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### Moving Onward with the Opportunity Zone Program

By Steven F. Mount, Esq.\*

A new program to encourage investment in low-income community businesses was included in the Tax Cuts and Jobs Act, signed into law on December 22, 2017.

Generally, new §1400Z-2<sup>2</sup> allows individual and corporate taxpayers to defer paying tax on gains from the sale of stock, business assets, or any other property by investing the proceeds into a "qualified opportunity fund" (O Fund),<sup>3</sup> which in turn must invest at least 90% of its assets, directly or indirectly, in businesses located in certain low-income communities designated as "qualified opportunity zones" (O Zone).<sup>4</sup> Partial forgiveness of tax on deferred gains and on future appreciation is possible for O Fund investments held for five, seven, and 10 years.

A detailed description of the benefits and requirements of the O Zone program is contained in an article by the author published in the *Bloomberg Tax Real Estate Journal*, 34 Real Est. J. 23 (Feb. 7, 2018).

The O Zone program was not self-executing. Instead, three things were needed to enable taxpayers to

reasonably take advantage of the program: (1) each state (and the District of Columbia and certain territories) were required to nominate O Zones within their jurisdictions pursuant to rules in §1400Z-1, which nominations had to be certified by the Treasury Department; (2) rules on how to certify an O Fund were needed; and (3) guidance from the IRS concerning compliance with several of the basic requirements of the statute was required. The first two have now occurred, but the timing of guidance from the IRS is unknown.

This article explores, in Q&A format, several practical questions that have been raised by potential investors and project owners that must be resolved for taxpayers to take full advantage of the program and speculates on guidance that may be forthcoming.

# CERTIFICATION AND OTHER O FUND REQUIREMENTS

**Question 1:** How is an O Fund certified?

Answer 1: A taxpayer must self-certify an O Fund by filing an election with their tax return. No approval or action by the IRS is required. Absent additional requirements being promulgated by the IRS, self-certification can only address the statutory requirements. These are (i) the O Fund is organized as a corporation or partnership, and (ii) the O Fund is organized for the purpose of investing in "qualified opportunity zone property" (O Zone Property). The requirement that the O Fund be a corporation or partnership references its treatment for federal income tax purposes, and thus a state law limited liability company with more than one member (and that has not made an election to be treated as an association tax-

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<sup>&</sup>lt;sup>1</sup> P. L. 115-97 (hereinafter the 2017 tax act).

<sup>&</sup>lt;sup>2</sup> As added by §13823, the 2017 tax act. All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

<sup>&</sup>lt;sup>3</sup> §1400Z-2(d)(1).

<sup>&</sup>lt;sup>4</sup> §1400Z-1(a). Other provisions of §1400Z-1 contain requirements for states to nominate and the Treasury Department to certify O Zones. O Zones have now been certified for all 50 states, the District of Columbia and Puerto Rico, American Samoa, Guam, the Northern Mariana Islands, and the U.S. Virgin Islands. *See* https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx for a list and maps of O Zones.

<sup>&</sup>lt;sup>5</sup> IRS, Opportunity Zone Frequently Asked Questions, https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.

<sup>&</sup>lt;sup>6</sup> §1400Z-2(d)(2)(A). "Qualified opportunity zone stock" and "qualified opportunity zone partnership interest" are, generally, stock in a corporation or a capital or profits interests in a partnership, in each case issued by the entity after December 31, 2017 solely in exchange for cash, if the entity is (or is organized for purposes of being) an O Zone Business (defined below).

able as a corporation) would be treated as a partnership.

An additional requirement in §1400Z-2(d)(1) that an O Fund hold at least 90% of its assets in O Zone Property is a requirement to qualify for the benefits of the program but should not be part of the self-certification and should not be included in the purpose clause of the organizational documents of the O Fund.<sup>7</sup>

**Question 2:** What other requirements are there to form an O Fund?

Answer 2: There are no other requirements to form an O Fund. In most cases, the formation of an O Fund will involve only filing a certificate of formation to create a limited liability company, drafting an appropriate operating agreement, and, if necessary, preparing offering documents.

There are no restrictions on who may organize, own, or manage an O Fund. Many O Funds will likely be single-investor funds in which a taxpayer who recognized a gain forms their own fund that they control to invest in projects they select. At the other end of the spectrum, there likely will also be multi-investor funds in which a sponsor raises funds from several taxpayers who have recognized gains and invests those funds in projects selected by the sponsor.

#### TIMING REQUIREMENTS

**Question 3:** How much time does a taxpayer have to invest proceeds from a sale transaction into an O Fund?

**Answer 3:** The statute provides a 180-day period in which the investment into the O Fund must be made beginning with (and including) the date of the sale or exchange.<sup>8</sup>

The statute is explicit that the event that starts the 180-day period is the sale or exchange, and thus without IRS dispensation a later start date would not be available in situations that may reasonably justify it. This could include a case where the gain is recognized for tax purposes on a date later than the date of the sale or exchange, for example, if the gain were deferred under the installment sale provisions in §453.

If gain were recognized by a partnership or an S corporation, the partners or shareholders may not know about the gain until they received their Schedule K-1 in the following year, which could be after the 180-day period had run. Thus, hedge funds may want to notify their investors about significant gains on a real-time basis. See Q&A 8 below concerning the

identity of the investor where gain is recognized by a pass-through entity.

**Question 4:** How much time does an O Fund have to invest proceeds into O Fund Property?

Answer 4: The only time requirement provided in the statute are two specified dates<sup>9</sup> on which, on average, the O Fund must have at least 90% of its assets invested in O Fund Property. Thus, depending on when funds are contributed into an O Fund, the O Fund would have six months at the most to invest at least 90% of its assets into O Zone Property. It is unclear how the rule would be applied to a short taxable year, but it appears that for the short year (assuming a calendar taxable year) the two dates could be six months following formation of the O Fund and December 31. Thus, the O Fund should not be formed prematurely, or the taxable year of the entity may start and the first six-month period would begin to run. <sup>10</sup>

The IRS is expected to provide a grace period to give an O Fund more time to invest its funds. A 12-month grace period, at minimum, seems likely, based on a similar rule in the New Markets Tax Credit program, 11 but a longer period, up to 30 months, would not be unreasonable in light of the substantial improvement requirement discussed in Q&A 6.

**Question 5:** How long does a corporate or partnership subsidiary of an O Fund have to invest funds so as to qualify as a "qualified opportunity zone business" (O Zone Business)?<sup>12</sup>

**Answer 5:** An O Fund can invest in qualifying projects directly (including through a single member limited liability company) or indirectly through a corporation or partnership. The time for an O Fund to make its investment directly or into the stock or partnership interest of a subsidiary is discussed in Q&A 4. This Q&A 5 discusses the time for a subsidiary corporation or partnership to invest funds received from an O Fund.

The statute does not specify when a subsidiary must satisfy the requirements to qualify as an O Zone Business. Many of the requirements, including the requirement that the subsidiary derive at least 50% of its

<sup>&</sup>lt;sup>7</sup> If the 90% test is not met, a specific monetary penalty is prescribed, but the O Fund does not lose its certification.

<sup>&</sup>lt;sup>8</sup> §1400Z-2(a)(1)(A).

 $<sup>^9</sup>$  §1400Z-2(d)(1) refers to "the last day of the first 6-month period of the taxable year of the fund, and . . . the last day of the taxable year of the fund."

<sup>&</sup>lt;sup>10</sup> The tax rules concerning when the first taxable year of a newly-formed partnership begins are surprisingly unclear. Reg. §1.6031(a)-1(a)(3), concerning the requirement to file a partnership return, provides that no return is required if the partnership has no income, deductions, or credits for the year. Although it would not be illogical to interpret this to say that a partnership's first year does not start until it first has income, deductions, or credits, the regulation does not say that.

<sup>&</sup>lt;sup>11</sup> See Reg. §1.45D-1(c)(5)(iv).

 $<sup>^{12}\ \$1400</sup>Z\text{-}2(d)(3)$  and  $\$1397C(b)(2),\ \$1397C(b)(4),$  and \$1397C(b)(8).

gross income from the active conduct of a trade or business, have less than 5% of the average of the aggregate unadjusted basis of its property attributable to "nonqualified financial property," and use a substantial portion of any intangible property in an active business, are incorporated by cross-reference to another section, which required that such tests be satisfied on a taxable year basis. Investing cash so as to satisfy these tests by the end of the first taxable year (which could be a short year) would be very challenging for most O Zone Businesses, and impossible in many cases.

The IRS is expected to provide relief by giving a subsidiary more time to satisfy the O Zone Business tests, and allowing it to hold cash for purposes of improving or constructing property. In the New Markets Tax Credit program, the IRS provided a safe harbor to ameliorate the nonqualified financial property problem, which deemed certain proceeds held to construct real property to be reasonable working capital for a 12-month period. Hopefully the IRS will provide a more generous safe harbor for this purpose, because the New Markets Tax Credit safe harbor has been insufficient based on its short time period, the application to only certain proceeds, and the limitation to real estate projects.

**Question 6:** How much time does an O Fund have to "substantially improve" property?

Answer 6: Either an O Fund or its subsidiary must substantially improve<sup>15</sup> the property it acquires unless the "original use" of the property in the O Zone commenced with the O Fund or subsidiary. See Q&A 13 below for a discussion of the original use requirement. Section 1400Z-2(d)(2)(D)(ii) provides that this must occur "during any 30-month period beginning after the date of acquisition of such property . . . ." Although the statute appears open-ended on when the 30-month period must commence, until further guidance is issued by the IRS, taxpayers should plan to

complete required improvements of their property during the 30-month period beginning on the date of acquisition. Note that until the IRS provides relief concerning other requirements in the statute, as discussed in Q&A 5, a taxpayer would not be able to take advantage of the substantial improvement rule.

#### LIMITATIONS ON CASH

**Question 7:** What are the limitations on cash?

Answer 7: Because an O Fund must invest at least 90% of its assets in O Zone Property, it could retain only up to 10% in cash and other liquid investments. In addition, if an O Fund invests through a corporate or partnership subsidiary, such subsidiary could retain up to an additional 5% of its assets in cash and other liquid investments, plus an amount equal to reasonable working capital. Even together, these limitations are likely not high enough to allow an O Fund or subsidiary to hold enough cash to fund construction or improvement of real property, or acquisition of assets to fund an operating business.

Therefore, guidance from the IRS, including safe harbors for holding cash for construction or improvement of property, are critically needed to permit smooth operation of the program.

#### TAXPAYERS ELIGIBLE TO INVEST

**Question 8:** Who can/must be the investor in the O Fund?

**Answer 8:** Where an individual or C corporation sells property at a gain, it is clear that such individual or C corporation must be the person that makes the investment in the O Fund. However, where a partnership or S corporation is the seller, it is unclear if the pass-through entity, the partner or shareholder in the pass-through entity, or both, may be the investor.

The statute requires "the taxpayer" recognizing a gain to invest in an O Fund. "Taxpayer" is defined as "any person subject to any internal revenue law." Although a pass-through entity does not normally pay tax, in certain instances it is required to, 17 and in any event it is subject to various internal revenue laws, such as tax return requirements. Each partner and S corporation shareholder would also be a taxpayer. It would therefore seem that with respect to a gain recognized by a partnership or S corporation, either the entity or a partner/shareholder should be able to invest in an O Fund.

Because the "taxpayer" recognizing gains must be the investor in the O Fund, feeder funds, or partner-

<sup>&</sup>lt;sup>13</sup> §1400Z-2(d)(3)(A)(ii) by cross-reference to §1397C(b)(8). "Nonqualified financial property" is defined in §1397C(e) as "debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations; except that such term shall not include (1) reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or (2) debt instruments described in section 1221(a)(4)." Such term would include bank accounts, checking accounts and other time and demand deposits. Although not specifically listed, it appears that it would also include cash on-hand.

<sup>14</sup> Reg. §1.45D-1.

<sup>&</sup>lt;sup>15</sup> Pursuant to \$1400Z-2(d)(2)(D)(ii), to "substantially improve" a property, an O Fund (or subsidiary) must make additions to basis with respect to such property during a 30-month period in the hands of the O Fund (or subsidiary) that exceed the basis at the beginning of the 30-month period.

<sup>&</sup>lt;sup>16</sup> §7701(a)(14).

<sup>&</sup>lt;sup>17</sup> See, e.g., §1374 (certain built in gains tax imposed on an S corporation) and §6225 (certain taxes imposed on a partnership following an audit).

ships aggregating investors with gains, could not be an investor in an O Fund, unless the IRS specifically permits.

#### TYPES OF PROJECTS/PROPERTY

**Question 9:** What types of projects/property are permissible investments?

**Answer 9:** All types of projects/property qualify as permissible investments, with the exception of the limited types of businesses listed in §144(c)(6)(B)<sup>18</sup> if the investment is made through a subsidiary (but not if the O Fund invests directly).

One of the requirements to be an O Zone Business (applicable if an O Fund invests through a corporate or partnership subsidiary, but not if it invests directly in projects) is that at least 50% of its total gross income be derived from the "active conduct" of a trade or business; some have raised the possibility that this may cause certain types of projects, particularly rental real estate, to not qualify. A similar requirement applied with respect to certain benefits available for projects in the Gulf Opportunity Zone, and authorities under those provisions are instructive. In Notice 2006-77, the IRS stated that "the determination of whether a trade or business is actively conducted by the taxpayer is to be made based on all of the facts and circumstances. A taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business." <sup>19</sup> Examples illustrate the application of the rule. In one example a partnership (and thus all of its partners) are deemed to actively conduct a business of owning and renting an apartment building where one of the partners manages and operates the building. In another example, a partnership owns and triple net leases a commercial building. The example holds that due to the triple net lease, the partnership does not meaningfully participate in the management or operations of the building. However, with respect to a second commercial building leased not pursuant to a triple net lease, and managed by one of the partners, the partnership is deemed to actively conduct a business. <sup>20</sup>

## DIRECT INVESTMENT VS. INDIRECT INVESTMENT

**Question 10:** What requirements apply whether the O Fund invests directly in projects, on the one hand, or invests indirectly through a corporate or partnership subsidiary, on the other hand?

Answer 10: In all cases, property must be acquired by the O Fund (or subsidiary) after December 31, 2017, from an unrelated person, and the original use of the property in the O Zone must commence with the O Fund (or subsidiary) or the O Fund (or subsidiary) must substantially improve the property.

**Question 11:** What requirements are different if the O Fund invests directly or indirectly?

**Answer 11:** The requirements for direct and indirect investments that differ are summarized in the table below:

<sup>&</sup>lt;sup>20</sup> See also PLR 201618008 (taxpayer deemed to actively conduct business where real property leased pursuant to an operating lease and not a triple net lease).

Comparison of Requirements for Direct and Indirect Investment by O Fund		
Requirement	<b>Direct Investment</b>	<b>Indirect Investment</b>
Percentage of O Fund's assets that must be invested in qualified opportunity zone business property	90%	N/A
Percentage of O Fund's assets that must be invested in qualified stock or partnership interests	N/A	90%
Percentage of O Fund's assets that may be held in cash or other liquid investments	10%	5% plus reasonable working capital
Percentage of O Fund's assets that may be invested in intangible property	10%	Unlimited, but intangible property must be used in active conduct of trade or business
Percentage of O Fund's assets that must be invested in tangible property	90%	No minimum

<sup>&</sup>lt;sup>18</sup> §144(c)(6)(B) lists a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, race-track or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

<sup>&</sup>lt;sup>19</sup> Notice 2006-77, §3.02(2).

Comparison of Requirements for Direct and Indirect Investment by O Fund			
Percentage of gross income that must be derived from O Zone	None	50%	
Ineligible Businesses	None	Sin businesses	
Active business test	None	50% of gross income must be derived from "active" conduct of trade or business	

#### **USE OF LEVERAGE**

**Question 12:** Can leverage be used in connection with an O Fund investment?

Answer 12: Yes, leverage can be used at several different levels. Because there is no required connection between gain a taxpayer desires to defer and cash proceeds to fund an investment in an O Fund, a taxpayer could borrow such amounts. In addition, there is no prohibition on an O Fund borrowing to partially fund (together with the taxpayer's equity investment in the O Fund) the purchase of O Zone Property. Similarly, a partnership or corporate subsidiary of an O Fund could borrow to help fund a project. Borrowing at the subsidiary level could potentially be tailored to comply with the timing requirements and cash limitations discussed above, e.g., a taxpayer's equity could be used to acquire an existing property and then borrowed funds could be drawn down as needed to improve the property.

#### **ORIGINAL USE REQUIREMENT**

**Question 13:** What is the "original use" rule and how is it applied to land and existing businesses?

**Answer 13:** For all projects, the original use of the property in the O Zone must commence with the O Fund, **or** the O Fund must substantially improve the

property.<sup>21</sup> The original use standard has been used in other programs similar to the O Zone program, including the Gulf Opportunity Zone program and the DC Enterprise Zone program. The application to tangible personal property is straightforward: new tangible personal property purchased by the O Fund or a subsidiary that constitutes an O Zone Business and first used in an O Zone will clearly qualify. Apparently, used tangible personal property previously used outside the O Zone but purchased and relocated to the O Zone would also qualify.

The rules with respect to real property are less clear. An existing building located in an O Zone could not satisfy the original use test when purchased by an O Fund, and thus would have to be substantially improved. It appears that vacant land located in an O Zone would also fail the original use test, and therefore would have to be substantially improved. This could be problematic in locations where land is expensive.

#### CONCLUSION

The O Zone program promises to bring needed capital to low-income communities, but critical guidance is needed on many items. Hopefully, the IRS will issues guidance soon that is consistent with the policy of the program and flexible enough to allow the program to operate efficiently.

 $<sup>^{21}\,\$1400</sup>Z\text{-}2(d)(2)(D)(i)(II).$  The substantial improvement requirement is discussed in Q&A 6.