WELCOME TO THE LAND OF OZ!

Tax and Real Estate Issues Raised by the New Opportunity Zone Tax Provisions added by the Tax Cuts and Jobs Act of 2017

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185 West Broadway, New York, NY 10013
RSVP: www.nyls.edu/TaxRSVP
CLE: 1.5 credits in Areas of Professional Practice (NY transitional and nontransitional)
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Qualified Opportunity Zones
or A Journey to the Land of OZ

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September 26, 2019
Topics to Cover

1) History and Policy of Opportunity Zones
2) Timeline of a Qualified Opportunity Fund
3) Tax Benefits to OZ Investors
4) Qualified Opportunity Fund Requirements
5) Regs Answer Many but Not All Open Questions
6) Comparison With 1031
Overview of Opportunity Zone Program

Taxpayers can get capital gains tax deferral (& more)

Qualified Opportunity Funds (QOFs)
for making timely investments in
which invest in

Qualified Opportunity Zone Property
Background to Opportunity Zones

• Opportunity Zone program created by the Tax Cuts and Jobs Act of 2017
• New Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code
  – Proposed Regs (“Regs1”), Rev Ruling and draft Certification Form issued October 18, 2018
  – Additional Proposed Regs (“Regs2”) issued April 17, 2019
• Intent is to spur economic growth in low income areas
  – Low income does not necessarily equal disadvantaged; e.g. college campuses
• Many comment letters submitted; second round of regs addressed many but not all issues
New York Opportunity Zones
OZ Benefits

1. Gain Deferral

2. Partial forgiveness

3. Exclusion of additional gains
Step 1 – OZInvestors Sell Appreciated Assets

- **TAX BENEFIT #1** – OZInvestors defer paying tax on gain reinvested into a Qualified Opportunity Fund (QOF).
- OZInvestors sell appreciated assets and reinvest the gain into a QOF.
  - Sale of any type of asset qualifies (stocks, real estate, etc.). There is no “like kind” requirement.
  - Investment can be cash or property per Regs2
  - No tracing of proceeds from realization event to investment in QOF
- The gain amount must be invested into a QOF within 180 days of the sale triggering those gains, but this may be extended in some cases
- OZInvestors can invest the amount of recovered invested principal (i.e. adjusted basis) as well as the amount of investment gains, but only the portion of a QOF investment attributable to the reinvested gain will be eligible for deferral or exclusion tax benefits.
Threshold Issues for Deferral

• If a partnership sells an asset and allocates the gain to its partners, partners can reinvest the gain into a QOF and get the associated tax benefits
• Capital gains (including 1250 gain) and 1231 gains qualify, but probably not:
  – Dealer or other ordinary income
  – 1245 depreciation recapture
  – Mark to market income of dealers
• 1231 Gains subject to year end netting limit
  – This is controversial and will be subject of comment and possible revision
Threshold Issues for Deferral

• Property Contributions
  – If carryover (e.g. 721) then credit for carryover basis and split interest for value exceeding basis
  – If taxable sale then FMV credit but no deferral on realized gain from sale

• May purchase from third party

• Pure profits (i.e. “carried”) interests do not get deferral but status of interests acquired with both profits and capital component still unclear.
Step 2 – QOF Invests in Qualifying Property

• QOF has to invest cash into one or more business activities (aka Qualified Opportunity Zone Business, or QOZB) located within areas designated as Qualified Opportunity Zones.

• There are numerous requirements that QOF must meet, including asset requirements and timing requirements.
  – Discussed in detail following
Step 3 – Payment of the Deferred Tax

• **TAX BENEFIT #2** – OZ Investors may get haircut on taxable gain

• OZInvestor pays tax on the deferred gain at the earlier of (i) the sale or transfer of interest in the QOF deemed an “inclusion event”, or (ii) December 31, 2026, with caveats.
  
  – If the OZInvestor holds QOF investment for at least 5 years, 10% of the deferred gain is permanently forgiven.
  
  – If the OZInvestor holds the QOF investment for at least 7 years, an additional 5% (for a total of 15%) of the deferred gain is permanently forgiven.
    
    ▪ Note that to get the 7 year benefit, an investment in a QOF must be made no later than December 31, 2019.
Step 4 – Elimination of Tax at Exit

• TAX BENEFIT #3 – If OZInvestor holds QOF investment for 10+ years, there is no tax on the gain realized at exit
• The QOF Program attempts to encourage long-term investments
• Applies only to interest acquired equal to deferred gain amount due to “split investment” rule of IRC 1400Z-2(e)(1)
• Code language implies that the exit must be an entity sale but Regs2 allow treatment for gain incurred on sale by QOF and allocated to OZInvestors.
  – Treatment does not seem to apply to gain recognized at a lower tier below the QOF – this is controversial and might be revised.
  – Taxpayers cannot rely on this until Regs go final.
Example

• Marie sells an existing investment on July 1, 2019 and realizes a capital gain of $300
• Marie invests $300 in a Qualified Opportunity Fund on November 30, 2019
• Since Marie invested an amount equal to her gains within the 180 day window, she defers tax on the $300 gain in 2019
Example

- Marie sells QOF interest on December 1, 2022:
  - 2022 tax on full $300 of gain because she sold prior to 12/31/2026 but still get 3 years deferral

- Marie sells QOF interest on December 1, 2024:
  - 2024 tax on $270 since she gets the benefit of the 10% reduction by holding for 5 years

- Marie sells QOF interest on December 1, 2026:
  - 2026 tax on $255 since she gets the benefit of the 15% reduction by holding for 7 years
Example

- If Marie holds QOF Interest past December 31, 2026 tax on $255 of the deferred Gain will be triggered on 2026 return even though she still holds the QOF Interest.

- However, if we assume that QOF Interest appreciates to $700 when she sells on December 1, 2029, Marie pays no tax at all on the $400 appreciation since she held the QOF Interest for 10 years.
What is a QOF Anyway?

• A Qualified Opportunity Fund is an investment vehicle organized as a domestic corporation or a partnership.
  – Regs say fed’l tax classification governs, so QOF can be an LLC
  – Can be in U.S. territories but only if the QOZB activity is in territory where organized
• A QOF cannot invest in another QOF, so no Holdco QOFs holding QOFs.
• 90% of the QOF’s assets must be invested in Qualified Opportunity Zone Property (QOZP).
  – Referred to as the 90% Test
• QOF must engage in a Qualified Opportunity Zone Business directly or through a subsidiary corporation or partnership
Single Tier Structure

- The QOF can meet the 90% Test by directly owning Qualified Opportunity Zone Business Property (QOZBP)
Two Tier Structure

- The QOF can also meet the 90% Test by owning **Qualified Opportunity Zone Stock (OZStock)** or a **Qualified Opportunity Zone Partnership Interest (OZInterest)**, which are each defined as QOZP.

- Stock or a partnership interest will be OZStock or an OZInterest if:
  1. acquired by the QOF after 12/31/17 for cash;
  2. at time of acquisition, the issuer was a QOZB (or, if a new entity, was being organized for the purpose of being a QOZB); and
  3. during substantially all (>90%) of the QOF’s holding period for interest, the issuer qualified as a QOZB.
Two Tier Structure

• A Qualified Opportunity Zone Business (organized as a corporation or partnership) is a trade or business where:

  1. substantially all (>70%) tangible property owned or leased by the QOZB is QOZBP:
  2. at least 50% of QOZB’s gross income is derived from active conduct of the trade or business;
  3. a substantial portion (>40%) of QOZB’s intangible property is used in active conduct of the trade or business,
  4. less than 5% of QOZB’s property is financial property such as stock, debt, options, etc. (but QOZB can hold reasonable amounts of working capital); and
  5. which is not a specified “sin business”.

[Diagram of two-tier structure showing the relationships between OZInvestors, GP Entity, Qualified Opportunity Fund (LP), LPs, JVs, and Property.]
Qualified Opportunity Zone Business Issues

• Substantially all tests
  – The partnership or corporation must be a QOZB during “substantially all” of QOF’s holding period of the OZStock or OZInterest
    ▪ 90% Test in Proposed Regs
  – “Substantially all” of the tangible property owned or leased by the QOZB is QOZBP
    ▪ 70% Test in Proposed Regs – NB: not 90%

• No more than 5% of the QOZB’s assets can be nonqualified financial property, but the QOZB can have a reasonable amount of working capital
  – Regs allow 31 months to deploy working capital
  – Note this seems to apply to QOZBs but not QOFs
90% Asset Test

• The 90% Test is measured by the average percentage of QOZP held by the QOF:
  – On the last day of the first 6-month period of the QOF taxable year, and
  – On the last day of the taxable year of the QOF.
• BUT, first testing date is at earlier of (i) end of full 6 mos after entity certifies as a QOF or (ii) end of first year if QOF election made less than 6 mos before end of year
  – If a QOF certifies on October 1, 2019 and uses the calendar year as its taxable year, the first testing date is December 31, 2019
• Regs2 allows election to use financial statement or alternate cost basis valuation methodology for 90% Test purposes rather than forcing use of financial statements where QOF has these.
QOFs Must Self-Certify

- There is no explicit approval or action required by the IRS.
- Form 8996 that a QOF must complete and attach to its tax return was released in draft on October 18, 2018. Regs2 indicate the form will be revised to require additional information.
Related Parties

- QOF/QOZB must acquire property by purchase from an *unrelated* party.
- “Acquired” – cannot be a carryover basis transaction.
- The relationship threshold for entities is maximum 20% common ownership (changes rule from usual 50%).
- Regs2 provide that this does not apply to leased property.
Original Use

• The “original use” of the property held by the QOF or QOZB commences with the QOF/QOZB.
• How can you meet this test while your property is being constructed?
  – Regs provide 30 month window
• What about a change in use?
  – Not relevant
• Original use refers to first party to place asset in service
  – Therefore OK to acquire newly constructed property not yet in service
• Regs adopt a 5 year lookback relating to vacant property being “in use”
• Acquisition of land cannot ever meet the original use test
Existing Assets:
Substantial Improvement

• The QOF/QOZB “substantial improves” the property during any 30-month period.
• The test is met if “additions to basis with respect to the property” in the hands of QOF/QOZB exceed the adjusted basis of the property at the beginning of the 30-month period.
  – Land basis not used for testing
• Which 30-month period can you choose?
  – Does it start on project commencement or date of investment in QOF?
• What counts as an addition to basis?
  – Repairs versus Capital expenditures become critical
Sin Businesses Not Permitted

• Cross reference to IRC 144(c)(6)B:
  – private or commercial golf course
  – country club
  – massage parlor
  – hot tub facility
  – suntan facility
  – racetrack or other facility used for gambling
  – any store the principal business of which is the sale of alcoholic beverages for consumption off premises

• No mention of cannabis
  – Does this matter if illegal under federal law?
Regs Provide Many Answers

Inclusion/Exclusion Regimes

• Specific rules adopted to determine events or transactions that cause “inclusion” of deferred gain in income prior to 2026:
  – Sales (voluntary or deemed)
  – Gifts
  – S Corp and Partnership ownership changes and corp reorgs
  – Distributions by partnerships in excess of outside basis
• Testamentary Transfers and non-recognition entity transfers (i.e. 721) generally not inclusion events
• Exclusion benefit will survive for 20 years after 2027 expiration of the OZone regime
Regs Provide Many Answers

Partnership Issues

• Basis rules: inside/outside disparity in partnerships
• Allocation of debt under IRC 752
• Partnership level debt allocated to a partner does not create second class of interest but doesn’t create deferral
• Consequences of interim distributions to a QOF investor: generally OK to the extent of outside basis determined under normal Sub K rules
Regs Provide Many Answers

QOF Investments and Operations

• Ground-up construction OK
• Triple net leases generally not regarded as active, but otherwise real estate leasing OK’d
• Leased Assets
  – Ground leases OK
  – Prior use by lessor does not preclude QOF lessee from satisfying original use requirement
  – Leases with related parties OK if on arms length terms
    ▪ Cannot have non-FMV lessee purchase option
• Treatment of QOF gain on asset sales: exclusion applies
  – Unclear how this will apply to gain at QOZB level allocated to QOF
• Phase in for working capital held by QOFs expanded
• Combinations of assets straddling OZone and non-Ozone permitted
Regs Provide Many Answers
QOF Investments and Operations

• Operating Businesses
  – OZ income sourcing: Regs create safe harbor methodologies to determine 50% test compliance
    ▪ Hours of work performed in the OZ
    ▪ Compensation for services performed in the OZ
    ▪ Property located OZ and Management functions performed in OZ
    ▪ Facts and circumstances
  – OZ asset sourcing to satisfy the “substantially all” test (70%)
But Leave Some Questions

• 1231 netting and anti-cherry picking
• Carried Interests combined with capital investment
  – Effect of the “highest share of residual profits” rule
• Calculation of penalty and reasonable cause exception for QOF qualification
Comparing 1400Z-2 to 1031

• Deferral of Old Gain
  – 1400Z – temporary on at least 85%, possibly permanent on 15%
  – 1031 – temporary, unless basis step up at death

• Deferral of New Gain
  – 1400Z – exclusion after 10 years
  – 1031 – no exclusion, but deferral available

• Timing
  – 1400Z – no ID, 180 days to invest, cannot invest equity prior to gain realization but maybe convertible debt
  – 1031 – 45-day ID, 180 days to invest, potential for “reverse” exchanges where purchase precedes sale creating gain
Comparing 1400Z-2 to 1031

- **Entities**
  - 1400Z – Partnership/S corp gain can be deferred via entity investment or individual partner/shareholder investment. Special timing rules apply.
  - 1031 – Partnership/S corp gain can be deferred only by entity investment; must reorganize to get separate deferral treatment for partners/shareholders

- **Investment Amount to Obtain Full Deferral**
  - 1400Z – Only amount of Old Gain required
  - 1031 – Amount realized on sale required

- **Source of Investment**
  - 1400Z – any source; no tracing of Old Gain sale proceeds. Can be entirely borrowed.
  - 1031 – sale proceeds must be reinvested; constructive receipt rules apply
Comparing 1400Z-2 to 1031

• Type of Investment
  – 1400Z – must be interest in a QOF, not limited to real estate
  – 1031 – must be ownership of like-kind real estate

• Related Party Limits
  – 1400Z – Limits on sales/purchases involving related parties including entities where >20% common ownership involved
  – 1031 – Limits on exchanges between related parties including entities where >50% common ownership involved

• Triple Net Leased Property
  – 1400Z – generally will not qualify as QOF asset
  – 1031 – no limitation
Comparing 1400Z-2 to 1031

• Construction
  – 1400Z – developments must reach minimum target amount within 30 months after investment
  – 1031 – like-kind rules require qualifying improvements exist at time of acquisition

• Accessing Cash Through Refinancing
  – 1400Z – general 2-year post formation limit
  – 1031 – no specific limit

• State Law Conformity
  – 1400Z – work in progress: CA not conforming
  – 1031 – all states conform, with some deviations relating to out-of-state replacement property
Speaker Contact Info

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Thank you!

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There's nothing like the real estate industry in New York. And for Sonia Bain, conquering its unique and exciting challenges every day is what gets her out of bed in the morning. Sonia is a transactional commercial real estate lawyer who represents developers, retail companies, hotel groups, landlords and tenants, and family offices with acquisitions, dispositions, development, ground and space leases, financing and leasing of numerous types of commercial real estate assets including mixed-use, residential, retail, hotel and industrial properties in New York City and also across the country. Clients engage Sonia for her killer legal prowess, but they value her for her thoughtful guidance, counsel and partnership. Often coming to her to think through strategies and help them make decisions that are best for their business, Sonia is there for her clients for more than just their real estate legal needs.

Practices

Retail (Co-Leader)
Hospitality and Leisure
Real Estate
Real Estate
Real Estate Private Equity, Investments and REITs
Asset Management
Corporate Occupiers and Tenants

Admissions

New York, 1997
United States Court of Appeals for the Second Circuit
United States District Courts for the Eastern and Southern Districts of New York

Education
In addition to her legal and business advice, Sonia is also frequently sought-after as a speaker, moderator and panelist on topics relating to the real estate industry. Sonia also serves as a mentor to other women in the real estate industry. As co-chair of the WX Mentoring Committee which promotes and supports women in commercial real estate, Sonia is a passionate supporter of fostering the success of talented women entering careers in real estate.

Sonia is a natural team builder. She enjoys making introductions and connecting people in social as well as business settings. She excels at bringing together individuals from different focus areas with different skill sets and motivating them to feel vested not just in their specific roles but also in the client's end goal.

The bottom line - **Sonia is there for her clients from the ground up.**

### Civic Involvement & Honors

- *Bisnow* “New York Power Women” 2018 and 2019
- Named one of the “Top Women in Real Estate” by New York’s *Sokol Media*
- March of Dimes - Long Island Division - Honoree, 2011

### Professional Affiliations

- New York Bar Association
- WX – New York Women Executives in Real Estate (Officer - Vice President 2018-current; WX Inc. Board Director - 2017-current; Co-chair of Mentoring Committee - 2016-current; WX Charitable Fund Board - Director)
Representative Experience

- Counsel to Sephora USA, Inc. in connection with leasing its 650,000 square foot distribution center.

- Counsel to developer in ground lease and acquisition of multi-phase 700-room hotel and 195,000 square foot retail/entertainment center within 42nd Street Redevelopment project created by a public-benefit corporation of New York State. Lead counsel to nation’s largest national retailer in connection with all aspects of the acquisition, development and leasing of new stores and remodel and expansion of existing stores throughout New York City and State.

- Counsel to land owners in connection with their long term ground leases to developers for the development of large scale mixed use commercial project in the Hudson Yards district.

- Counsel to developer in acquisition and financing of $80MM assemblage of parcels in New York City with 1,000,000 square feet of leasing space.

- Represented one of the nation’s largest banks in the financing of a 55MW utility-scale solar facility (approximately $250MM in value) in New Mexico. The bank provided the construction financing and will provide the long-term financing.

- Counsel to national developer in the acquisition and financing of $131 million New York City residential tower, including conversion to residential condominium.

- Counsel to developer/purchaser in acquisitions, financing and joint venture of $86 million mixed-use building in New York City.

- Counsel to various retailers in connection with leasing and subleasing.

- Counsel to private equity group in their acquisition and financing of New York City hotel property.

- Acting as outside general counsel for a Manhattan coop board in connection with their acquisitions, sales and disposition of their real estate interest, including air-rights, retail unit and financing needs.
Publications


Speaking Engagements

- The Legal Executive Institute's Transforming Women's Leadership in the Law's (TWLL) Ask-a-Mentor session, June 20, 2019
- She Builds Brooklyn - Slaying Dragons in Brooklyn, Fordham University Real Estate Institute, May 17, 2019
- Increasing Diversity at Law Firms: The Role We All Play, New York Women Diversity & Change Summit, May 8, 2019

Events

Bain to Moderate Panel during ‘Real Estate Weekly’ Women’s Forum

Bain Moderates Real Estate Panel on the Hospitality Industry

New York Attorneys to Speak at YMBA Panel
Lillian A. Plata is a founding member of the law firm of Nee Plata Law LLC (NP Law). Ms. Plata specializes in the area of tax and structured finance. Ms. Plata has over 15 years of experience structuring and implementing complex financings having practiced at several prominent law firms in New York & New Jersey. Ms. Plata provides tax and structuring advice to corporations, partnerships, developers, non-profits and government entities on an array of complex transactions with a focus on Opportunity Zones, New Markets Tax Credits, syndicating Low Income Housing Tax Credits (LIHTCs) and Historic Tax Credits as well as other federal and local tax credit and incentive programs. She has been instrumental in advising clients on the best way to leverage both public and private sources of funding. Ms. Plata has also advised clients on structuring transactions under HUD’s Rental Assistance Demonstration program, utilizing Section 103 tax-exempt financing and LIHTCs. She has represented corporate entities and investment firms in various projects consisting of corporate acquisitions, infrastructure projects, redevelopment projects, construction of professional athletic facilities and negotiating intercreditor agreements and credit facilities.

Ms. Plata has coordinated with developers, issuers, underwriters, financial advisors and state and local government agencies to structure and implement these complex financings that have included taxable and Section 103 tax-exempt general obligation bonds/notes, mortgaged back securities, conventional and revenue financings with fixed rate, variable rate, auction rate and hybrid structures, as well as interest rate swap agreements and other derivative products. In addition, Ms. Plata regularly handles the firm’s tax matters including advising clients on all aspects of Section 103 tax-exempt financing and the formation of nonprofit organizations, corporations and partnerships.

Ms. Plata is also involved in various professional and community activities. She is currently on the Board of Directors of Don Pedro Development Corporation and the NJCC NMTC Advisory Committee. Ms. Plata is the former Vice Chair of the Neighborhood House Association, former Vice President of LUPE Fund, Inc. and was a Board of Director of Boys to Leaders Foundation. Ms. Plata was also Vice Chair of the Board of Trustees of Roseville Community Charter School, a member of the New Jersey Supreme Court Ethics Committee, District XII, and the Chair of Latinas United for Political Empowerment Political Action Committee and has served as a Region III Deputy Regional President of the Hispanic National Bar Association. In addition, she has served on the Board of Directors of the New Jersey Women Lawyers Association, and the Board of Trustees of the Tri-County Chapter of the American Red Cross.

Ms. Plata received her Master of Laws in Taxation from New York School of Law in 2014, her Juris Doctorate from Rutgers University School of Law – Newark in 2002 and her B.A. degree in English from Drew University in 1999. Ms. Plata is admitted to practice law in the State of New Jersey, State of New York and the District of Columbia.
Lou Weller is Managing Partner of Weller Partners, LLP, a boutique law firm focusing on income tax planning for real estate transactions. He was formerly a principal in Deloitte Tax, LLP, where he served as National Director of Real Estate Transactions Tax Planning group and leader of Deloitte’s Like-Kind Exchanges practice. Lou has extensive experience designing and implementing strategies for business start-ups, limited liability companies, partnership and joint venture formations, real estate acquisitions, transfers, exchanges, leases, development projects, financing and work-outs. He is a frequent speaker in the fields of tax, business law and real estate, is author of many articles relating to these subjects and is co-author of the treatise, *Real Property Exchanges, 3rd Edition*. Lou serves as Real Estate department editor of the Journal of Taxation and consults with the Internal Revenue Service and the Department of the Treasury on Section 1031 matters. He is a past Chair of the Real Estate Committee, American Bar Association Taxation Section, the Bar Association of San Francisco Taxation Section, the San Francisco Tax Club and of the Federal Taxation of Real Estate Transactions Committee, American Bar Association Real Property, Probate and Trust Section. Lou is also an elected Fellow of the American College of Tax Counsel and is active in various professional and civic organizations. He received a B.A. *cum laude* in Political Science from Yale University and joint J.D.-Masters in Public Policy degrees from the University of California, Berkeley. He is admitted to practice in the State of California.