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## Opportunity Zone Talking Points for Cocktail Parties

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**A**s you sip champagne and munch on canapés at your next client holiday party, we suspect the conversation will eventually turn to qualified opportunity zones (QOZs). Our gifts to you during this festive season are talking points on this year's hottest topic in real estate.

### The Basics

The 2017 tax act added new sections 1400Z-1 and 1400Z-2 to the Internal Revenue Code, which created QOZs and conferred tax benefits on certain investments in QOZs. Generally speaking QOZs are low-income census tracts that Treasury has designated with a special status.

Taxpayers can receive federal income tax benefits by investing in a QOZ, generally, if that investment is the reinvestment of capital gain into a special investment vehicle (called a "qualified opportunity fund" or QOF) within approximately six months of the sale of property that triggered the capital gain. As is common in the case of debt-financed real estate, gain from the sale of property may be in excess of the actual cash proceeds, meaning that taxpayers who wish to take full advantage of the benefits may need to come out of pocket. However, to be clear, cash invested that is not the reinvestment of capital gain does not receive any tax benefits.

A taxpayer who makes a qualifying investment into a QOF receives up to four benefits: (1) deferral of paying tax on gain until as late as 2026; (2) after five years, reduction of deferred gain by 10 percent; (3) after seven years, reduction of deferred gain by an additional 5 percent; and (4) after 10 years, any additional gain on the sale of the taxpayer's interest in the QOF is permanently excluded from tax.

A qualified opportunity fund (QOF) (that special investment vehicle) is, generally, an entity that is a partnership or corporation for tax purposes (including certain limited liability companies) of which at least 90 percent of its assets are certain qualifying assets. A QOF does not need to be a "fund" in the common use of the word. For example, interests in a QOF do not need to be offered to outside investors; rather, a taxpayer could set up his own "private" QOF.

Generally speaking, a QOF may invest in a "one-tier" structure by directly acquiring qualifying assets (which are called "QOZ business property") or, in a "two-tier structure," by investing through a special subsidiary called a "QOZ business" (which investment will be treated as a qualifying asset if certain requirements are met). Notably, cash is not a qualifying asset for these purposes (meaning that cash must comprise less than 10 percent of a QOF's direct assets).

QOZ business property (the qualifying assets) are, essentially, tangible property used in a QOZ that are acquired by purchase after Dec. 31, 2017. An additional requirement for property to

qualify as QOZ business property is that either (i) its original use must be in a QOZ or (ii) the acquirer must "substantially improve" the property (meaning, generally, that within 30 months of acquisition, the acquirer spends an additional amount equal to the acquisition cost of the property on improving the property).

### Structuring the Acquisition of Property

Ownership of property must be carefully structured from the moment of acquisition so as to initially meet and to continue to meet the QOF requirements. One particular structuring challenge is maintaining a QOF's qualifying assets at the 90 percent level where the QOF holds cash or not-yet-substantially-improved property. However, proposed regulations have created certain safe harbors that ease this burden in the two-tier structure (although not the one-tier structure).

### Taxpayers Who Already Own Property in a QOZ

In the case of property in a QOZ that was acquired on or prior to Dec. 31, 2017, there is no "off the shelf" solution for the current owner to enjoy QOZ tax benefits, even with respect to subsequent investment in the property. Among other issues, there are certain rules that deny the QOZ tax benefits to property a QOF acquires from a related party. However, there are techniques that can be tailored to the particulars of a transaction that

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may permit QOZ tax benefits for subsequent investment to redevelop the property.

A somewhat easier situation is property that was acquired after Dec. 31, 2017, but without a QOF structure in place. In many cases, with proper structuring, it may be possible for subsequent investment to redevelop the property to qualify for QOZ tax benefits.

#### **QOZ Investment Versus a §1031 Like-Kind Exchange**

Unlike a §1031 exchange (which applies only to the sale of direct interests in real property), tax benefits for qualifying QOZ investment are available with respect to capital gain from the sale of any type of property (e.g., stock, partnership interests). Additionally, unlike in the §1031 context, a partner in a partnership that sells property may elect to reinvest his gain into a QOF, even if the partnership declines to do so.

Further, due to the reasonable working capital safe harbor and the application of certain testing dates, a QOF may not need to immediately utilize cash it receives from investors, which effectively extends the approximately six-month period a taxpayer has to reinvest his or her gain. Compare this to a §1031 exchange, which has a generally rigid 180-day limit for reinvestment.

Even with these advantages, a §1031 exchange may still be a better alternative for many taxpayers. While the exclusion of tax on the “upside” of a QOF investment may be a major inducement, that benefit needs to be weighed against deferring paying tax on gain until 2026, as opposed to the more “permanent” deferral of a §1031 exchange.

#### **Looking Ahead**

Although Treasury issued a package of proposed regulations in October, many questions remain unanswered.

Among others, it is not yet clear the extent to which an investor will be able to (i) enjoy the benefit of tax losses from a QOF or (ii) receive a tax-free distribution of refinancing proceeds from a QOF. In addition, it remains to be seen whether there will be a mechanism through which a QOF can sell assets and reinvest the proceeds without causing its investors to owe tax. Future regulations, which will hopefully address some of these issues, are said to be forthcoming.

To the extent the October proposed regulations answered questions, the responses were generally favorable for taxpayers. More important than the answers, however, was the tenor of the regulations, which indicates that Treasury is doing what it can to make these rules work for taxpayers. We are only at the beginning of this exciting opportunity for real estate investors.

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