Opportunity Zone Basics

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The Objective

- To get investors to invest in low income communities
- In general, Opportunity Zones are 25% (or 25, if more) of the Low-Income Community Census Tracts in each state and Territory and DC, as designated by the state and approved by Treasury.
- All LIC Census Tracts in Puerto Rico are designated
- Up to 5 percent of the tracts may be contiguous to LIC Census Tracts

The Incentives

Three Incentives:

- Invest gain in an “Opportunity Fund” within 180 days, and postpone recognition until sale of interest or December 31, 2026
- Step up in basis of 10% after 5 years and another 5% (total of 15%) after 7 years
- Recognition in 2026 is lesser of actual gain or fair market value of interest
- If interest is held for 10 or more years, then basis equals FMV at time of sale or exchange

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Illustration -- 1

Sale of Smith Street. A is the general partner and B-Corp is the sole limited partner of Smith St Limited Partnership which owns a housing development (the "Smith Street Building") that qualified for Section 42 credits. Smith St Limited Partnership now sells the Smith Street Building, and allocates the resulting gain to A and B-Corp. Owing to nonrecourse debt and a negative capital account, B-Corp has a $4M gain from the sale of the Building. Assume that this gain is entirely long term capital gain, and that B-Corp only gets a $1,000 distribution from Smith St Limited Partnership in liquidation of its interest. The date of the sale of the Smith Street Building is April 15, 2018; the Smith St Limited Partnership is liquidated, and proceeds of the sale are distributed to B-Corp, on May 1, 2018.

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Illustration -- 2

Investment in Jones Street. C undertakes a new housing development (the "Jones Street Building") which also qualifies for Section 42 credits. On September 1, 2018, within 180 days of the sale of the Smith Street Building, B-Corp borrows $3.99M and combines that with the $1000 that it received in liquidation of its interest in Smith St Limited Partnership, and it contributes this amount to the newly formed Jones St Limited Partnership. Jones St Limited Partnership acquires the just-built, and never previously occupied, Jones Street Building. C is the .01% general partner of the Jones St Limited Partnership. Assume that the Jones Street Building and the Jones St Limited Partnership qualify as qualified opportunity zone business property and a qualified opportunity fund, respectively. Jones St Limited Partnership also undertakes nonrecourse borrowing to pay for the rest of the cost of the Jones Street Building.

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Illustration -- 3

- “Normal” Tax Liability. A would have $4M of gain, resulting in a $840,000 tax liability (assuming a 21% tax rate) but for the O Zone rules.

- Measuring the 180 Days. If the building had been sold on February 15, 2018, and the Smith St Limited Partnership had still been liquidated on May 1, 2018, it would fail the 180 day test, even though the liquidation happened within 180 days of the contribution to Jones St Limited Partnership, because the event that generated the capital gain happened more than 180 days before the contribution.

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Illustration -- 4

- Computation of the December 31, 2026 Liability. On December 31, 2026, B-Corp must recognize the gain, $4M, less the 15% basis step up ($600,000), which is $3.4M. Presuming the same tax rates, it owes $3,400,000 times 21%, or $714,000. NOTE: Assume that B-Corp gets an appraisal of its Jones St Limited Partnership Interest on December 31, 2026, and the value is $100,000. The tax due on December 31, 2026 is then $0, since the fair market value of the investment does not exceed the tax basis of $600,000 (after taking into account the 5% and 10% basis step-ups).

Illustration -- 5

Sale of Jones Street Partnership Interest. B-Corp stays as the limited partner of Jones St Limited Partnership for 15 years, until the Section 42 "compliance period" has ended. At that time, B-Corp sells its limited partnership interest in Jones St Limited Partnership to C for its fair market value. As a low income housing development, assume that its fair market value is $1000 over the debt on the property, and that B-Corp has a negative capital account at this time of minus $3 million.

Analysis –

Sale of Fund Interest After More than 10 Years. At the time that B-Corp sells its interest in Jones St Limited Partnership, which is 15 years later, its basis is stepped up to fair market value, or the debt plus $1,000. Assume that there are no Section 751 "hot assets." Accordingly, the sale of B-Corp's partnership interest will not generate any tax liability.

What’s an Opportunity Fund

- Organized as a domestic corp or partnership that holds at least 90%of its assets in (i) QOZ stock or QOZ partnership interests of Qualified Opportunity Zone Businesses or (ii) QOZ Business Property
- The entity “self certifies”
- 90% test is done at 6 month and end of taxable year and averaged.
- Failure to meet the 90% test results in a monthly penalty based on IRC underpayment rate, with an exception for reasonable cause.

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More on Opportunity Funds

- Stock or Partnership Interest must be acquired from the entity after December 31, 2017, for cash.
- During substantially all of the holding period of the stock or partnership interest, the entity must qualify as a QOZ Business.

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Opportunity Zone Business Requirements

- At least 50% of gross income from the active conduct of a trade or business in an OZ
- A substantial portion of intangible property (if any) must be used in the active conduct of a trade or business in the OZ
- No more than 5% of the unadjusted basis of its assets may consist of nonqualified financial property
- Cannot be a golf course, massage parlor, hot tub facility, suntan facility, racetrack or gambling facility, or retail liquor store

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Additional Requirements

- Property must be acquired by purchase, and seller cannot be more than 20% related (this is harsher than the usual 50% level).
- The original use of the property is with the QOZ business OR the QOZ business substantially improves the property.
- Substantially improves requires that additions to basis “with respect to the property” in some 30-month period exceed the property’s adjusted basis at the start of the period.

Illustrations

- Affordable Housing Project (is residential leasing okay?)
- Manufacturing Business
- Leasing Businesses? (are they active?)
- Banking Businesses? (do they have nonqualified financial property?)
- Software development (is it developed for sale to others?)

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Open Issues -- 1

- There are many!
- If a partnership has a gain, who should do the investing?
- What gains are eligible? E.g., depreciation recapture? Gains that are taxed at ordinary rates (e.g., Section 291) or a banks' sale of debt instruments
- Does rehabilitated property qualify if it is under construction? What about the 30-month rule? What about the "with respect to" rule?
- Can an investor "sit on" the cash it invested until the project needs it, or is this NQFP?

Open Issues -- 2

- Can the QOZ business borrow the money from a third party or the investor, and then have the loan taken out by the investor’s capital gain investment?
- There are 5 references to “substantially all.” How should these be applied?
- How to address the lack of basis in investments until the gain is recognized. This can be a problem with investments that generate losses or tax credits that require a basis reduction.

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Other considerations

- Using Other incentives, e.g., tax credits
- Urban vs rural projects
- Interim gains and need for some funds to pay taxes in 2026.
- Multi-investor funds vs single investor funds; multi-investment funds vs single investment funds
- Waiting for guidance

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