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## DUVAL & STACHENFELD LLP

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### MEMORANDUM

To: Friends of Duval & Stachenfeld Date: May 2, 2018

From: Duval & Stachenfeld Real Estate and Tax Practice Groups

Subject: Opportunity Zones – At Last, a Major Tax Advantage for Real Estate

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One of the sleeper provisions in the 2017 Tax Reform bill is now picking up steam – the creation of Opportunity Zones (more info on Opportunity Zones below). The new legislation, which we are going to refer to as the “**OZ Program**”, is intended to be a win-win both for low income communities in need of development dollars, as well as investors looking to minimize taxes on their capital gains. Notably, the OZ Program could be very useful for:

- Developers seeking investors for Opportunity Zone investments;
- Real estate **and non-real estate players** sitting on large capital gains from real estate, stocks, bonds, and pretty much any other asset (collectively, “**Appreciated Assets**”), that would like to transition to real estate investments without triggering taxes;
- Municipalities that have Opportunity Zones in them; and
- Any other party that has development, investment, lending or other business dealings that could take place in an Opportunity Zone.<sup>1</sup>

Before we get into the tax-savings issues, we note that Opportunity Zones are located in every state (nominated by the governor of each state and the mayor of the District of Columbia). Although not yet finalized, the Opportunity Zones that have already been approved can be seen on a map at this website: <http://eig.org/opportunityzones>.

One thing to be mindful of at the outset is the fact that the maximum tax benefits are available only if you jump on the Opportunity Zone train quickly.

Part I is a summary of the timing aspects of the OZ Program and the corresponding tax benefits. Part II has some examples of potential tax savings so you can see how the numbers play out. Part III includes

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<sup>1</sup> The possibilities here extend to other parties as well, including non-profits looking to partner with developers to spur development in Opportunity Zones. There may even be an overlap with financial institutions looking to benefit from programs like the Community Reinvestment Act, although this White Paper does not address these angles.

some key takeaways for the real estate industry. The relevant defined terms in the Internal Revenue Code (the “Code”) applicable to the OZ Program are in Exhibit A.

**I. How the OZ Program Works Tax-Wise**

The OZ Program has a tight timetable, and the ultimate tax benefits depend heavily on timing. As mentioned above, the statutory language in the Code with all of the relevant defined terms is included in Exhibit A if you want to parse the technical language, but the OZ Program generally works as follows:

**a. Sale of Appreciated Asset**

You can defer capital gain from the sale of an Appreciated Asset by investing that gain in a Qualified Opportunity Fund (such investment in a Qualified Opportunity Fund, an “OZ Investment”). Note that even though a Qualified Opportunity Fund is referred to as a “fund”, a Qualified Opportunity Fund can have a single investor and there is no requirement that it be operated as a fund in the traditional sense. The full definition of Qualified Opportunity Fund is included in Exhibit A.

The Qualified Opportunity Fund has to invest that cash in low-income communities.

**b. Reinvestment of Gains into a Qualified Opportunity Fund**

In order to defer the gain realized from the sale of your Appreciated Asset, you must reinvest those gains into a Qualified Opportunity Fund within 180 days of realizing those gains. You can invest the return of your principal investment as well as the gains, but only the portion of your OZ Investment attributable to the gain from your Appreciated Asset will be eligible for the exemption from tax on future appreciation in the OZ Investment, as explained below in Part I.e.

Notably, the OZ Program is broader than a 1031 exchange in this respect, since you can sell any Appreciated Asset and reinvest that gain through the OZ Program. There is no requirement to invest in “like kind” property to benefit from the tax deferral.

**c. Payment of the Deferred Tax**

The deferred gains are taxable when the OZ Investment is sold or, if earlier, on December 31, 2026. Note that if you still hold your OZ Investment on December 31, 2026, you will have phantom income (taxable income with no corresponding cash) since your deferred gains become taxable at that point, but we expect that many Qualified Opportunity Funds will coordinate some sort of tax distribution to alleviate this concern.

**d. Reduction of the Deferred Tax**

The OZ Program has a number of incentives to promote long-term OZ Investments. If you hold an OZ Investment for at least 5 years, 10% of the deferred gain is permanently forgiven. If you hold an OZ Investment for at least 7 years, an additional 5% (for a total of 15%) of the deferred gain is permanently forgiven. The examples below in Part II illustrate these reductions.

If you want to realize the maximum benefit before you are forced to pay the deferred tax that is triggered on December 31, 2026, you must make your OZ Investment in a Qualified Opportunity Fund before

December 31, 2019. When the tax is triggered at the end of 2026, you will have held your OZ Investment for 7 years, qualifying for the 15% reduction in taxable gain.

**e. Elimination of Tax on Gains in OZ Investment**

If you hold your OZ Investment for at least 10 years, you pay no tax at all on any appreciation in your OZ Investment. As noted above, this benefit is only available for any gains that you reinvest into an OZ Investment. If you invest other cash on hand, or the return of principal on the Appreciated Asset you sold to generate the gains for your OZ Investment, that amount is treated for tax purposes as a completely separate investment and you will pay tax on any ultimate gains from that investment under applicable tax law at that time, regardless of how long you keep your OZ Investment.

**f. Timing Aspects are Important**

The timing aspects of the OZ Program cannot be overstated. In addition to the 6 month deadline to reinvest gains before they become taxable, a Qualified Opportunity Fund must have 90% of its assets invested in Qualified Opportunity Zone Property (as defined in Exhibit A), and that 90% test is an annual requirement. So a Qualified Opportunity Fund cannot sit on large amounts of cash for very long. There must be precise coordination between a Qualified Opportunity Fund's acceptance of capital and its investment of that capital into qualifying property.

**g. Development Transactions Are Ideal**

Also, a Qualified Opportunity Fund will be best suited for development transactions. Qualifying property in a Qualified Opportunity Fund must be either newly built or substantially improved, but the standard for substantial improvement requires adding improvements equal to the property's initial cost within a 30-month period.

**II. Running the Numbers**

Here are some examples to illustrate the calculation of tax savings for investors that participate in OZ Investments. These are quite fact-dependent; however, there are some similarities to a 1031 exchange in that you get to defer otherwise taxable gain, except it works for both real estate and non-real-estate assets.

- a. Example 1:** Assume that Toby sells an existing investment on June 1, 2018 and realizes a capital gain of \$300, all of which Toby reinvests in a Qualified Opportunity Fund on September 1, 2018. Toby reinvested his gains within the 6 month window, so he pays no tax on the \$300 gain in 2018.
- i. If Toby sells his OZ Investment on October 1, 2022, Toby will pay tax in 2022 on the full \$300 of gain because he only kept his OZ Investment for 4 years. 1. Toby still gets the benefit of 4 years of deferral though on gains from his prior investment.
  - ii. If Toby sells his OZ Investment on October 1, 2023, Toby will pay tax in 2023 on \$270 since he gets the benefit of the 10% reduction (10% of \$300 is \$30) for holding his OZ Investment for 5 years.

- iii. If Toby sells his OZ Investment on October 1, 2025, Toby will pay tax in 2025 on \$255 since he gets the benefit of the 15% reduction (15% of \$300 is \$45) for holding his OZ Investment for 7 years.
  - iv. If Toby sells his OZ Investment on October 1, 2028, the deferred gain will have been triggered on December 31, 2026 even though Toby still has his OZ Investment.
    - 1. Toby will pay tax in 2026 on \$255 of phantom income since he gets the benefit of the 15% reduction (15% of \$300 is \$45) for holding his OZ Investment for at least 7 years.
    - 2. If we assume that Toby's OZ Investment has appreciated to \$700 when he sells on October 1, 2028, Toby pays no tax at all on the appreciation of his OZ Investment since he held his OZ Investment for 10 years.
- b. Example 2:** Assume that Toby sells an existing investment on June 1, 2022 and realizes a capital gain of \$300, all of which Toby reinvests in a Qualified Opportunity Fund on September 1, 2022. Toby reinvested his gains within the 6 month window, so he pays no tax on the \$300 gain in 2022.
- i. If Toby still holds his OZ Investment on December 31, 2026, the deferred gain will be triggered. Toby will pay tax on the full \$300 of phantom income since at the time the tax is triggered on December 31, 2026, he will have only held his OZ Investment for 4 years.
  - ii. If Toby sells his OZ Investment on October 1, 2027 for \$700, he will have held his OZ Investment for 5 years.
    - 1. The technical language of the Code indicates that he gets the benefit at that point of the 10% reduction of his deferred gain (10% of \$300 is \$30). His basis in his OZ Investment will be the \$300 he paid tax on in 2026, plus the \$30 benefit from having held his OZ Investment for 5 years, for a total basis of \$330. Therefore, in 2027, Toby would pay tax on \$370.
    - 2. Since Toby did not hold his OZ Investment for 10 years, he does not get the benefit of complete elimination on any gain in his OZ Investment.
- c. Example 3:** Assume that Toby sells an existing investment on June 1, 2022 and realizes a capital gain of \$300, all of which Toby reinvests in a Qualified Opportunity Fund on September 1, 2022. Toby reinvested his gains within the 6 month window, so he pays no tax on the \$300 gain in 2022.
- i. If Toby still holds his OZ Investment on December 31, 2026, the deferred gain will be triggered. Toby will pay tax on the full \$300 of phantom income since at the time the tax is triggered on December 31, 2026, he will have only held his OZ Investment for 4 years.

- ii. If Toby sells his OZ Investment on October 1, 2032 for \$700, he will have held OZ Investment for 10 years.
  1. Toby pays no tax at all on the appreciation of his OZ Investment. However, in this scenario, Toby does not get the benefit of reducing his deferred gains at all for having held his OZ Investment for at least 5 or 7 years.
  2. Unlike Example 2, where Toby got the benefit of the 5 year rule when he sold his OZ Investment in 2017, in this Example 3, the benefit of the 10 year rule to eliminate gain on appreciation in Toby's OZ Investment wiped out the benefit of the 5 or 7 year rule to reduce his deferred gain.

### **III. Some Thoughts about the OZ Program and the Real Estate Industry**

So how would a real estate player take advantage of this program? There are likely many ways, but here are some thoughts:

- First – this is a new provision of the Code designed to spur development in Development Zones. We do not advocate starting a development in a Development Zone purely to take advantage of some new tax benefits.
- Second – we do advocate looking through the locations on the government website to ascertain if there are locations you would otherwise find good for investment and perhaps meet (or close-to-meet) your underwriting criteria.
- Third – once you have such a location we advocate seeking investors that will realize a tax savings for investing in your project. So you should find funding from investors who are comfortable with your project without tax savings, but who, due to the tax advantages, find it a lot easier to invest the necessary funds than would ordinarily be the case. This allows a win/win scenario.
- Fourth – looking at from the point of view of the investor, it is really the reverse way of thinking. We do not advocate seeking out projects solely in order to save tax dollars. Instead, we suggest that if you are planning to invest in real estate – perhaps for diversification purposes – investing in an Opportunity Zone may enhance the upside of those investments.

### Exhibit A

There are the relevant definitions from the Code applicable to the OZ Program. No regulations have yet been issued.

- A **Qualified Opportunity Fund** is an investment vehicle (corporation or partnership) that holds at least 90% of its assets in Qualified Opportunity Zone Property. The 90% requirement is determined each year by averaging the percentage of Qualified Opportunity Zone Property held by the Qualified Opportunity Fund at six-month intervals (i.e. June 30<sup>th</sup> and December 31<sup>st</sup> for a calendar year taxpayer). It is not clear whether the percentage is to be determined by reference to the adjusted tax basis or fair market value of the Qualified Opportunity Zone Property held by the fund, or on some other basis. Technically there is a monthly penalty for any month when the requirement is not met, but it is not clear how the monthly penalty is imposed when the test is on an annual basis.
- **Qualified Opportunity Zone Property** includes Qualified Opportunity Zone Stock, Qualified Opportunity Zone Partnership Interests and Qualified Opportunity Zone Business Property, in each case located in Qualified Opportunity Zones.
- **Qualified Opportunity Zone Stock** is stock of any domestic corporation (i) acquired by the Qualified Opportunity Fund after December 31, 2017, at original issuance solely in exchange for cash, and (ii) which, at the time such stock is issued and during substantially all of the Qualified Opportunity Fund's holding period, is a Qualified Opportunity Zone Business (as defined below). If the corporation is newly formed, it must be organized for purposes of being a Qualified Opportunity Zone Business.
- **Qualified Opportunity Zone Partnership Interests** are capital or profits interests in a domestic partnership (i) acquired by the Qualified Opportunity Fund after December 31, 2017, at original issuance solely in exchange for cash, and (ii) which, at the time such interests are issued and during substantially all of the Qualified Opportunity Fund's holding period, is a Qualified Opportunity Zone Business. If the partnership is newly formed, it must be organized for purposes of being a Qualified Opportunity Zone Business.
- A **Qualified Opportunity Zone Business** is a trade or business (i) in which substantially all of the tangible property owned or leased by the entity is Qualified Opportunity Zone Business Property, and (ii) which (a) derives at least 50% of its gross income from the active conduct of a trade or business, (b) uses a substantial portion of any intangible property in such trade or business, and (c) has less than 5% of its assets invested in nonqualified financial property. A Qualified Opportunity Zone Business does not include a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or liquor store.
- **Qualified Opportunity Zone Business Property** is tangible property used in a trade or business if:
  - (i) the property is acquired by the Qualified Opportunity Fund by purchase after December 31, 2017;

(ii) the original use of the property in the Qualified Opportunity Zone commences with the Qualified Opportunity Fund, or the Qualified Opportunity Fund substantially improves the property; and  
(iii) during substantially all of the Qualified Opportunity Fund's holding period, substantially all of the use of the property is in the Qualified Opportunity Zone. Note that property is "substantially improved" for this purpose only if during any 30-month period following acquisition of such property there are additions to basis that equal the adjusted basis as of the beginning of such 30-month period.

- A **Qualified Opportunity Zone** is nominated by the governor of each state (and the mayor of the District of Columbia). Qualified Opportunity Zones can be up to 25% of the qualified census tracts in a state, and if the state has less than 100 qualified census tracts, the governor can nominate up to 25 of those tracts. A qualified census tract for this purpose is generally any census tract that has a poverty rate of at least 20% or that has a median income that does not exceed the higher of 80% of the median income of the metropolitan area or of the statewide median income. A map of the eligible census tracts can be accessed on the Treasury's Community Development Financial Institutions Fund website here: <https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx>. All low-income community population census tracts in Puerto Rico were automatically designated as Qualified Opportunity Zones.