Existing Owners of Property in an Opportunity Zone – Right Place, Right Time?

A Lexis Practice Advisor® Practice Note by Jessica Millett, Duval & Stachenfeld LLP

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As knowledge of the Opportunity Zone Program (the OZ Program), which was tucked away inside the 2017 Tax Reform package (codified at I.R.C. Sections 1400Z-1 and 1400Z-2), trickled out to the real estate community, ears began to perk up all over the country. As tax professionals parsed through the new provisions in the Internal Revenue Code (the Code) and explained the suite of tax benefits, investors and developers alike sat up a bit straighter in their chairs to make sure they had heard correctly.

> No tax at all upon exit after 10 years? *That's right!*
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> Reinvestment of capital gains from any source, so no like-kind requirement? *Correct!*
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> You can self-certify, so no pool of credits to be awarded through an application process? *Yes!*
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> I own property in an opportunity zone and I can take advantage of these tax benefits too? *Well . . . maybe.*

An existing owner of property in an opportunity zone may have an economic advantage in the opportunity zone era to sell the property at a higher price as a result of the opportunity zone classification, but the OZ Program requires an existing owner to jump through a series of hoops in order to be eligible for the opportunity zone tax benefits (the OZ Tax Benefits).

The OZ Program is complex, and the rules are still evolving. To illustrate the structuring hurdles for existing owners of property in opportunity zones, I have included below some of the basic rules, but there are additional requirements that are not covered here that are critical to properly structure a Qualified Opportunity Fund (QOF). Specialized tax counsel familiar with the intricacies of the OZ Program is a must for properly structuring and executing such a transaction.

A Quick Primer on OZ Tax Benefits

- This article does not go into depth on the OZ Tax Benefits, but in case you need a refresher, the benefits package available to investors in a QOF includes:
- Deferral until 2026 of the eligible capital gain timely invested into a QOF
- Potential reduction of the gain required to be included in income at the end of the deferral period if the QOF interest is held for at least five or seven years –and–
- Tax-free exit upon sale of the QOF interest after 10 years

Requirements at Every Level

The OZ Program rules can be difficult to parse, in part because every level of the structure has a different set of requirements.

For a bit of context, assume the following two-tier QOF structure (for a number of reasons beyond the scope of this article, this two-tier structure is the recommended structure for QOF investments):

- Investors with eligible capital gains invest those gains into a QOF.
- The QOF contributes at least 90% of the eligible gain from investors into a lower-tier partnership, hereinafter referred to as the JV, in exchange for a partnership interest.
- The JV uses the QOF's cash contributions, as well as cash from other investors or obtained through financing to acquire and either construct or improve property in an opportunity zone.

At the investor level, each investor must invest eligible capital gain into a QOF within a prescribed time period. The general rule is that an investor has 180 days from the date of the sale that generated the capital gain, but partners in a partnership may have a bit longer when the partnership itself sells the appreciated asset and passes the gain up to its partners on IRS Schedule K-1.

At the QOF level, the QOF has a 90% asset test to meet every six months. Qualifying assets can include property in an opportunity zone or an interest in a JV, as long as the JV meets its own set of requirements. Cash is not a good asset. The testing dates are typically June 30 and December 31, but the first testing date in the QOF's first taxable year may vary.

At the JV level, one of the key requirements is that the JV qualify as a Qualified Opportunity Zone Business (a QOZB). One of the asset tests at the QOZB level requires 70% of the tangible property owned or leased by the JV to be Qualified Opportunity Zone Business Property (a QOZBP).

How Existing Owners Can Qualify Their Property as QOZBP

The QOZBP rules are the reason that existing owners of property in opportunity zones must get creative to take advantage of the OZ Tax Benefits.

As defined in the Code and as applied to our two-tier structure, QOZBP is tangible property used in a trade or business of the QOZB if:

- The property was acquired by the QOZB by purchase after December 31, 2017 (the Acquired by Purchase Requirement)
- The original use of such property in qualified opportunity zone commences with the QOZB or the QOZB substantially improves the property –and–
- During substantially all of the QOZB's holding period for such property, substantially all of the use of such property was in a qualified opportunity zone

Hoop #1 – Acquired by Purchase

The first hoop that existing property owners need to jump through is the Acquired by Purchase Requirement. This requirement is the roadblock that limits existing property owners' access to the OZ Tax Benefits, since in many cases those owners acquired the property prior to December 31, 2017. Those owners need to sell their property to a new QOF/QOZB structure for the property itself to qualify as QOZBP. Contributions of property to an entity do not meet the Acquired by Purchase Requirement.

Hoop #2 – The 20% Related Party Rule

The second hoop to jump through is that the QOZB must acquire the property from an unrelated person, and the relatedness standard is set very low for this purpose. If both the QOZB and the selling entity are partnerships for tax purposes, the seller and the buyer will be considered related if the same persons own, directly or indirectly, more than 20% of the capital interests or profits interests of both entities.

Wholly apart from its application in the context of the OZ Program rules, the measurement of a partner's ownership interest in a partnership is not well defined generally in the tax law, particularly with respect to partnership profits. Without exaggeration, there are tax articles well in excess of 100 pages that painstakingly run through all the various ways you could measure a partner's interest in partnership profits, without a clear winner. The main uncertainties relate to profits interests and promotes, both in respect of timing (when do you measure ownership?) and likelihood (do you have to include speculative profits or only certain ownership?).

For example, assume Geoff owns property in an opportunity zone and wants to develop it. He acquired the property well before 2018, so he needs to sell the property to a new QOF/QOZB structure and bring in other investors. Geoff has real estate expertise and will assist in the development of the property, so he strikes a deal with his other investors so that he is paid a promote of 20% after the other members get their capital back and a return on that capital. However, Geoff's investors want him to be at risk as well so he agrees to invest 10% of the capital. What is Geoff's interest in partnership capital and profits at the time the QOZB acquires the property? Do you measure just the 10% capital interest because the 20% promote is speculative? Or do you have to assume all possible future outcomes, including the upside, in which case he could be cumulatively over the 20% limit on partnership capital and profits?

The short answer is that no one knows. Given the risk of getting it wrong (that the property fails to be QOZBP, in which case the JV fails as a QOZB, so that the QOF flunks its asset test), most people are taking the conservative route and limiting either capital investment or promotes to any carryover investors from the seller side to keep them below 20% under any scenario.

Even in a straight percentage interest deal with no promote, existing owners are limited to no more than 20% of the QOF/QOZB ownership, so the policy behind this rule appears to weigh heavily on bringing new investors into Opportunity Zones, rather than letting existing property owners claim the OZ Tax Benefits.

Hoop #3 – The Sale Has to Occur Before the Gain

There is a third hoop to jump through for existing owners of opportunity zone property that want to sell their property to a new QOF/QOZB structure and reinvest some or all of the resulting gains from that sale into the new QOZ/QOZB structure that is acquiring their property. A taxpayer must invest eligible gain into a QOF to qualify for the OZ Program tax benefits. That gain must exist before it can be reinvested into a QOF. By definition, a taxpayer can only have gain after a taxable disposition occurs, so the sale has to happen before the seller can have gain to invest.

For example, assume Lea owns property in an opportunity zone that she acquired before 2018, and she is going to sell it to a new QOF/QOZB structure for $10 million. Because of the related party rule, she can only invest $2 million into the deal, and she has no other eligible gains to invest into the QOF. In this case, the other investors could invest $8 million into the QOF, and the QOF would invest that $8 million into the JV that will qualify as a QOZB (assume there is another minority investor in the JV so it is a partnership for tax purposes). The JV would then acquire the property from Lea for $8 million in cash plus a note of $2 million. Lea could then take $2 million of the cash she received at closing and invest that amount into the QOF. The QOF would contribute the $2 million of cash to the JV, and the JV would use the cash to pay off the note of $2 million.

Although the Code does say that an investor's 180-day period to invest begins on the date of sale, it may be prudent to let the gain settle for at least a day before reinvesting it into a QOF that owns the same property. This would add some certainty to the characterization of the investor's QOF contribution as eligible gain, and it helps in avoiding a recharacterization risk that 20% of the property was contributed as opposed to having been acquired by purchase.

Keep in mind that neither the IRS nor Treasury has explicitly blessed the concept that an existing owner can reinvest gain from the sale of opportunity zone property into a QOF that acquires that same property. However, the related party rule appears to be the main guardrail on the QOZBP definition to address this, so as long as existing owners can jump through these hoops, they should be in compliance with the rules.

Land Contributions – A Potential Shortcut to QOZB Status, but No OZ Tax Benefits

If existing owners of property in an opportunity zone are not interested in OZ Tax Benefits themselves but want to use QOF funds to develop the property, they may be able to contribute the property to the QOZB in exchange for a JV interest. Hang on, you may be saying, what about the Acquired by Purchase Requirement? I thought contributions were not permitted?

It is true that any property contributed to a QOZB will not meet the Acquired by Purchase Requirement and therefore will not be QOZBP. However, the asset test at the QOZB level requires that only 70% of the QOZB's tangible property be QOZBP. So technically, up to 30% of a QOZB's tangible property does not need to be QOZBP and therefore does not need to meet the Acquired by Purchase Requirement.

Assume that Max owns property in an opportunity zone that he acquired before 2018. The property is raw land, but a developer approaches Max with a proposal to build a mixed-use complex on the site. Max contributes the property to a QOZB, and a QOF contributes cash to the QOZB to develop the property. Once the project is built, if the land value is less than 30% of the tangible property in the QOZB, then perhaps it does not matter that the initial land was contributed instead of acquired by purchase, as long as at least 70% of the QOZB's tangible property constitutes QOZBP.

This scenario is a bit riskier at the moment given the lack of guidance on exactly when the various tests at the level of the JV need to be measured and fulfilled. If the 70% test is applied before the project is finalized and the land is still more than 30% of the value of the property, then the QOZB flunks its test. However, if we get comfort on this scenario under the second set of proposed regulations, which should be released in the coming weeks, that will ease up some of the structuring for these existing landowners in opportunity zones that want to admit QOF investors without triggering their own gains.

Until then, existing opportunity zone property owners should be prepared to jump through the hoops.

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Jessica Millett is co-chair of Duval & Stachenfeld's Tax Practice Group. She has particular expertise in U.S. tax issues that arise in complex real estate transactions, notably Qualified Opportunity Fund structures. She regularly advises clients on tax structuring and documentation for QOF investments, real estate acquisitions, joint ventures, restructurings and refinancing arrangements, including inbound and outbound investments, and structures involving REITs.

Most recently, Ms. Millett has been at the forefront of structuring investments into Opportunity Zones. To date, she has been quoted in Bloomberg, Real Estate Weekly, The Commercial Observer, and The Wall Street Journal and she has made numerous presentations to industry groups. Ms. Millett was also named as one of the Top 50 People Shaping the Future of Opportunity Zones by Opportunity Zone Magazine.

Ms. Millett ensures that tax advice is an integral part of the deal from the very beginning. She is able to translate complex tax concepts into simple and straightforward issues, and clients appreciate that she is business savvy and understands the industry as well as the current market.