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Early Navigation of Opportunity Zone Waters Leaves Many Questions.

Opportunity Zones provide investors a new method to defer or eliminate tax on gains that is more flexible than Section 1031 exchanges. While I.R.C. §1031 like-kind exchanges now only permit delaying capital gains recognition for real estate investments, the 2017 Tax Cuts and Jobs Act created a new program that permits temporary and sometimes permanent deferral of capital gains for certain private investments in businesses and property in low income areas for the purposes of economic revitalization and community development. There is also no cap on the amount of money that may be invested pursuant to this program.

To qualify for this tax treatment, the investment must be in certain low-income areas designated as Qualified Opportunity Zones (“O Zones”). The investment is made via a Qualified Opportunity Fund (“O Fund”) which is an investment vehicle that must hold at least 90% of its assets in Qualified Opportunity Zone Property, which may be stock or a partnership interest in a business located in an O Zone (“O Zone Business”), or other property located in an O Zone (“O Zone Property”). O Zone Property has three prongs and is defined as: 1. tangible property used in a trade or business of the O Fund if such property was acquired by the O Fund by purchase after December 31, 2017; 2. the original use of such property in the O Zone commences with the O Fund or the O Fund substantially improves the property; and 3. during substantially all of the O Fund’s holding period, substantially all of the use of such property was in an O Zone.

Depending on the length the Opportunity Zone investment is held, the existing gain invested may be deferred, up to 15% of that gain may be cancelled via a stepped-up basis, and additional capital gain on the appreciation may be exempt. O Funds offer investors a means of deferring built in gain (or a portion of the gain) from sales of existing assets. Investors may defer paying taxes on gains from the sale to, or exchange with, an unrelated person of any property held by the investor if those gains are invested within 180 days in an O Fund. Use of a qualified intermediary is not required. As long as the O Fund is certified, (i.e., holding at least 90% of its assets in O Zone Property), the gain qualifies for favorable tax treatment.

Qualifying gain can be deferred until the earlier of December 31, 2026, or the date the investment in the O Fund is sold or exchanged. The amount of gain includible is the lesser of the amount of gain originally deferred, or the excess of the fair market value of the investment over the investor’s basis in the investment. In addition, the law provides for the possible reduction of the amount of gain realized while invested in the O Fund through a step-up basis adjustment if the investment in the O Fund is held beyond five and seven years, and the possible permanent exclusion of gain on the appreciation for the interest in an O Fund if the investment is held in the O Fund for 10 years or more.

Despite growing interest in O Funds and investing in O Zones, the law does not address many practical issues of how O Funds will operate and the timing for compliance measures. Very little guidance has been given to date, however, it is expected that additional guidance will be provided by the Treasury Department by the end of summer 2018. Additional guidance from the Treasury

Department is needed most notably on the following provisions:

Initial O Fund Investments

The statute provides that an O Fund must hold at least 90% of its assets in Qualified Opportunity Zone Property, which includes stock or partnership interests in an O Zone Business, and O Zone Property acquired by the O Fund after December 31, 2017. The 90% requirement is determined twice a year, on the last day of the first 6-month period of the taxable year of the O Fund, and on the last day of the taxable year. Assuming the O Fund has a January to December taxable year, then the O Fund must satisfy the 90% requirement on June 30 and December 31 of each year. The statute does not provide for a grace period for initial investments to meet these deadlines, and this is needed, especially now as the tax benefits for investors in O Funds are time-sensitive.

Valuation of the 90% Asset Requirement

The statute is silent on how to value an O Fund's assets for purposes of satisfying the 90% requirement. Because there are various ways to value an asset, such as fair market value, adjusted tax basis, and original cost basis, guidance will be needed from the Treasury Department on how to meet this requirement.

Definition of a Qualified Opportunity Zone Business

An O Zone Business is defined in part as a business in which substantially all of the tangible property owned or leased by the taxpayer is Qualified Opportunity Zone Business Property. There is no additional information in the statute regarding what "substantially all" means and the Treasury Department should provide a percentage threshold amount to give that term substantive meaning. Additionally, while the statute is intended to provide for investments in both existing businesses and new businesses located in an O Zone, an existing business may have difficulty meeting the "substantially all" test if the definition of O Zone Business Property is interpreted to require that the property owned by the business had to have been purchased after December 31, 2017. Accordingly, some clarification is needed to ensure that existing businesses operating in an O Zone meet the qualifications of an O Business.

Definition of Qualified Opportunity Zone Business Property

It is unclear from the definition of Qualified Opportunity Zone Business Property what property will satisfy the original use test versus the substantial improvement test in the second prong. If an O Fund purchases vacant land and proceeds to develop the land by constructing an apartment complex, will this be considered "original use"? What if the land holds abandoned single family homes and the O Fund demolishes the homes first and then proceeds to construct the apartments? As the statute does not answer those questions, clarification is needed to determine what constitutes original use and what constitutes substantial improvement. Further, guidance is needed on how funds are treated during the substantial improvement phase of the O Zone Business Property. The statute provides that property will be treated as substantially improved if during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the O Fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period. It is unclear from the statute whether property which is in the process of substantial improvement qualifies as O Zone Business Property. Additionally, it is also unclear from the statute whether funds used for the substantial improvement of the property qualify as O Zone Property for purposes of the 90% asset requirement. The Treasury Department will need to issue guidance on this matter since a large portion of investments in O Funds will likely be used for new construction and development.

Definition and Certification of Opportunity Funds

The statute defines O Funds as any investment vehicle organized as a corporation or partnership. It's unclear whether an O Fund can be organized as a limited liability company ("LLC"). While a LLC with more than one member can be treated as either a corporation or a partnership for tax purposes, the Treasury Department should clarify whether an O Fund can be organized as a LLC. The statute also requires that the Treasury Department prescribe regulations for the certification of O Funds. The IRS has issued guidance indicating that O Funds will be able to self-certify on their tax returns, however, no certification form has been issued to date. There is also confusion over whether the O Fund must satisfy the 90% asset requirement before it may be certified. Until the self-certification form is published, it's unclear what is required.

Opportunity Zone tax incentives provide an innovative investment device for favorable gain tax treatment to spur investment in distressed areas. Investing in O Zones is a promising way to defer gains and stimulate the economy in distressed areas across the U.S. Interested stakeholders have addressed the statute's deficiencies with the Treasury Department and with the right regulatory guidance, O Funds and O Zones could rise to meet their intended potential.

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