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An introduction to investing in opportunity zones

Dentons' Opportunity Zones group

Dentons' multidisciplinary Opportunity Zones group helps clients optimize the benefits of the federal Opportunity Zone Program. Dentons' Opportunity Zones group has extensive experience with investments and economic development incentives, as well as ongoing engagement with allied groups addressing technical and administrative issues that arise under the Opportunity Zone Program. Our lawyers team with you to explore and maximize opportunity zones-related transactions, providing measured analysis of the current program and multidisciplinary perspectives from our Corporate, Real Estate, Fund Formation, Securities, Tax and Tax-Advantaged Investing practices.

An introduction to investing in opportunity zones

The Tax Cuts and Jobs Act (TCJA) included tax incentives for investments in opportunity zones, which are census tracts comprising economically distressed communities. An opportunity zone investor may temporarily defer including eligible capital gains in their gross income for tax purposes, as long as those gains are timely reinvested in a qualified opportunity fund (QOF, defined below). An investor may also permanently exclude capital gains from the sale or exchange of an investment in a QOF. Both cases are subject to certain long-term holding periods and other requirements.

An opportunity zone is a **population census tract** that meets certain criteria for economic distress.

A QOF is required to deploy the cash proceeds received from such capital gain investments in one or more opportunity zones through the acquisition of qualified opportunity zone property (QOZP). Generally, this is done either by acquiring interests in a qualifying business operating in an opportunity zone, referred to as a qualified opportunity zone business (QOZB), or by directly acquiring qualified opportunity zone business property (QOZBP).

Below is a summary of the key terms and general requirements of the Opportunity Zone Program and a few observations on investing in qualified opportunity funds.

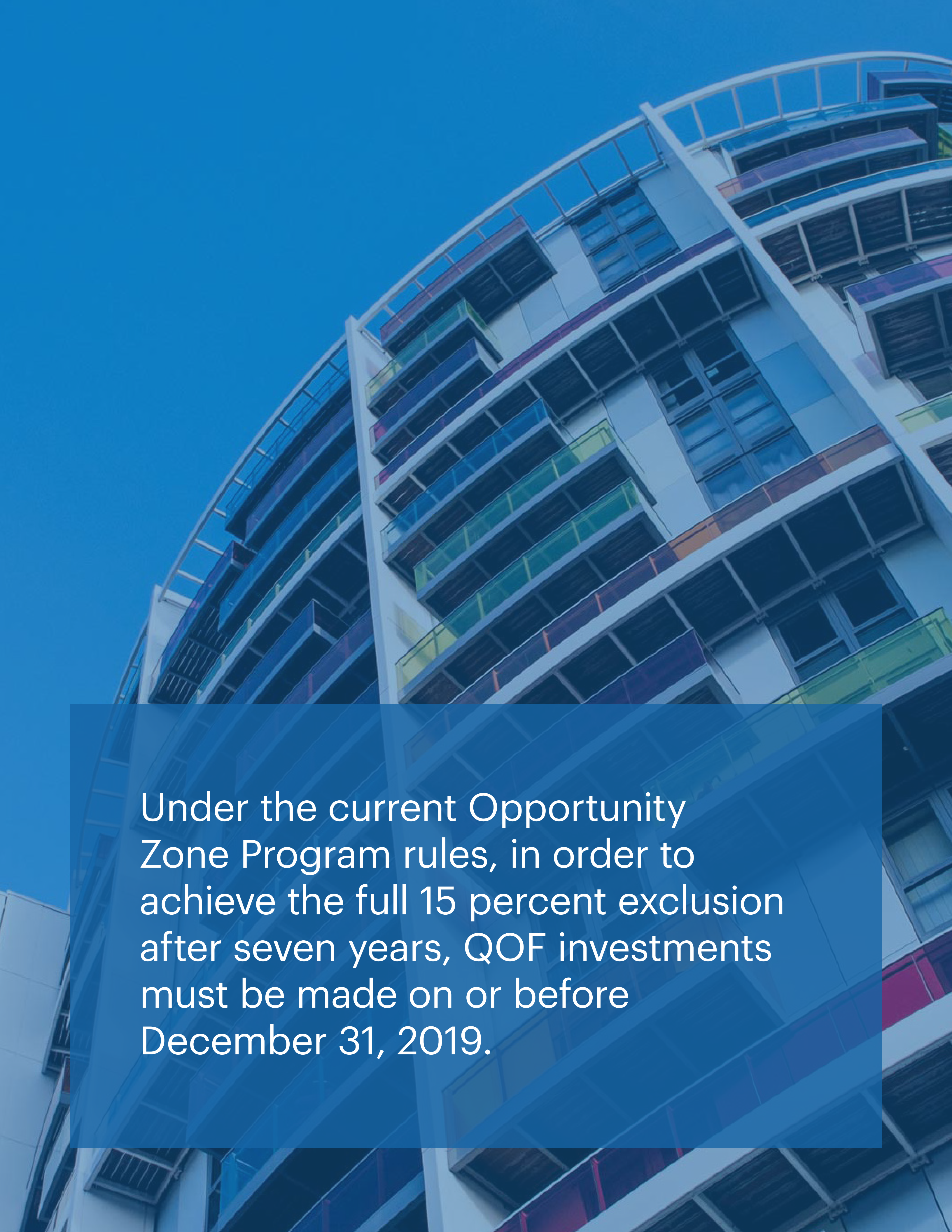
1. What is an opportunity zone?

An opportunity zone is a population census tract that meets certain criteria for economic distress. All 50 states, along with the District of Columbia and the territories of American Samoa, Guam, the Northern Mariana Islands, Puerto Rico and the Virgin Islands, have designated opportunity zones within their borders. The designation remains in effect for 10 years.

You can identify whether a planned investment or proposed project is located in an opportunity zone by visiting the Opportunity Zone Resources webpage of the Treasury Department's Community Development Financial Institutions Fund. The CDFI Fund maintains a list of census tracts that are designated opportunity zones, as well as a mapping tool that allows you to determine whether a site or project area is located in an opportunity zone.

[1]Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code of 1986, as amended.

[2]For simplicity, we use the term Opportunity Zone Program to collectively refer to Sections 1400Z-1 and 1400Z-2 together with additional guidance released by the IRS and Treasury Department in the form of proposed regulations on October 19, 2018, and April 17, 2019.



Under the current Opportunity Zone Program rules, in order to achieve the full 15 percent exclusion after seven years, QOF investments must be made on or before December 31, 2019.

2. What are the tax benefits from investing in a qualified opportunity fund?

The Opportunity Zone Program provides several federal income tax benefits to taxpayers who invest eligible capital gains in in a QOF, as long as the QOF, in turn, invests 90 percent of its assets in QOZP.

Deferred inclusion/partial exclusion of certain capital gains

If a taxpayer invests capital gains from the sale or exchange of property with an unrelated person in a QOF within the 180-day period beginning on the date of the sale or exchange, the taxpayer can elect to defer (i.e., not include in gross income for the taxable year of such sale or exchange) the gain from that sale or exchange until either the date on which the QOF investment is sold or exchanged, or December 31, 2026, whichever is earlier.

For tax purposes, the taxpayer's basis in the QOF investment is considered to be zero at the time of investing, subject to the following increases:

- If the QOF investment is held for five years, the taxpayer's basis is increased by 10 percent of the amount of the original QOF investment, thus permanently excluding 10 percent of the capital gains invested from taxation.
- If the QOF investment is held for seven years, the taxpayer's basis is increased by an additional five percent, thus permanently excluding up to 15 percent of the capital gains invested from taxation.

The remaining amount of the QOF investment must be included in gross income on the earlier of (1) the date on which the QOF investment is sold or exchanged, or (2) December 31, 2026.

Assuming the taxpayer held its QOF investment for at least seven years or until December 31, 2026, and achieved the 15 percent basis increase on its QOF investment, subject to certain exceptions, the taxpayer would then include the lesser of (1) 85 percent of the original investment (that is, original investment less the 15 percent basis step-up) or (2) the fair market value of the QOF investment in gross income for the year ended December 31, 2026.

Representative experience

- Advised on structuring opportunity zone investments in Texas for a real estate private equity fund, including establishing the qualified opportunity fund and preparing private placement and related fund documentation
- Advised on structuring opportunity zone investments for hotel developments in California and Arizona, including formation and structuring of the qualified opportunity fund and opportunity zone business venture
- Advised various bank lenders on utilizing the Opportunity Zone Program in connection with tax credit transactions
- Provided general advice to investors on various aspects of the Opportunity Zone Program

Permanent exclusion for post-acquisition gains held for 10 years or more

A taxpayer that holds a QOF investment for at least 10 years can elect to increase the basis of its investment to fair market value immediately before the sale or exchange of such QOF investment. This permanently excludes from tax the appreciation in value of the QOF investment. However, this exclusion is with respect to the appreciation in value of the QOF investment held for at least 10 years and after the taxpayer takes into income the remaining amount of the original deferred gain on or before December 31, 2026.

Other considerations

There are various and complex rules that taxpayers must keep in mind in planning for a QOF investment, including:

- Determining who is the "taxpayer" that may take advantage of the Opportunity Zone Program; taxpayers may be individuals or entities such as partnerships, among other possibilities
- Determining which capital gains are eligible to be invested in a QOF
- Computing the amount of capital gains and timely making the QOF investment within the 180-day investment period
- Planning for the long-term economic and tax benefits of the investment

3. What is a qualified opportunity fund?

A QOF is either a partnership or a corporation that meets three criteria:

- Is formed for the stated purpose of investing in qualified opportunity zone property (see below)
- Holds at least 90 percent of its assets in qualified opportunity zone property
- Self-certifies as a QOF on IRS Form 8996 (Qualified Opportunity Fund) filed with its federal income tax return for the year of certification and for each year thereafter

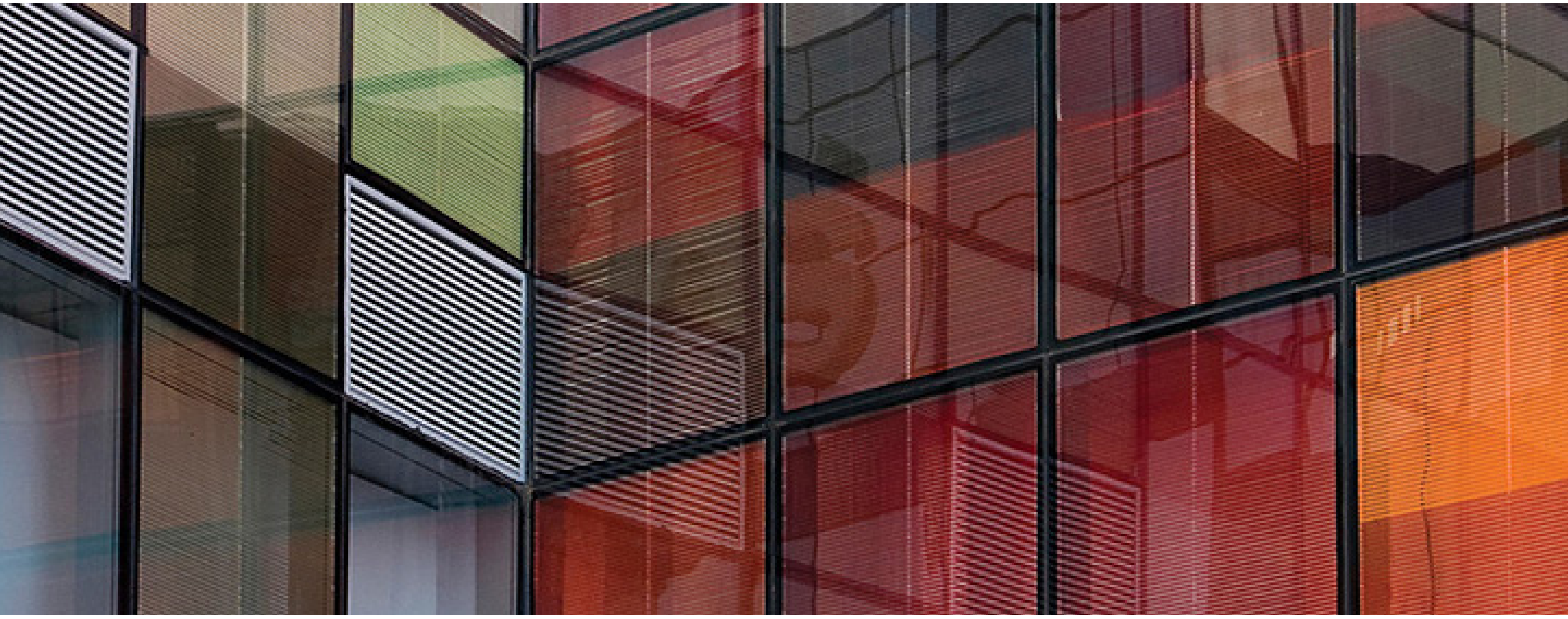
A pre-existing entity may qualify as a QOF provided that it meets these criteria and amends its organizational documents to reflect its stated purpose to act as a QOF.

An entity's self-designation as a QOF on Form 8996 must identify the first month in the initial taxable year in which the entity intends to be a QOF. Determining the initial month of a QOF is a crucial step because investments in a QOF prior to that month are not eligible for tax deferral.

As noted above, a QOF must continuously hold at least 90 percent of its assets in qualified opportunity zone property. The "90 percent asset test" is a value-based test that is computed by the QOF to satisfy compliance twice annually. The test generally must be performed by the QOF every six months, though in the first year of a QOF's existence the testing dates may be less than six months apart.

A QOF must calculate and report compliance with the 90 percent asset test on IRS Form 8996 annually. A QOF that fails to meet the 90 percent asset test will incur a monthly penalty equal to the amount of the shortfall per month multiplied by the IRS underpayment rate. This penalty will be assessed every month until the test is met.

Currently, the IRS proposes to value such assets based on unadjusted cost basis or based on a QOF's applicable financial statements in accordance with GAAP. We expect that compliance with the 90 percent asset test will be subject to some uncertainty for the foreseeable future, and the manner and methodologies for computing this test may change.



4. What is qualified opportunity zone property?

A QOF must continuously invest at least 90 percent of its assets in QOZP, defined as one of the following:

- Stock in a corporation or an interest in an entity classified as a partnership for tax purposes (in both cases, acquired after December 31, 2017, by a QOF solely in exchange for cash) that meets the criteria of a qualified opportunity zone business (QOZB)
- Qualified opportunity zone business property (QOZBP)

A QOZB, whether it be a corporation or partnership, must be engaged in the active conduct of a trade or business. It must also continuously meet certain requirements with respect to its operations in an opportunity zone, including that substantially all of the tangible property owned or leased by the entity consists of QOZBP (see below). Various other requirements are designed to ensure that a certain percentage of the tangible and intangible assets and income of the QOZB (into which the QOF invests) is used or otherwise derived from permitted activities within the opportunity zone. In general, QOZBs are either operating businesses or real estate development businesses.

QOZBP is tangible property that is used in the trade or business of either a QOF or a QOZB if three criteria are met:

- The property was acquired by purchase from an unrelated party after December 31, 2017, or under a lease satisfying certain criteria entered into after December 31, 2017
- The original use of the property in the opportunity zone commences with the QOF or the QOZB, or the QOF or QOZB substantially improves the property
- During substantially all (90 percent) of the QOF's or the QOZB's holding period of the property, substantially all (70 percent) of the use of the property was in an opportunity zone

Property is generally considered "substantially improved" if, during the 30-month period after the property is acquired, the additions to the property's basis exceed the adjusted basis of the property at the beginning of that period.

Subject to various conditions, leasing of property in a trade or business of a QOF or QOZB with related or unrelated parties in an opportunity zone is permitted.

5. How are opportunity zone investments structured?

Once a taxpayer timely makes its QOF investment, the QOF will need to deploy that capital into opportunity zones via the acquisition of QOZP, as summarized above.

Generally, an investment by a QOF into an opportunity zone can either use a single-tier or two-tier structure, depending upon the manner in which the QOF deploys its assets in the opportunity zone. At its simplest, directly acquiring and using QOZBP will be a single-tier transaction, whereas acquiring a partnership interest or stock in a QOZB will be a two-tier transaction.

In the first scenario, the QOF effectively will be conducting business in an opportunity zone and subject to many of the requirements that pertain to QOZBs.

In the latter case, the QOF will be an investment fund that holds partnership interests or stock in one or more lower-tier QOZBs, each of which is subject to all tax code requirements applicable to QOZBs. Either situation will bring planning opportunities and pitfalls unique to the QOF's investment strategy and the invested businesses.

Overview of the Opportunity Zone Program

Taxpayers

Invest eligible capital gains in QOF within 180 days of sale/exchange (subject to rules specific to certain taxpayers and assets)

Qualified opportunity fund

Corporation or partnership

Self-certifies as QOF

Maintains at least 90 percent of its assets in QOZP (QOZP is either QOZBP or a QOZB)

Qualified opportunity zone business property

Tangible property acquired or leased after December 31, 2017, by the QOF or QOZB and must be original use property or substantially improved

Qualified opportunity zone business

Trade or business in an OZ (subject to rules for maintaining assets, income and operations in the OZ)

Substantially all of tangible property owned must be QOZBP

If you wish to discuss further anything in this overview, or any other facet of the Opportunity Zone Program, please contact one of the Dentons' Opportunity Zones group lawyers listed below or your Dentons relationship partner.

6. Key takeaways

To recap:

- Taxpayers are eligible for temporary deferral and partial permanent exclusion of eligible capital gains invested within 180 days of sale or exchange in a QOF and maintained in a QOF for certain periods of time (five years for a 10 percent exclusion; seven years for an additional five percent exclusion or until the earlier of (1) the sale or exchange of the interest or (2) December 31, 2026; minimum of 10 years for permanent post-acquisition exclusion on the appreciation in value of the QOF interest).
- A QOF must use its assets (primarily, the deferred capital gains invested in the QOF) to acquire and hold QOZP.
- QOZP may be one of the following: (1) stock in a corporation that is a QOZB, (2) an interest in a partnership that is a QOZB or (3) tangible property that qualifies as QOZBP.
- A QOZB is a trade or business conducted by a corporation or partnership that meets certain requirements as to income generation and tangible or intangible assets held and used in an opportunity zone, and that avoids engaging in certain specified excluded businesses.
- QOZBP is tangible property acquired or leased after December 31, 2017, and either used for the first time or substantially improved by the QOZB or by the QOF itself.
- In all cases, the QOZP must be located and used in (in the case of QOZBP) or operating in (in the case of stock or interests in a QOZB) an opportunity zone for substantially all of the QOF's holding period of that property.
- The 90 percent asset test measures a QOF's compliance with these requirements throughout substantially all the life of the QOF.
- Taxpayers invested in a QOF will be subject to tax on the lesser of the deferred gain or fair market value of the QOF interest at the earlier of (1) the date of sale or exchange of their interest in a QOF, or (2) December 31, 2026. That amount (subject to the 10 percent and five percent exclusions, if applicable) will be included in the taxpayer's gross income at such time.
- Taxpayers holding their QOF for a minimum of 10 years will step up the basis of their interest in the QOF (after the required inclusion on or before December 31, 2026) to fair market value at the time of sale or exchange of that interest, and the QOF, if it is a partnership, may also step up the basis of its assets at that time.

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