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INSIGHT: Twenty Hot Topics About Opportunity Zones

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By now, you have undoubtedly heard of ''Opportunity Zones,'' a group of tax incentives that was part of the 2017 tax law. In brief, the law was designed to encourage taxpayers to sell appreciated assets, and then invest the resulting gain in certain low income areas with an added tax break if the money is invested for 10 years or more. The low income areas have been formally designated as ''opportunity zones'' and they comprise approximately 11 percent of the U.S.

There are essentially four incentives. First, provided the amount of the gain is invested in a qualifying ''Opportunity Fund'' within 180 days of realizing the gain, the gain is not included in income until the investment is sold, or Dec. 31, 2026, if sooner. Second, if the investment in the fund is held for at least five years, the gain is effectively reduced by 10 percent, and if for at least seven years, another 5 percent. Third, if at the end of 2026 (or the time of disposition, if earlier), the investment in the fund is worth less than the deferred gain, then the amount included in income is that lesser amount. And finally, if the investment is held for at least 10 years, then at the time it is sold or transferred, its basis is increased to its then fair market value, which should result in any appreciation in the investment beyond the amount recognized in 2026 will escape taxation.

Stated a bit differently, the benefits are: delaying payment of the tax for as much as eight years, reducing the amount of taxable gain in many circumstances by at least 15 percent, possibly more, and finally, avoiding tax on future appreciation if the investment is held at least 10 years.

It must be noted that the rules are far more complex than this. For example, at least 90 percent of an opportunity fund's assets must consist of stock, partnership interests, or direct investment in opportunity zone businesses that pass timing, location, and activity tests. And, an opportunity zone business must spend at least as much ''with respect to'' used property within a 30-month period as its basis in the property at the start of the period. With these, and many other rules in mind, be sure to work with someone who is well versed in the applicable law before trying to set up a fund or make a qualifying investment in an opportunity fund.

If you have been following the press on the new incentive, then you've heard some amazing numbers thrown around—approximately 6 trillion dollars of ''pent up'' capital gain—that's 6 trillion, as in six thousand billion dollars that could potentially avoid tax and be rolled into low income communities, and it seems that we are hearing from fund managers, syndicators, investment bankers, and others who are forming funds with nine-figure endowments—$100 million, $500 million, and more.

Despite all of this enthusiasm, the program has been slow to get off the ground, and that's because the applicable tax code sections have a fair number of loose ends and inconsistencies. As a result, the investment community has been awaiting the Internal Revenue Service publishing guidance, most likely regulations, that will explain and clarify all kinds of open questions. It's been promised several times now, with the latest reports reaching the ''any day now'' level. At the same time, lawyers, accountants, and other advisors have been trying to develop strategies and pin down ways to best take advantage of the new incentive with the tools they have so far.

Here are some of the hot issues that the community is facing:

(1) **What Gains Are Eligible?** It's easy for people with large stock portfolios to time their gains to fit the 180-day and other timetables of the OZ rules. But sales of the family business or home are much tougher to plan for a specific investment window. And what about ''gains'' that are subject to different kinds of tax, e.g., depreciation recapture, short term gains, ordinary tax treatment when a bank sells loans. Are these eligible?

(2) **Comparison to Like Kind Exchanges.** Note that unlike like-kind exchanges, which are only for real estate, with opportunity zones, you can sell stock or equipment or real estate (or other assets) and then delay/avoid tax when you buy those or other items. The assets sold and bought don't have to match. For example, you can sell stock and buy real estate. Similarly, the money from the sale doesn't have to be escrowed or set aside with an intermediary, as is done with exchanges. Indeed, the event that generated the gain doesn't have to yield any cash. If you had a transaction that generated ''phantom income,'' where all the cash went to pay off a lender, you could use other money, or even borrow funds to provide the cash necessary to capitalize your opportunity fund. On the other hand, there is one important way that these investments are NOT as good as like-kind exchanges. There is likely to be a tax due, based on the original gain, for the 2026 tax year.

(3) **A Basic Formation Question.** The tax code refers to opportunity funds as being ''organized'' as partnerships or corporations. Some advisors worry that an LLC is merely ''taxed'' as a partnership or corporation, so until the IRS says otherwise, should opportunity funds be formed only as partnerships or corporations (and not LLCs)? Considering the ''cliff'' problem of being wrong on this question, many advisors are erring on the side of caution unless and until the IRS clarifies this requirement.

(4) **Borrowing by the Fund.** If an opportunity fund that is a partnership borrows money to make an investment or build a project, does this count as cash contributed by the investor that may or may not correspond to capital gains? THIS IS A HUGE ISSUE THAT THE TAX COMMUNITY IS WORRIED ABOUT. It is based on a technical reading of the tax code that the IRS may or may not adopt. Here's how it might apply: assume an investor has a $1 million capital gain, and she invests $1 million in a fund formed as a partnership. The fund borrows $4 million at the fund level, and it builds a project. Some are concerned that the $4 million borrowed by the fund will nonetheless be treated as ALSO contributed by our investor, so that only one-fifth of her investment was related to gains. As a result, only one-fifth of any future appreciation would get the benefit of the no-tax-after-10-years rule. Note that this concern would NOT apply to an opportunity fund that is a corporation because the applicable tax code provisions are different for corporations. Of course, it is rare that it is wise to hold real estate in a corporation, so the different rule is unlikely to change deal structures.

(5) **Public Funds.** Yes, there are many investment advisors announcing that they are setting up funds for the public to invest in, but how soon will this REALLY happen? Without technical rules, it is very hard to address the needs of diverse investors. At least in the short term, we may see a lot more ''private label'' funds set up for a particular corporate or individual investor. And a further consideration: as noted previously, at least a portion of the original gain will become taxable on an investor's 2026 tax return. Public funds may be expected to provide some kind of distribution to their investors to help pay that tax.

(6) **Promotes as Non-Taxable Compensation.** An individual service provider should be able to make a modest investment in the fund he or she is managing in order to buy a small ''operating interest'' that will ''flip'' to a larger interest down the road. Properly applied, this structure has been used for years to make the service partner eligible for the lower tax rate that applies to capital gains. However, now it could give him or her a NON-TAXABLE promote when the fund interest is ultimately sold. But remember: the service provider will still need a gain to support his or her initial investment.

(7) **What About Partnership Gains?** It's unclear how the investment rules work if a partnership or LLC has a gain that shows up on a partner/member's Schedule K-1. Suppose that the gain was more than 180 days ago? How would the partner know? And should the opportunity fund investing be done by the partnership/LLC? Or the individual partners/members? In letters to the Treasury, we and others have encouraged the IRS to allow either to make the investment, and hopefully, this will be addressed in guidance. Still, partners may want to add a provision to their partnership agreement requiring notice of gains. Of course, limited partner approval is often required for so-called ''major transactions.''

(8) **Timing of the Fund's Activities.** IRS guidance is desperately needed on timing questions. Do you have a trade or business if you are building something that won't be completed for a year or two? How will the 30-month period to double your basis in used property work? What about cash that is set aside? There's also a 5 percent limit on a fund holding ''nonqualified financial property.'' People have talked about ''grace periods'' and defining ''working capital'' to include money that will be used to build a project, similar to what is done with the new markets tax credit.

(9) **What About Land?** Is land ''used property'' subject to the double-your-basis requirement? Can an opportunity fund (or a subsidiary partnership or LLC) back land (or other assets) out of these requirements by leasing them?

(10) **Proving That the Fund Passes the 90% Test and Similar Issues.** How does an opportunity fund show that 90 percent of its assets are invested? By fair market value? Cost? Is an appraisal needed? Similarly, the tax code provision uses the phrase ''substantially all'' five times, leaving an investor unsure of whether it is passing other tests that appear in the tax code. Presumably, these will be addressed by IRS regulations.

(11) **What About Funds That Are Worth Less in 2026?** Are there areas in which the gain recognition in 2026 will actually be reduced, because the investment has declined in value? Consider a low income housing tax credit project that has used up half its tax credits by 2026. At that time, the investment is very likely worth

LESS than the original investment. What about simple family partnerships, where the sum of the parts may be worth less than the whole due to lack of control or lack of a ready marketplace to buy and sell minority interests.

(12) Rollovers Inside the Opportunity Fund. Will the IRS offer any tax avoidance/reduction/delay for sales or other income arising INSIDE an opportunity fund if the income is rolled into other investments? The people who developed the concept wanted such a rule. Can a taxpayer accomplish part of this objective even without a special rule from the IRS (or an amendment from Congress)? It would require a few steps, but an investor could at least delay recognition until 2026 by making a new opportunity fund investment at that time, based on this new gain.

(13) Depreciation Recapture. Can the 10-year step-up-to-fair-market-value rule enable an investor in equipment to avoid depreciation recapture? If the basis is equal to fair market value at the time of disposition, then it appears the investor won't have any gain to re-characterize as recapture.

(14) Accounting Issues? Are some/many publicly traded corporations less excited by O-Zones because they have to accrue the income tax in the current year, even if they don't have to pay the tax till 2026? The 2026 date was included in the law on account of the requirements of ''reconciliation,'' the process that enabled Republicans to pass the tax act with just 51 votes. It may be wishful thinking, but if the law was amended to no longer require eventual gain recognition, then presumably, the adverse accounting treatment would no longer be required.

(15) Debt in Excess of Basis. Can the 10-year step-up-to-fair-market-value rule enable an investor in real estate avoid a big gain when it departs a real estate partnership that is encumbered by a lot of debt? There's support in the tax code for this position, which provides that the fair market value of property is at least the non-recourse debt to which it is subject.

(16) One Fund for One Project? Should each opportunity fund include just one ''bite size'' investment? It's very important to remember that the OZ provision provides the fair market value step-up (and therefore, no tax) on a sale of the investment in the opportunity fund. The rule does NOT apply to a sale by the fund of an asset or business that it holds. (Not yet, anyway!). So, it may make sense to have one asset or business per fund to facilitate a sale of the fund to a new buyer who may only want the one business. Of course, you still have to contrast the safety of a single diverse fund investing in multiple assets with the ease of sale when a fund holds just one investment. Might we be able to use spin-offs and split-ups down the road to address this issue? Might the IRS or Congress provide that there is no tax on the sale of assets inside the opportunity fund?

(17) Use of OZ Partnerships and OZ Corporations. Should the opportunity fund invest DIRECTLY in the business or assets, or should it invest through a subsidiary corporation/partnership/LLC? As noted in the introduction, opportunity funds can hold partnership interests and stock in appropriate Opportunity Zone businesses. They don't just have to make direct investments in business assets. The timing and the rules for testing the assets of the business are enough different that this is likely an important strategy.

(18) Side-by-Side Investing With Other Incentives. Remember that opportunity funds don't have to be for everyone, and every investor doesn't have to build an opportunity fund into its investment. While an affordable housing investor might want to take advantage of both tax credits and opportunity zone incentives, in an historic tax credit transaction, we might have TWO investors. One would be a traditional real estate investor at the landlord level, and it would put in cash for a long term OZ play, while a completely different tax-equity investor might invest in the master tenant, seeking the historic tax credits.

(19) Singles/Doubles/Triples/Homers. Remember that an investor doesn't have to get ALL the benefits of O-Zones in order to justify the transaction. When I speak about opportunity zones, I like to use a baseball analogy. Simply postponing the tax on a current year gain until 2026 might be seen as a ''single.'' Getting the 5 percent and 10 percent basis step-ups, which effectively reduce the taxpayer's tax liability by 15 percent is a ''double.'' The possibility of a reduction in tax because the asset declines in value at 2026, OR the ability to avoid depreciation recapture after 10 years or more, OR the ability to avoid tax on debt in excess of basis (again after 10 years) is a ''triple.'' And, of course, not paying tax on future appreciation from your investment in the next Apple is a ''homerun.'' Even if your investment only produces one or two of these benefits, it is still a ''hit'' and it should be strongly considered.

(20) Further Legislation. Will the Congress change any of the rules? For example:

- delay or eliminate the 2026 recognition date;
- make the no tax rule apply to assets sold BY the fund, and not just a sale of an interest IN a fund;
- provide for a second round of designations 10 years from now; or
- require any kinds of reports or record keeping?

There are undoubtedly more hot issues than I have identified here. And, when we get IRS guidance, we may find that while many of these questions have been answered other new concerns and issues will arise to replace them! Whatever these answers and new questions may be, it seems very likely that the new legislation will steer billions of dollars into low income communities.

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