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# THE STATE OF OPPORTUNITY ZONES

Presented to: Council of Development Finance Agencies

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## AGENDA

- Why invest in an Opportunity Zone fund?
- How did Opportunity Zones come to be?
- Steps in the Opportunity Zone process
- Opportunity Zone property
- “Substantial improvement”
- Some of the things to think about
- Questions?

## WHY INVEST IN AN OPPORTUNITY ZONE FUND?

- The short answer . . . If the investor meets the requirements (of which there are many):
- Defer federal income tax on recognized capital gains,
- Have a portion of that deferred gain forgiven, and
- Avoid federal income tax on gain from the Opportunity Zone investment.

# HOW DID OPPORTUNITY ZONES COME TO BE?

- Creation of the Tax Cuts and Jobs Act of 2017.
- Goal is revitalization of economically depressed geographies.
- Attempt to implement lessons learned from prior efforts . . .
  - Requisite long term investment to maximize benefits.
  - Attempt principally to capture investor's gains from other successful investments.
  - Broad - but not unlimited categories of qualifying investments.
  - To fully benefit from the Opportunity Zone provisions, the taxpayer needs to make astute opportunity zone investments.

# STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 1: A taxpayer realizes and recognizes any capital gain.
  - Shares of stock
  - Real estate
  - Partnership interest that result in capital gain
  - Other property
- Step 2: The taxpayer invests the gain dollars in a “Qualified Opportunity Fund” (Fund)
  - Timing: Investment within 180 days for realization/recognition event
  - Taxpayer cannot invest directly in property, even if it’s in opportunity zone
  - The Fund can self-certify

# STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 2: The taxpayer invests the gain dollars in a “Qualified Opportunity Fund” (continued).
  - Fund must be “organized as a corporation or partnership”
  - Initial adjusted basis in the Fund is 0
- Step 3: Fund makes equity investment in “opportunity zone property”
- Step 4: Fund must hold 90% of its assets in opportunity zone property
  - Twice annual testing
  - Penalty for failure to comply

## STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 5: If the taxpayer holds its Fund interest for 5+ years, the taxpayer receives an increase in his/her adjusted basis of 10% of the deferred gain
- Step 6: If the taxpayer holds its Fund interest for 7+ years, the taxpayer receives an increase in his/her adjusted basis of 5% of the deferred gain



# STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 7: On 12/31/2026, there is a “deemed disposition,” so that all the deferred gains related to the investment in the Fund ends and gain is recognized.
  - The gain is the lesser of:
    - The original deferred gain, or
    - The FMV of the taxpayer’s Fund investment
  - Reduced by the taxpayer’s basis the Fund investment.

## STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 7 (continued): Putting the “deemed disposition” rule in context . . .
  - The deferred gain is the building block for the tax on the deemed disposition
  - So, protecting the cash on sale attributable to the adjusted basis from the originating transaction is paramount
  - The basis adjustment (up to 15%) essentially is free . . .
  - Taxpayer has interest-free use of the adjusted basis dollars until, say, April 15, 2027
  - What is the value of free use of that cash on a discounted present value?
- Step 8: If the taxpayer holds the Fund investment for 10+ years, the taxpayer is permanently exempt from capital gains from the sale of his/her Fund interest

# OPPORTUNITY ZONE PROPERTY

- Category 1: Opportunity Zone Property
- Tangible property
  - Real property
  - Land and improvements to real property
  - Equipment and other personal property
- Tangible property needs to be in the opportunity zone during “substantially all” of the Fund’s holding period.

## OPPORTUNITY ZONE PROPERTY

- Category 2: Opportunity Zone Stock or Partnership Interests
  - Fund is not limited to direct ownership of real estate
  - The stock or partnership interest can be an investment in a domestic operating business.
  - “Substantially all” of the business tangible property must be:
    - Acquired by purchase from unrelated third parties after 2017, and
    - Used in the opportunity zone during “substantially all” of the business’s holding period.
  - Among other things, at least 50% of the business’s gross income comes from the “active conduct” of the business.
  - A “substantial portion” of the intangible property of the entity is used in the active conduct of the trade or business.

## OPPORTUNITY ZONE PROPERTY

Category 2: Opportunity Zone Stock or Partnership Interests:

- The balance sheet cannot contain too much financial property, which would imply the business's focus is investment speculation, rather than economic development
  - Less than 5% of average aggregate unadjusted basis is “nonqualified financial property”
- By statute, certain businesses don't qualify (golf courses, country clubs, massage parlors, hot tub or sun tan facilities, race tracks, gambling, package liquor stores)

## “SUBSTANTIAL IMPROVEMENT”

- An Opportunity Zone Fund has a 30-month window to improve property
- Amount of improvements must exceed acquisition basis in the property
- When does 30-month period start?
- Must land be “substantially improved”? Does the basis allocable to land count?
- How does this apply to operating businesses?

## SOME OF THE THINGS TO THINK ABOUT

- Does this make sense for a given investor or gain?
  - Incremental benefit
  - Comparative after-tax returns
- State law conformity/nonconformity
- Who is the taxpayer?
  - S corporations and/or their shareholders?
  - Partnerships or their partners?
- Mixed fund investments

## SOME OF THE THINGS TO THINK ABOUT

- How does an investor think about opportunity fund investment versus a like-kind exchange?
- Does deferred gain mean roll-over investors start with an adjusted basis of \$0?
  - Investor's allocable share of annual tax loss?
  - Taxation of operating cash flow distributions?
- Does partnership-level nonrecourse borrowing solve all the problems?
- What is the tax result from a distribution of refinance proceeds?
- In a mixed fund, can the partnership make special allocations?



## SOME OF THE THINGS TO THINK ABOUT

- How best to structure Funds with multiple properties? How does the Fund structure an exit?
- How should developers and sponsors think about the related party rules?
  - Can/should the Fund purchase of assets owned by the developer?
  - Can the Fund pay the developer property management or asset management fees?

# QUESTIONS?

## CONTACT

**Marshall Phillips**

**CohnReznick LLP**

Project Finance & Consulting

Charlotte, NC

704-900-2650

[marshall.phillips@cohnreznick.com](mailto:marshall.phillips@cohnreznick.com)