THE OPPORTUNITY ZONE TAX BENEFIT – HOW DOES IT WORK AND CAN FOREIGN INVESTORS BENEFIT?

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The U.S. Federal, state, and local governments typically offer tax benefits to businesses to encourage economic growth and investment in certain industries and geographic areas. The Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") added an important new provision that provides a tax break aimed at bringing together private capital and low-income communities, which otherwise would not have been the recipients of similar investments. The goal is to unlock unrealized gains (estimated at over $6 billion) and direct the gains to be invested in funds that are active in distressed areas designated as "Opportunity Zones" because they fall within low-income community census tracts.

New Code §1400Z-2 provides for the following three tax benefits:

- A temporary deferral of gains realized prior to 2026 on a sale or exchange of an appreciated asset
- A step-up in basis for the interest in the "Qualified Opportunity Fund" of up to 15% of the deferred gain that was invested in the Qualified Fund
- A complete exclusion of capital gains on the appreciation of the interest in the Qualified Fund if held for at least ten years

This article will discuss the elements of the provision and the potential ability of non-U.S. investors, who generally are not subject to U.S. taxation on dispositions of capital property other than U.S. real property, to utilize the new provision.

A QUALIFIED OPPORTUNITY FUND

A Qualified Opportunity Fund ("Qualified Fund") is an investment vehicle that can be organized as a corporation or a partnership and that was formed for the purpose of investing in "Qualified Opportunity Zone Property" (herein, "Eligible Property," as explained below). If the criteria is met, it will offer investors the attractive tax breaks discussed in this article.

To qualify, at least 90% of the fund's holdings must be in Eligible Property (other than another Qualified Fund) purchased after December 31, 2017.

The 90% test is determined by an average of the Eligible Property measured at two points in time:

- After the first 6 months of the taxable year
- On the last day of the taxable year

This is designed to put the investment to work quickly and to make sure available capital is reinvested. Regulations will provide rules to ensure that a fund has

reasonable time to reinvest the return of capital on Eligible Property.

If the 90% test isn't met, and a reasonable cause exception doesn't apply, the fund will pay a penalty for each month that it fails to meet this test, calculated as a percentage of the amount by which the Eligible Property is short of the 90% requirement.

What Is an Opportunity Zone?

An Opportunity Zone is an economically distressed community that has been designated by the state and certified by the I.R.S. Roughly 8,700 areas in all 50 states have been designated.[1] Qualified Opportunity Zones retain their designation for ten years.

What Is a Qualified Opportunity Zone Property?

Eligible Property includes

- "Qualified Opportunity Zone Stock" (herein, "Qualified Stock"),
- "Qualified Opportunity Zone Partnership Interests" (herein, "Qualified Partnership Interest"), and
- "Qualified Opportunity Zone Business Property" (herein, "Qualified Business Property").

Qualified Stock is stock in a domestic corporation purchased after December 31, 2017, for cash at original issue. A Qualified Partnership Interest is a capital interest or profits interest in a domestic partnership purchased for cash after December 31, 2017. The corporation or partnership in which a Qualified Fund wishes to invest must operate a "Qualified Opportunity Zone Business" (defined below) at the time the fund purchases the interest and during substantially all of the fund's holding period.

Qualified Business Property is tangible property acquired after December 31, 2017, to be used in a trade or business in the opportunity zone, provided that the purchased property is new (or was not already used in the opportunity zone by the seller) or that previously used property is substantially improved by the fund. For the property to be treated as a Qualified Business Property, the fund may not use the property in a meaningful way outside the opportunity zone.

What Is a Qualified Opportunity Zone Business?

A Qualified Opportunity Zone Business ("Qualified Business") is generally any trade or business in which substantially all of the property owned or leased is Qualified Business Property (as defined above) and which meets the following two tests:

- At least 50% of the taxpayer's gross income is from the active conduct of the business.
- Less than 5% of the average unadjusted basis of all of the property may be attributable to nonqualified financial assets.

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[1] The full list of designated zones, and a map, is available here: Opportunity Zones Resources

Certain businesses are prohibited *per se*, including, *inter alia*, casinos, liquor stores, golf courses, and country clubs.

How Does a Fund Become Qualified?

The statute does not require a special qualification process. Consistent with the language of the law, I.R.S. frequently asked questions ("F.A.Q.'s") stipulate that no I.R.S. approval or action is required for a fund to become a Qualified Fund. Based on the F.A.Q.'s, an eligible fund self-certifies its status on a form to be published by the I.R.S., which must be included on the fund's Federal tax return for the tax year.

THE OPPORTUNITY ZONE TAX BENEFITS

"An Opportunity Zone is an economically distressed community that has been designated by the state and certified by the I.R.S."

There are two main benefits available under the new provision:

- The first benefit relates to the gain from a sale of an existing appreciated property, which includes two tax benefits:
  - The tax on such gain can be deferred up to 2026 (the "Tax Deferral Benefit").
  - If held for at least five years, up to 15% of the gain realized can be exempt (the "Partial Step-Up Benefit").
- The second benefit relates to the appreciation of the investment in the opportunity fund, which may be completely tax free if held for ten years or more (the "Appreciation Step-Up Benefit").

The benefits are available only with respect to gain realized before December 31, 2026 and invested within the timeline.

How Does the Tax Deferral Benefit Work?

To receive the Tax Deferral Benefit, taxpayers must

- sell an appreciated property to an unrelated person before December 31, 2026,
- make an election to defer the gain (or the invested amount, if lower) in the tax return for the year of the sale,
- not have another election to defer the tax in effect with respect to the same sale or exchange, and
- invest the deferred gain in one or more Qualified Funds within 180 days from the day of the disposition.

While the tax is deferred, the disposition transaction must be reported in the year it was made on Form 8949 (Sales and Other Dispositions of Capital Assets), which will also be used to make the election to defer the tax, pending further instructions from the I.R.S.

What Types of Appreciated Properties Qualify?

While initially aimed at capital assets, with a particular view to a capital market's

unrealized gain, the Code doesn't limit the type of property to which the provision applies. Gain from the disposition of any property may be invested in a Qualified Fund and benefit from the provision.

There is also no limitation on the amount of gain that can be deferred by reinvestment, provided that the amount deferred is invested in accordance with the provision.

Who Is a Related Person?

The disposition of the appreciated property must take place through in a transaction with an unrelated person. In determining whether the two persons are related, certain modified constructive ownership rules apply. Thus, the following persons, among others, are treated as related:

- Members of a family[2]
- An individual and a corporation if more than 20% of the value of the corporation is owned directly or indirectly by or for the individual
- Two corporations that are members of the same controlled group or the same persons own more than 20% of the value in each
- Two partnerships in which the same persons own, directly or indirectly, more than 20% of the capital or profits interests
- A grantor and a fiduciary of any trust
- A fiduciary of one trust and a fiduciary of another trust established by the same grantor
- A fiduciary and a beneficiary of a trust
- A fiduciary of a trust and a beneficiary of another trust established by the same grantor
- A fiduciary of a trust and a corporation if more than 20% of the value of the corporation is owned, directly or indirectly, by or for the trust or by or for the grantor of the trust

What Is the Timeframe to Make the Investment in a Qualified Fund?

The deferred gain must be invested in a Qualified Fund within 180 days of the day of disposition of the property. Unless further guidance is issued, this period includes weekends and holidays.

No intermediary is required to hold the funds during the period between the disposition of the property and the investment in the Qualified Fund. This requirement differs in an exchange under Code §1031, which prohibits a taxpayer from taking possession of the proceeds from a sale made in the interim period before investment in the replacement property. The I.R.S. indicated on its F.A.Q. webpage that gains realized in 2017 (the proceeds of which must have already been received by the taxpayer) can also be invested in Qualified Funds and enjoy the tax benefits, as

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[2] This includes an individual's spouses, siblings, parents, grandparents, great-grandparents, children, grandchildren, and great-grandchildren, etc.

long as they are invested within 180 days. Thus, it is possible that no intermediary will be required even after further guidance is issued.

Can Funds from Other Sources Benefit?

> ***"The deferred gain must be invested in a Qualified Fund within 180 days of the day of disposition of the property."***

Cash investments from other sources do not qualify. This includes investments of more than the realized gain in a sale of an appreciated property and could include situations in which only part of the gain realized was initially invested, and thereafter, the taxpayer wishes to invest the remaining realized gain in the same Qualified Fund. This may be the result due to the limitation on election, under which if an election with respect to the same sale or exchange was made and is in effect, no additional election may be made.

When mixed funds are invested, the fund must segregate the amount of investment and treat the investment as two separate investments. All potential step-up benefits would only apply to the investment of the deferred gain to which an election applies.

Until When Can the Tax on the Realized Gain be Deferred?

The tax is deferred until the earlier of

- the date the investment in the Qualified Fund is sold or exchanged, or
- December 31, 2026.

Note that if the inclusion date is in 2026 and no corresponding disposition takes place, taxpayers will have tax on phantom income, which they should take into account and have cash available.

What Is the Basis Received in the Investment in a Qualified Fund?

The basis received in the investment is zero. The zero basis is subject to several potential adjustments:

- A step-up by 10% of the deferred gain
- A step-up by 15% of the deferred gain
- A step-up through the recognized gain
- A step-up to the fair market value of the investment in the Qualified Fund

The step up for the recognized gain seems to be relevant only for investments that are held past the mandatory recognition time of December 31, 2016. Therefore, depending on the holding period at this time, this step-up is in addition to the Partial Step-Up that is already granted based on the holding period discussed below, resulting in potentially tax-free appreciation of the gain reinvested under the provision.

How Much of the Deferred Gain Is Recognized?

At the time of the disposition or, if earlier, on December 31, 2016, the taxpayer includes in their gross income

- the full amount of the deferred gain or, if less, the fair market value of the investment and
- the taxpayer's basis in the investment.

How Does the Partial Step-Up Benefit Work?

After five years, the taxpayer is eligible for a step-up in the basis of the investment in the fund. The step-up amount is 10% of the deferred gain.

After seven years, the taxpayer is eligible for an additional 5% step-up, resulting in a total step-up of up to 15% of the deferred gain.

Thus, a taxpayer who sells an appreciated asset and invests it in a Qualified Fund can exempt up to 15% of its realized gain if it held on to the investment for at least seven years.

Since 2026 is a mandatory inclusion date, in order to benefit from the full Partial Step-Up Benefit of 15%, taxpayers should invest in Qualified Funds by December 31, 2019.

How Does the Appreciation Step-Up Benefit Work?

If an investment in a Qualified Fund is held for at least ten years, at the election of the taxpayer, the basis in the interest is stepped-up to the fair market value of the interest at the time of the disposition.

While no more than 15% of the deferred gain can be exempt from tax (because of the mandatory inclusion in 2026), the full appreciation may be tax exempt.

APPLYING THE PROVISION[3]

The application of the new provision is best illustrated through an example.

In October 2018, a taxpayer sells appreciated property with built-in gain of $1,000,000. No tax is paid in 2018 on the realized gain of $1,000,000 because within 180 days, the taxpayer invests the full amount into a Qualified Fund. The investment appreciates 6% per year.

- If the investment is sold in less than five years, the following will apply:
  - The investment is assumed to be worth $1,120,000.
  - The basis in the investment is zero.
  - Therefore, the tax is due on $1,120,000 – $0 = $1,120,000.
  - If broken into its elements, deferred gain and appreciation, $1,000,000 ($1,000,000 – $0) of the 2018 deferred gain is included in the taxpayer's gross income for the year of the sale, and the appreciation ($1,120,000 – $1,000,000) is taxed in full.
  - Federal tax applied to the 2018 realized gain is $200,000.
  - Federal tax applied to the appreciation is $24,000.
- If the investment is sold prior to 2026 after it was held for more than five years but less than seven years, the following will apply:

[3] For ease of computation, the example uses a 20% Federal rate and does not apply the 3.8% N.I.I.T.

- The investment is assumed to be worth $1,400,000.
- After five years, the taxpayer receives a step-up in the basis of the investment of 10% of the deferred gain. The adjusted basis is $100,000.
- Therefore, the tax is due on $1,400,000 – $100,000 = $1,300,000.
- If broken into its elements, deferred gain and the appreciation, $900,000 ($1,000,000 – $100,000) of the 2018 deferred gain is included in the taxpayer's gross income for the year of the sale, and the appreciation ($1,400,000 – $1,000,000) is taxed in full.
- Federal tax applied to the 2018 realized gain is $180,000.
- Federal tax applied to the appreciation is $80,000.

- If the investment is sold after 2026 when it was held for more than seven years but less than ten years, the following will apply:
  - The investment is assumed to be worth $1,700,000.
  - After seven years, the taxpayer receives a step-up in the basis of the investment to 15% of the deferred gain. The adjusted basis is $150,000.
  - In 2026, notwithstanding that the investment is not sold, the taxpayer must recognize the 2018 realized gain. Of the deferred gain, $850,000 ($1,000,000 – $150,000) is included in the taxpayer's gross income for the year 2026.
  - The new basis in the investment is then $150,000 (the Partial Step-Up received after holding the investment for seven years) + $850,000 (the step-up received after recognizing the gain on the deferral) = $1,000,000.
  - When the taxpayer sells the investment after 2026 but before the ten-year mark, the appreciation is taxed [*i.e.*, the fair market value over the new basis ($1,700,000 – $1,000,000)].
  - Federal tax applied to the 2018 realized gain (in 2026) is $170,000.
  - Federal tax applied to the appreciation is $140,000.

- If the investment is sold after 2026 when it was held for more than ten years, the following will apply:
  - The investment is estimated to be worth $2,000,000.
  - In 2026, the taxpayer includes $850,000 of the 2018 deferred gain as explained above. Following such recognition, the taxpayer's basis is stepped up from $150,000 (received after seven years) to $1,000,000 by adding the gain recognized to the basis.
  - At the election of the taxpayer (at the time of sale after ten years), the basis in the investment is stepped-up further to the fair market value of the investment on the date of the sale (*i.e.*, $2,000,000 in this example).

- Federal tax applied to the 2018 realized gain (in 2026) is $170,000.
- Federal tax applied to the appreciation is $0.

For comparison, if the taxpayer invested in a private equity fund that isn't a Qualified Opportunity Zone fund, the $200,000 tax due on the $1,000,000 gain realized in 2018 would have been due in 2018. Only the net amount of $800,000 would have been available for investment, and the appreciation would have been fully taxed.

CAN FOREIGN TAXPAYERS BENEFIT?

The provision does not limit the type of taxpayer that can benefit from this provision; accordingly, foreign investors, including trusts, may benefit from the new provision.

Under U.S. tax law, non-U.S. investors are generally not subject to U.S. tax on the sale of appreciated capital assets not treated as a U.S. real property interest ("U.S.R.P.I."). Therefore, as it applies to unrealized gains in capital markets, non-U.S. investors are not anticipated to liquidate their portfolios in time for a 2019 investment in a Qualified Fund.

The provision does not address the applicability to U.S.R.P.I. and F.I.R.P.T.A. withholding. In principal, non-U.S. investors may sell appreciated real property and reinvest the gain in a Qualified Fund. Since the consideration may be subject to 15% F.I.R.P.T.A. withholding, investors may find it complicated to utilize the new provision.

However, just like in a non-simultaneous exchange under Code §1031, where taxpayers may apply to the I.R.S. and request a withholding certificate to eliminate the withholding, it is assumed that non-U.S. sellers would be able to do so in these circumstances. There is no doubt that this would impose some complications; however, unless regulations impose limitations, the benefits may be worth it. The process to obtain an I.R.S. withholding certificate normally takes 90 days and first requires the issuance of a U.S. Tax Identification Number, which isn't a simple process either, but well-advised taxpayers who plan in time may be able to invest the proceeds within the required 180-day window and benefit from this new provision.

In comparison with a Code §1031 exchange, under the new provision, if the "replacement" property is held for more than ten years, the appreciation would be completely tax free and only 85% of the deferred gain would be taxed.

Interests in some of the Qualified Funds will surely be treated as an investment in U.S.R.P.I. It is yet to be seen how F.I.R.P.T.A. withholding will apply to a disposition of interests throughout the lifetime of the investment and whether it is necessary to obtain an I.R.S. determination letter for a disposition that occurs after ten years and on which no gain should be taxable.

OTHER STRUCTURES USED BY NON-U.S. PERSONS THAT MAY BENEFIT

Many non-U.S. persons use U.S. domestic trusts in their structures with the intention of accommodating U.S. beneficiaries. These trusts may have invested in the U.S. stock market and may now take the opportunity to cash out on appreciated

portfolios and benefit from the tax benefits described above.

U.S. non-domestic trusts have seen a rise in popularity in recent years following C.R.S. Trusts used for these purposes are often treated as foreign trusts for U.S. tax purposes. While these trusts would not have unrealized gain in U.S. stock markets, they may have appreciated F.I.R.P.T.A. assets.

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CONCLUSION

A battle, like the one for Amazon's second headquarters, is expected to begin among states that wish to attract Qualified Funds to their opportunity zones. It is possible that taxpayers will rush to dispose of appreciated assets for a timely reinvestment in Qualified Funds, no later than December 31, 2019, a timeline that would allow them to utilize the 15% Partial Step-Up in basis by the time of the mandatory gain recognition.

The current requirements are somewhat relaxed compared to other deferral provisions in the Code (*e.g.*, Code §1031) indicating the possibility of further changes as new guidelines and proposed regulations are issued.

It is yet to be seen whether this initiative will be successful in developing the identified zones while at the same time providing benefits for investors.

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