Breaking Ground

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COMMERCIAL REAL ESTATE OUTLOOK

MBA

QUALIFIED OPPORTUNITY ZONES: INVESTORS WANTED – BUT PROCEED WITH CAUTION

BY JUNE E. SWANSON AND KEVIN F. ISRAEL

The 2017 Tax Cuts and Jobs Act established an important investment vehicle designed to benefit both individual taxpayers and distressed communities – the Opportunity Zone Program. In an effort to spur development in lower-income areas across the U.S., the program allows investors facing a hefty capital gains tax bill to contribute the cash equivalent of the gain into an Opportunity Fund, which in turn invests that money in businesses and properties in approved Opportunity Zones. The Opportunity Zones, which include both rural and urban communities, were selected from low income census tracks that already qualified for New Markets Tax Credits. Each proposed zone was designated by the state governor and approved earlier in the year by the federal government. Eighty-six Opportunity Zones were identified in the 10-county Southwestern Pennsylvania Region.

Though the Opportunity Zone program presents a host of valuable options for real estate investors looking to offset impending tax implications, careful attention should be paid to ensure investments are made in the most efficient way.

Benefits for taxpayers

Investing in Opportunity Funds provides three tax incentives for taxpayers:

- Deferral of tax on capital gains invested into an Opportunity Fund (taxed on the earlier of December 31, 2026 or when investment in the Opportunity Fund is sold);
- Partial reduction of the deferred gain (in addition to the deferral of the original capital gain) through a step-up in basis by 10% if the investment is held for 5 years and 15% if the investment is held for 7 years; and
- Total exclusion of Opportunity Fund gain on the sale or exchange of the interest in the Opportunity Fund held for at least 10 years through an increase in basis to fair market value.

Taxpayers holding their investments in Opportunity Funds after December 31, 2026 will be forced to recognize the deferred gain (and pay the resulting capital gain tax) even though their investment is not liquidated. Taxpayers should plan for this by having adequate cash on hand from other sources to pay the resulting tax. Taxpayers could partially liquidate their Opportunity Zone investment to raise cash to cover the December 31, 2026 tax bill, but that will reduce the full potential benefit available from the investment (i.e., potential exclusion of the full capital gain from taxation).

To take advantage of these benefits, within 180 days after the sale or exchange of a capital asset to an unrelated party, the same taxpayer must reinvest the resulting capital gain into an Opportunity Fund.

Setting up the Opportunity Fund

The Opportunity Fund can be a partnership or a corporation (or a limited liability classified as a corporation or partnership for tax purposes). The investor receives either stock or an interest in the Opportunity Fund. The Opportunity Fund must meet a 90% Asset Test (measured at 6 months after formation and at the end of Opportunity Fund tax year) in a Qualified Opportunity Zone Business (stock or partnership interest) or in Qualified Opportunity Zone Business Property, both of which must be acquired after December 31, 2017. Significant monthly penalties are imposed on the Opportunity Fund (and investor) for failure to meet the 90% Asset Test. Opportunity Funds may self-certify, but there does not appear to be any approval process.

A Qualified Opportunity Zone Business may be any type of business except a "sin" business (i.e., golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, gaming facility or liquor store) and must meet property and income tests as follows:

- Substantially all of its tangible property (owned or leased) must be a qualified Opportunity Zone business property (defined below)
- Property must be used in the qualified opportunity zone during substantially all of the ownership period
- Less than 5% of its property can be attributable to non-qualified financial property

- At least 50% of its total gross income must come from active conduct of business in a qualified opportunity zone

Qualified Opportunity Zone Business Property is tangible property (no restrictions on type) used in the trade or business which is:

- Acquired by purchase from an unrelated third party after December 31, 2017;
- Either the original use of the property begins with the Opportunity Fund or Qualified Opportunity Zone Business or the Opportunity Fund or Qualified Opportunity Zone Business substantially improves the property (capital expenditures must equal or exceed basis in 30 months); and
- Substantially all of the use is in a Qualified Opportunity Zone.

Establishing the Program

The brainchild of the Economic Innovations Group –a bi-partisan think tank funded by tech billionaire and Facebook founder, Sean Parker – the Opportunity Zone Program evolved from the Investing in Opportunity Act first introduced into Congress in 2016. The primary sponsors were Senators Cory Booker (D-N.J.) and Tim Scott (R.-S.C.) and Congressmen Pat Tiberi (R-Ohio) and Ron Kind (D-Wisc.), but by the time it became part of the Tax Cuts and Jobs Act in 2017, it had more than 100 congressional co-sponsors. The Opportunity Zone Program did not make it into the initial House version of the tax reform bill, but Senator Scott maneuvered it into the Senate version. Senator Booker refers to Opportunity Zones as "domestic emerging markets" (Forbes, 7/17/18, An Unlikely Group of Billionaires and Politicians Has Created the Most Unbelievable Tax Break Ever) "If we can get the trillions of dollars off the sidelines and get the best investment minds coming into our communities, we can end up creating jobs and opportunity."

The Opportunity Zone Program is designed to appeal to a variety of investors from the traditional real estate developer to venture capitalists to the tax credit project owner trying to sweeten the return on its projects. Since the Opportunity Zone Program requires the substantial improvement of the property within 30 months and given the 90% Asset Test% that Opportunity Funds are subject to, cash investments must be put to work quickly. Venture capitalists can have significant impact on start-up businesses located and operating in the Opportunity Zones, which at the time of designation, experienced an individual poverty rate of at least 20 % and a median family income no greater than 80 % of the area median.

Proposed Regulations

On October 19, 2018, the Department of Treasury and the IRS issued Proposed Regulations along with a Revenue Ruling providing certain guidance to taxpayers on the Opportunity Zone Program. Not all the questions were answered, but significant direction was provided for the operation of an Opportunity Fund and the Qualified Opportunity Zone Business. Potential investors are advised to review the regulations carefully in advance of making any significant contributions to an Opportunity Fund.

The Proposed Regulations provide clarification on which types of taxpayers can defer capital gains under the Opportunity Zone provisions. They include any person or entity that recognizes capital gain for federal income tax purposes including individuals, partnerships, "C" and "S" corporations, REITs, mutual funds and trusts. For pass-through entities such as partnerships, "S" corporations and trusts, there are special rules which allow either the pass-through entity or the entities' partners, shareholders or beneficiaries to make the deferral election. Pass-through entities should update their governing documents (partnership agreements, operating agreements, etc.) to provide notice and coordination provisions concerning the deferral elections.

The Proposed Regulations also clarify which types of capital gains are eligible for deferral. These include gains on the sale of collectibles (such as artwork), capital gain dividends recognized by owners of mutual funds and REITs, and "unrecaptured Section 1250 gain" on real estate sales.

The IRS addressed the 90% Asset Test that an Opportunity Fund needs to pass at 6 months and at tax year end. Under the "safe harbor" adopted by the IRS, cash and other financial property count toward the 90% Asset Test if the Opportunity Fund has written records to show that those amounts will be held for the acquisition, construction or substantial improvement of Opportunity Zone Business Property and that the amounts will be (and are) expended within 31 months. The "written records" do not need to be provided to the IRS when the asset test is evaluated but need to be available should the IRS perform an audit.

Another "safe harbor" is provided to determine whether "substantially all" of the tangible property held by a Qualified Opportunity Zone Business is Qualified Opportunity Zone Business Property. If 70% of the tangible property owned by the business is Qualified Opportunity Zone Business Property, the "substantially all" standard is met.

Of particular interest to real estate developers, the Proposed Regulations and the Revenue Ruling provide that Qualified Opportunity Zone Business Property can be "substantially improved" in 30 months if only the basis of the building is doubled within that period. The land--provided it is all within an Opportunity Zone-- can be excluded from basis for purposes of that calculation.

The Bottom Line

These are win-win projects for both the investors looking for tax perks and the community, which may have been largely ignored in previous federal programs. Community leaders are mindful that gentrification doesn't force out those within the community that the Opportunity Zone Program was designed to benefit. Investors can expect to see local government and nonprofit leaders take an active role in ensuring that residents are hired during construction and that plans include affordable housing and good paying jobs to permit those residents to remain.

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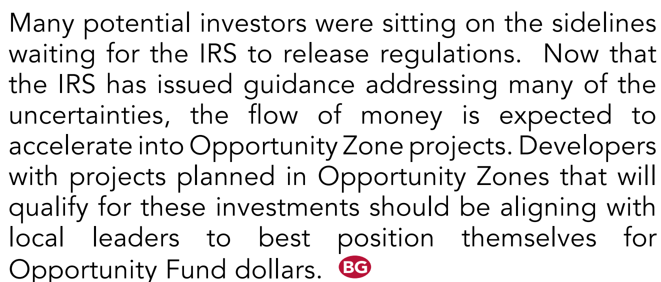

Many potential investors were sitting on the sidelines waiting for the IRS to release regulations. Now that the IRS has issued guidance addressing many of the uncertainties, the flow of money is expected to accelerate into Opportunity Zone projects. Developers with projects planned in Opportunity Zones that will qualify for these investments should be aligning with local leaders to best position themselves for Opportunity Fund dollars. BG

June Swanson is an attorney in the Commercial Real Estate practice at Meyer Unkovic & Scott LP. June may be reached at jfs@muslaw.com. Kevin Israel is an attorney in the Corporate & Business Law practice at Meyer Unkovic & Scott LP. Kevin may be reached at kfi@muslaw.com.

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