Opportunity Zone Program Opportunities.

The "Opportunity Zone Program" ("OZP") was enacted as part of the Tax Cuts and Jobs Act of 2017 and is the first new economic development tax incentive program since the New Markets Tax Credits Program was enacted in 2000. OZP is designed to provide a federal tax incentive for investors to reinvest capital gains generated in 2018 into economically distressed areas. The incentive is two-fold: first the deferral, until December 31, 2026, of taxation of the amount of capital gain realized upon the sale of current original assets, that is reinvested within 180 days in a "Qualified Opportunity Fund" ("QOF"), and second, the potential complete exemption of federal income tax upon the gain, if any, derived from the disposition of the OZP investment if it is held for more than 10 years. The value of the eight-year deferral of the original gain from currently held assets is a function of the discount rate applied and the value of the Opportunity Zone Investment exemption is a function of the amount of gain realized on the disposition of the OZP.

To date, Treasury has approved the designated opportunity zone census tracts for almost 40% of the states and many US territories. Approval of many more state-designated census tracts will be published shortly. The census tracts must be selected from "distressed" census tracts as identified under the New Markets Tax Credit program, plus a small number of census tracts that are contiguous to "distressed" census tracts. Mapping resources to identify designated opportunity zone census tracts may be found here and here. While many of the designated census tracts are located in urban areas, there are abundant designated rural census tracts as well. The legislative history indicates that the states should consider areas that (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives, (2) have demonstrated success in geographically targeted development programs, and (3) have recently experienced significant layoffs due to business relocations or closures. There are no restrictions on combining other tax credit or economic incentive programs with the OZP. The remainder of this memorandum will describe the requirements that must be satisfied for investment to qualify for the OZP incentive.

II. OZP Requirements

A. Qualified Entities

To qualify for the OZP incentive, an individual, corporation, S-corporation, partnership or limited liability company taxpayer, must invest capital gains proceeds into a QOF. A QOF is an investment vehicle organized to invest in "Qualified Opportunity Zone Property" ("QOZP"). The fund may be a corporation or, more likely, a partnership or limited liability company that permits the pass-through of losses and avoids double taxation, but in all events the QOF must invest at least 90% of the aggregate basis of its assets in (1) qualified opportunity zone stock, (2) qualified opportunity zone partnership interests, or (3) qualified opportunity zone business property ("QOZBP"). An equity investment in an entity that holds at least 90% of its property in a "Qualified Opportunity Zone Business" ("QOZB") constitutes qualified opportunity zone stock or qualified opportunity zone partnership interests. A QOZB is an active business that holds at least 90% of its tangible real and personal property within a designated QOZ. Each QOF entity will be tested twice annually to determine compliance with the 90% threshold.

B. Active Business

“Active” business means a business other than a “sin business,” such as a golf course or country club, suntan parlor, massage parlor, hot tub facility, race track or other gambling facility, or a store the principal business of which is the sale of alcoholic beverages for off-site consumption. A passive investment business or holding company would not qualify as a QOZB. A QOZB must hold less than 5% of the aggregate unadjusted basis of its property in the form of “non-qualified financial property” (“NQFP”). NQFP includes liquid financial assets, debt other than accounts or notes receivable from the sale of inventory, stock or partnership interests, warrants, options, future contracts and similar property, but excludes reasonable working capital.

C. QOZBP

The purpose of the OZP is to incentivize investment in tangible property located and used within economically distressed areas and used within economically distressed areas targeted by each state and territory. The property must be acquired by purchase from an unrelated seller after December 31, 2017, the original use of the property must commence with the QOZB, or the QOZB must substantially improve the property, and substantially all of the use of the property must occur within the QOZ. “Substantially Improve” means that the additions to basis of the property must equal or exceed, at the end of any 30-month period beginning after the date of acquisition, its adjusted basis at the time of acquisition by the QOF.

D. Restrictions

The original capital gain that is deferred must be derived from a sale of assets of any type to an unrelated person. Moreover, the property purchased with the proceeds of the QOF investment must be from an unrelated person. Both of these “relatedness” tests are measured on a 20 percent standard that is, 20% or more direct, indirect or attributed common ownership constitutes a related party. For example, the OZP capital gain generated by a sale of assets to an entity with 21 percent common ownership would not qualify for the OZP incentives. Likewise, purchase of assets held by a related party would not constitute QOZBP. It is important to note, however, that a 20% or greater owner of the QOF could also own 20% or more of the QOZB, provided that the QOF investment is used to construct or improve tangible property or purchase tangible property from unrelated parties.

E. Non-compliance

If a QOF fails to satisfy the 90 percent requirement, subject to a reasonable cause exception, the QOF is subjected to a monthly penalty charge equal to the excess of 90% over the percentage of its assets that constitute QOZBP, multiplied times the IRS underpayment interest rate. In the case of QOFs taxed as partnerships, each partner is required to take into account its distributive share of the penalty.

F. Future Guidance

Like any new legislation, the OZP has generated some areas of uncertainty. Future guidance is anticipated with respect to the requirements that may be imposed with respect to entities that will qualify as a QOF. Currently, entities may self-certify as a QOF. We anticipate that any such QOF qualification requirements will not be substantial. The tax treatment of dispositions of a QOF’s investments prior to the expiration of the 10-year holding period are not clearly specified. We anticipate that a QOF will be permitted to dispose of an investment in a QOZB without the imposition of federal income tax provided that it reinvests the proceeds of the disposition in another

QOZB within a reasonable time. We will be closely monitoring the issuance of any formal or informal guidance with respect to the OZP.

III. Investment Structure

The investment into the QOF must constitute an equity investment, and the QOF investment into the QOZ corporation, partnership or QOZB must also qualify as an equity investment. We note in this regard that the QOF could own active business assets in a QOZ directly, without an equity investment in an intermediary. We anticipate, however, that most investments would be made through an intermediary entity to isolate the assets of the intermediary located in the QOZ for the purpose of ensuring compliance as a QOF and QOZB.

Moreover, we anticipate that most QOZB will be operated through limited liability companies or partnerships, so that initial period losses and depreciation can be passed through to the investor. The losses would reduce basis and increase the exempted gain ultimately realized upon disposition after the ten year holding period is satisfied. The basis, capital account and allocation rules applicable to a particular investment would need to be analyzed to ensure that the anticipated tax results are achieved.

IV. Investor Appetite

The OZP can be beneficial for owners of businesses located in QOZ through deferral and, perhaps, ultimate exemption of capital gains, or in the event that the QOZ business owner does not have its own capital gains to invest, through equity investments on a below-market basis from individuals and entities that will subsidize their return under the OZP. It remains to be seen what type of business investments become popular under the OZP.

A number of investors have noted the fit between OZP and the Low-Income Housing Tax Credit ("LIHTC") program. Investors may obtain 100 percent of the anticipated LIHTC and still dispose of LIHTC investments in year 12 without triggering recapture, provided that the purchaser remains in compliance with the LIHTC program. Frequently, the investor's basis is substantially reduced by year 12, and if invested in a QOF, the gain upon disposition would be eliminated, a result which substantially increases the yield for the LIHTC investment. The combination of these programs could double the current market yield from LIHTC investments.

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