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Questions To Answer Before Investing In An Opportunity Fund

By **Marc Schultz** (June 12, 2018, 3:49 PM EDT)

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The recent Tax Cuts and Jobs Act created as a new federal income tax incentive program the opportunity zone program, located in Section 1400Z-1 and Section 1400Z-2 of the Internal Revenue Code of 1986. The opportunity zone program is designed to encourage private capital investment in qualified opportunity zones — which are areas designated throughout the United States and includes possessions of the United States. The opportunity zone program provides investors with significant tax benefits for investing in qualified opportunity funds. The opportunity funds serve as intermediaries between the investor and the investment in the opportunity zone.

The opportunity zones have now been designated (with four states still remaining), and folks are really excited about this new capital source. Still, many questions have been asked — most of which need to be answered in order for opportunity funds to successfully raise and deploy the significant amount of capital that folks are expecting.

This article describes the tax benefits for investors, explores the deployment requirements for opportunity funds and addresses some of these questions.

Tax Benefits to Investors

The opportunity zone program provides three primary tax incentives to taxpayers who invest in opportunity funds.

First, a taxpayer (by making an election) may defer any gain by investing all or a portion of such gain generated from the sale or exchange of property with an unrelated person in an opportunity fund within 180 days of the sale or exchange. The amount of such gain to be deferred by the taxpayer is equal to the amount that the taxpayer contributes to the opportunity fund. The deferred gain is required to be included in income upon the earlier of: the date that the taxpayer sells or exchanges his or her interest in the opportunity fund, or Dec. 31, 2026. Second, to the extent that the taxpayer's holding period in the interest in the opportunity fund is at least five to seven years, the amount of the deferred gain to be included in income in the previous sentence may be reduced by up to 15 percent of the deferred gain (i.e. 10 percent for five years and an additional 5 percent for seven years).

The third major benefit of the program is where the taxpayer holds an interest in the opportunity fund for at least 10 years. In such a case, taxpayers may make an election to increase the tax basis of their investment (which is zero at the time that such investment is made) in the opportunity fund to the investment's fair market value on the date of a sale or exchange of such interest, thereby eliminating any taxable gain. This is where much of the excitement in the program has been generated because it allows taxpayers to obtain tax-free appreciation (and potentially avoid the effect of depreciation recapture) on their opportunity fund investment.

Deployment of Capital by an Opportunity Fund

An opportunity fund is an investment vehicle that has been organized as either a corporation or a partnership, has undergone the requisite certification process, and holds at least 90 percent of its assets in qualified opportunity zone property. Guidance has been issued providing that the certification will be a self-certification process where the opportunity fund will attach a form to its tax return. The form is expected to be released this summer. At this point, we do not know what the fund will need to certify.

The 90 percent requirement appears to be determined by using the average of the percentage of the opportunity zone property held by the entity as measured on the last day of the first six-month period of the taxable year of the opportunity fund, and on the last day of the taxable year of the opportunity fund. There is a monthly penalty for failure to comply. The period for testing the 90 percent requirement does not appear to sync mechanically with the monthly penalty. It is important for guidance to clarify this. Many folks have also questioned how to determine compliance in the year of formation when there is a short taxable year.

Opportunity zone property consists of certain stock and partnership interests in entities referred to as "Qualified Opportunity Zone Businesses," and certain business property called "Qualified Opportunity Zone Business Property." Effectively, to satisfy the 90 percent requirement, the opportunity fund can make an equity investment (meeting certain requirements) directly in a qualified opportunity zone business and/or acquire qualified opportunity zone business property where the opportunity fund is the direct owner of such property. The opportunity fund cannot make a loan to satisfy the 90 percent requirement, but preferred equity should be fine as long as it is considered equity for federal income tax purposes.

It is unknown how to exactly measure the 90 percent requirement. This could be measured based upon the original or adjusted tax bases of the assets of the opportunity fund, the fair market value of such assets, or some other metric. Using tax basis appears to be the less onerous of the alternatives because using fair market value implies that regular appraisals will be necessary.

Another issue is the length of time that the fund can hold invested cash that will eventually be deployed in opportunity zone property without failing the 90 percent requirement since cash does not appear to be opportunity zone property. As stated above, investors have 180 days to invest in the opportunity fund. This means that taxpayers will not have much flexibility to stage their capital contributions in the opportunity fund in coordination with the deployment of capital by the opportunity fund. Based on the 90 percent requirement, the opportunity fund appears to have an issue to the extent that it has significant cash on the date of measurement. It would make sense for guidance to provide the opportunity funds with a grace period for satisfying the 90 percent requirement with respect to the deployment of newly contributed cash — especially when the cash is being used for construction of property.

Opportunity Zone Business Property

An opportunity fund can satisfy the 90 percent requirement by directly acquiring opportunity zone business property. Opportunity zone business property is tangible property used in a trade or business that was acquired by purchase from an unrelated person after Dec. 31, 2017. Relatedness is based upon a “more than” 20 percent test. Also, to be considered as opportunity zone business property, either the original use of such tangible property in the opportunity zone is required to commence with the opportunity fund (or the opportunity zone business, as discussed below), or the opportunity fund (or the opportunity zone business, as discussed below) is required to substantially improve the tangible property.

The substantial improvement requirement will likely be necessary for projects where land is acquired because the original use of such land could not have commenced with the opportunity fund in the opportunity zone. Tangible property is treated as substantially improved where additions to tax basis are made to the tangible property during any 30-month period commencing after the acquisition date that exceed an amount equal to the adjusted tax basis of such property at the beginning of the 30-month period.

Questions have arisen with respect to the treatment of leases. Opportunity zone business property is tangible property that was acquired from an unrelated person after Dec. 31, 2017, and meets certain requirements. However, a true lease, for federal income tax purposes, of tangible property does not involve an acquisition of tangible property. Also, the payment of an acquisition premium to acquire a tenant’s leasehold interest of tangible property could be problematic because this may be treated as the acquisition of intangible property (an interest in a lease) rather than tangible property.

Arguably, if the 90 percent requirement is measured based upon tax basis, then a true lease of tangible property (assuming no acquisition premium payment) appears not to negatively impact the 90 percent requirement because the opportunity fund would not have any tax basis in a true lease. However, using fair market value for measuring the 90 percent requirement appears to cause a problem where the lease has an inherent market value. Since a true lease is not an acquisition, it would appear that any market value within the lease would not be counted as being opportunity zone business property if fair market value is used. This could be a problem for many transactions on Native American land where ground leases are often involved and many of these leases have inherent market value.

Opportunity Zone Businesses

An opportunity fund can satisfy the 90 percent requirement by making a direct cash equity investment after Dec. 31, 2017, in a domestic corporation or partnership that constitutes an opportunity zone business at the time of such investment, and for “substantially all” of the opportunity fund’s holding period. Many folks believe that a limited liability company could constitute an opportunity zone business but guidance here would be helpful.

In order to qualify as an opportunity zone business, a number of requirements and restrictions similar to those found under the new markets tax credit, or NMTC, program and with respect to enterprise zone businesses are required to be satisfied, including, but not limited to, a prohibition on certain “sin” businesses. Additionally, “substantially all” of the tangible property owned or leased by the business is required to be opportunity zone business property. This requirement has generated some confusion and guidance is needed here as well. Since the definition of opportunity zone business property requires the acquisition of tangible property, it appears literally impossible to satisfy this requirement where a business leases tangible property. Also, guidance is needed with respect to testing the "substantially all" requirement on the date that the investment is made by the opportunity fund so that the business can satisfy this requirement using the proceeds from the opportunity fund's investment. The next two paragraphs set forth below presume that such guidance will be provided which allow for the business to have the ability to use the equity proceeds from the opportunity fund to satisfy such requirement.

Also, there is no definition of the term "substantially all" and no indication as to how this requirement is measured. As stated above, tangible property of a business acquired prior to Jan. 1, 2018, cannot be opportunity zone business property. This means that operating businesses with tangible property acquired prior to 2018 would not qualify as opportunity zone businesses unless such businesses acquire enough tangible property from the opportunity fund transaction to represent "substantially all" of the tangible property for these businesses. Specifically, in order to use equity financing from an opportunity fund, a current operating business with a significant amount of tangible property acquired prior to 2018, would be required to undertake an expansion that involves the acquisition of tangible property that could be three or four times the current amount of tangible property the business holds (depending on how "substantially all" is defined). Also, some folks believe that if the "substantially all" test is based upon fair market value of the assets, then this could impair the use of opportunity fund equity for many current operating businesses located in opportunity zones because the amount of required expansion would not be realistic and would appear to also involve the need for appraisals.

One suggestion for meeting the "substantially all" test would be to consider using tax basis of tangible property instead of fair market value as follows: using the adjusted tax bases of the tangible property of the business acquired prior to the opportunity fund's equity investment in the business and using the acquisition (or cost) basis of the tangible property acquired as a result of the transaction with the opportunity fund. Using adjusted tax basis for previously acquired tangible property would take into account previously taken depreciation — which presumably would make this amount much more manageable for meeting the "substantially all" test. Using the cost basis for the newly acquired property would avoid the impact on the "substantially all" computation from the 100 percent depreciation deduction provision in the Tax Cuts and Jobs Act. An expansion of a current operating business in the opportunity zone would still be required but the level of required expansion would appear to be more realistic and reasonable. Guidance is of course needed here and hopefully this guidance will provide enough flexibility for current operating businesses located in opportunity zones to participate in this program.

The other requirements for an entity to be an opportunity zone business are as follows:

- At least 50 percent of the gross income of the business is required to be derived from the active conduct of such business;

- A substantial portion of the intangible property of the business is required to be used in the active conduct of such business; and

- No more than 5 percent of the average of the aggregate unadjusted tax bases of the property of the business can be comprised of what is called "nonqualified financial property" (a requirement that folks practicing in the NMTC area have dealt with for years).

Guidance is needed with respect to the active business requirement. It is unclear what the term “active conduct of a trade or business” means. In some areas of the code, this term means the meaningful participation in the management or operations of the trade or business. This interpretation would likely preclude a triple net lease of improved real estate and cause difficulty using this financing for many real estate projects. Hopefully, any guidance will adopt the definition used under the NMTC program — requiring the reasonable expectation of the business to generate gross revenues within a certain period of time.

Unless the guidance states otherwise, it would appear that there are structuring opportunities as to whether the opportunity fund acquires property directly or invests in an opportunity zone business that acquires such property. For example, if it is determined that a triple net lease of improved real property is a problem for an opportunity zone business, then perhaps it would be possible to have the opportunity fund engage in the triple net lease since the active business requirement does not appear to be applicable at the opportunity fund level.

Conclusion

The opportunity zone program is an exciting new tax incentive program that offers substantial opportunities for its participants. Guidance is obviously needed, and this guidance will hopefully answer these questions in a manner that allows for the robust growth of this nascent industry.

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