 5 percent step-up in basis, meaning that only 85 of the Original Gain is thereafter subject to tax upon the end of the deferral.
- After an investment in a Qualified Fund is held for 10 years, there is a step-up in basis equal to the entire gain realized within the Qualified Fund ("OZ Gain"). Accordingly, the OZ Gain is not taxed.

Therefore, the potential benefits include:

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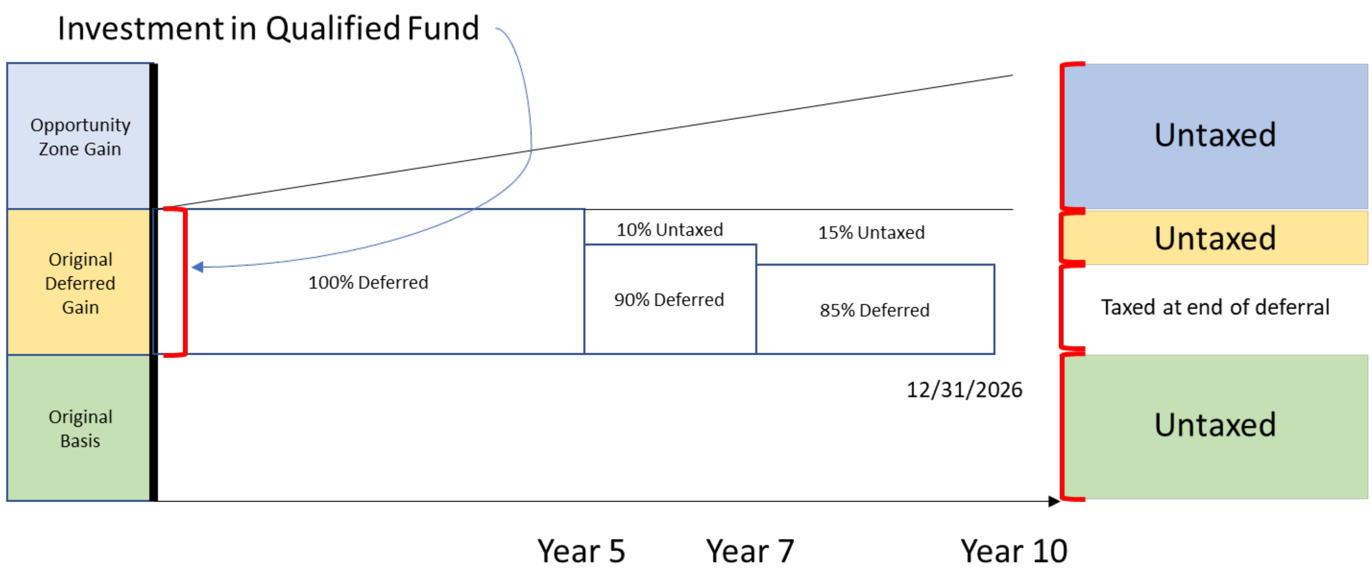
[1] Certain areas that are adjacent to economically distressed areas, though not economically distressed as such, could be added to designated Opportunity Zones as permitted in the statutory language. Only areas officially designated as Opportunity Zones pursuant to the statute, however, will qualify for purposes of investment in Qualified Opportunity Zone Property. As will be discussed hereinafter, it will be nevertheless possible for a Qualified Fund to invest in some level of property that is outside of an Opportunity Zone so long as the overall requirements are met. Such "outside" property need not necessarily be adjacent to the Opportunity Zone property.

[2] This is in contrast to the Section 1031 "like-kind exchange" in which all of the proceeds of the subject sale (both gain and basis) must be reinvested.

- **Deferral of capital gain taxation on the Original Gain** until December 31, 2026.

- **Elimination of up to 15 percent of the capital gain taxation on the Original Gain** if the investment is held for the seven-year period.

- **Elimination of 100 percent of the capital gain taxation on the OZ Gain** if the investment is held for the 10-year period.



How to Obtain the QOZ Benefits

The means to obtain the benefits of deferral, reduction and elimination of capital gains through the QOZ program is to ensure that the investment of the Original Gain is in a Qualified Fund. **The purpose of a Qualified Fund is to make investments in Qualified Business Property**.

The reinvestment of the Original Gain must take place within 180 days of the sale that results in the gain.[3] The gains that can be deferred must be capital gains realized by a gain from the sale to or exchange with an unrelated person[4] of property held by the taxpayer.[5]

The investment in a Qualified Fund must be an equity investment and not a debt instrument. Nevertheless, the proposed regulations indicate that the interest in the Qualified Fund can be used as collateral for a loan.

Any entity that is taxed as a partnership or C-corporation (whether existing or newly created) can declare itself to be a Qualified Fund using new Form 8996. A limited liability company will qualify

[3] If the sale that results in the Original Gain is made at the partnership level, then special rules can apply. If the partnership does not reinvest in a Qualified Fund, then individual partners may still do so.
[4] 26 U.S. Code §1400z-2(a)(1). The definition of "related person" follows existing tax law, except that an individual and an entity will be considered "related" if the individual owns more than 20 percent of the entity (whereas in other cases the threshold is 50 percent).
[5] Therefore, a taxpayer could not create and own a fund for the purpose of purchasing appreciated assets already owned by the taxpayer, since such a fund would be a "related person."

so long as same is taxed as a partnership or C-corporation. An entity taxed as an S-corporation will not be eligible to become a Qualified Fund. The Internal Revenue Service will not make prior determinations of Qualified Fund status; the entity simply declares its intent to be recognized as such.

Importantly, however, the Qualified Fund must declare itself using Form 8996 *before* a taxpayer can invest in said fund for purposes of deferring capital gain.

The most important aspect of meeting the test to be a Qualified Fund is the "90 Percent Asset Test."[6]

The Qualified Fund must be able to demonstrate at two six-month intervals each tax year that it holds assets that constitute "Qualified Opportunity Zone Property."[7]

The proposed regulations, however, provide an important "grace period." Under the proposed regulations, **a Qualified Fund may hold "working capital" for up to 31 months**, if there is a written plan that such will be used in the ordinary course of business within such 31-month period and the plan is substantially adhered to.

> *Accordingly, funds can be raised for a project that will entail Qualified Business Property upon completion even if said project may take up to two-and-one-half years to be fully realized.*

A Qualified Fund may liquidate investments and re-invest its assets so long as it continues to satisfy the 90 Percent Asset Test.[8]

The liquidation and re-investment of assets within the Qualified Fund will not affect the five-, seven- and 10-year holding periods for investors who have invested in the Qualified Fund for purposes of obtaining the capital gain deferrals and reductions, so long as the fund remains a Qualified Fund.

What Will Constitute "Qualified Business Property"?

As noted, a Qualified Fund must meet the test of owning at least 90 percent of its assets as Qualified Opportunity Zone Property. Ultimately, and somewhat confusingly, the Qualified Opportunity Zone Property must be made up of a substantial portion of "Qualified Opportunity Zone Business Property" or "Qualified Business Property."

[6] 26 U.S. Code §1400z-2(d)(1).

[7] "Qualified Opportunity Zone Property" is slightly different under the statute and regulations from "Qualified Opportunity Zone *Business*s Property" (which is referred to herein as "Qualified Business Property").

[8] The original Opportunity Zones designated by state governments will be in effect until 2028. The expiration of the "Zone" designation, however, will not end the ability to obtain the tax advantages from investments made based on Qualified Business Property so defined at the time of the investment. It is possible that additional Opportunity Zones will be added to the initial designated Zones. Bipartisan legislation has already been introduced to add areas impacted by hurricanes and wildfires as additional Opportunity Zones.

- *If the Qualified Fund owns the property directly*, then the Qualified Opportunity Zone Property and the Qualified Business Property are the same. In such a case, the Qualified Fund must own 90 percent of its assets as Qualified Business Property.

- *If the Qualified Fund owns the property through an equity interest in a subsidiary*, then the Qualified Business Property can be property owned by the subsidiary.

    - The Qualified Fund still must meet the 90 Percent Asset Test, but some or all of the 90 percent can be equity interest in a qualifying subsidiary.
    - The subsidiary can still qualify if at least 70 percent of *its* assets are Qualified Business Property.[9]
    - Accordingly, **where subsidiaries are employed, a smaller percentage of the overall assets can be permissibly invested in Qualified Business Property**.

Either way, there must be a significant portion of the assets of the Qualified Fund ultimately invested in Qualified Business Property.[10]

The key to obtaining the benefit of the Opportunity Zone investment, then, is to ensure that the Qualified Fund has sufficient investment in Qualified Business Property:

- The property must be used in a qualifying trade or business.[11]

    - The business must derive at least 50 percent of its gross income from the active conduct of business in the Opportunity Zone and meet certain other criteria.

    - The business need not be a new business so long as it meets the criteria.

- The property must be acquired for use in the trade or business on or after January 1, 2018. The Qualified Business can preexist January 1, 2018, but the qualifying *property* ("Qualified Business Property") must be acquired after said date, and the Qualified Business must have at least 70 percent of its assets classified as "Qualified Business Property.[12]

- The property must be within the Opportunity Zone (if real property) or substantially used within the Opportunity Zone (if tangible personal property).[13]

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[9] For example, the subsidiary may own a chain of retail outlets. In such a case, the subsidiary would need to own at least 70 percent thereof as Qualified Business Property. Similarly, if a project has elements that are both within and outside of an Opportunity Zone, at least 70 percent of the assets would need to be within the Zone.

[10] The proposed regulations acknowledge that the minimum percentage would be 63 percent, since a Qualified Fund may own 10 percent of its assets that do not qualify as Qualified Opportunity Zone Property and may own the remaining 90 percent in the form of equity in an entity that owns as little as 70 percent of its assets as Qualified Business Property. In such a case, the Qualified Fund would own 63 percent of its overall assets (90 percent of 70 percent) in Qualified Business Property.

[11] Certain classes of "sin" businesses (including liquor stores, tanning salons and golf courses) are excluded.

[12] Accordingly, the "preexisting" portion of a preexisting Qualified Business can only constitute 30 percent of the total assets of the business after the new investment constituting Qualified Business Property.

[13] Intangible property does not qualify.

- The property must be either:
    - **New to the subject Opportunity Zone**[14]; or
    - **If existing property, "substantially improved" within 30 months** of the acquisition.
- Where existing property is "substantially improved" to meet the qualifying test:
    - The "substantial improvement" must entail an investment equal to or greater than the basis in the existing property.
    - Where "substantial improvement" is made to real property, the basis in the underlying land is excluded from said calculation.

> *Accordingly, if an existing building is purchased in an Opportunity Zone for $2 million, of which $500,000 is attributable to the underlying land, then to qualify as a "substantial improvement" there would need to be an investment of at least $1.5 million ($2 million minus $0.5 million) to satisfy the test.*

Status as Qualifying Business Property is not mutually exclusive with other tax-advantaged programs at the federal, state or local level.

Therefore, a project could employ programs such as New Market Tax Credits, Low Income Housing Tax Credits or Historic Preservation Tax Credits and still qualify as an asset for a Qualified Fund. Banks are likely to be interested in qualifying projects since investment in Opportunity Zones will likely produce benefits to the bank under the Community Reinvestment Act. In addition, state and local incentives such as Tax Increment Financing and other economic development incentives may also apply.

Pulling Everything Together

Taxpayers who realize significant capital gains can defer and reduce same by rolling over such gains into a Qualified Fund. Moreover, the gains realized within such Qualified Fund could be entirely untaxed.

In order to obtain such benefits, the taxpayer must form or invest in a Qualified Fund.

The Qualified Fund must declare itself to be such and must demonstrate that it can satisfy the 90 Percent Asset Test.

To meet the 90 Percent Asset Test, the Qualified Fund must ensure that a sufficient amount of its assets will be treated as Qualified Business Property.

Qualified Business Property will be property used in a business substantially within an Opportunity Zone, that is either new investment or investment in an existing asset that is "substantially improved."

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[14] Used equipment can be moved from outside the Opportunity Zone to within same and qualify.

Once the foregoing is achieved, the significant potential tax benefits can be realized for the investors, and improved access to capital is expected to result for those conducting businesses within the Opportunity Zones.