

REAL ESTATE - AN ATTRACTIVE INVESTMENT FOR OZ FUNDS UNDER NEW PROPOSED REGULATIONS

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Real Estate Alert

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The Tax Cuts and Jobs Act (the "Act") created a significant new tax incentive for taxpayers that invest capital gains in Qualified Opportunity Funds (each a "QOF" and collectively, "QOFs"). Investors can defer paying tax on the capital gains until 2026, receive up to a 15% increase in basis on those gains, and avoid paying federal taxes altogether on the investment in a QOF if held at least 10 years. The intent of this new benefit is to promote economic development and job creation in low-income communities nationwide through QOF investments in Qualified Opportunity Zones (each a "QOZ" and collectively "QOZs"). QOZs are low-income census tracts nominated by governors and designated by the Secretary of the Treasury. For additional details about the basics of the OZ incentive, [see our previous alert](#).

The Department of Treasury (the "Treasury") released long anticipated proposed regulations (the "Proposed Regulations") and the Internal Revenue Service ("IRS") released Revenue Ruling 2018–29 (the "Revenue Ruling") on October 19, 2018, providing needed guidance to help instruct investors with respect to their investments in a QOF. These Proposed Regulations may be used for OZ transactions if applied consistently, even before final regulations are issued.

BIGGEST SPUR TO REAL ESTATE DEVELOPMENT SINCE NEW MARKETS TAX CREDIT

While the QOZ incentive benefits many industries, it has set the stage to be one of the largest initiatives to spur real estate development since the New Markets Tax Credit (the "NMTC") program was established in 2000. The Treasury has designated over 8,700 census tracts, approximately ten percent of all U.S. census tracts, as QOZs. Based on the scope and benefits of the QOZ incentive, and the estimated \$6 trillion in unrealized capital gains resting in the markets, Treasury Secretary Mnuchin has predicted that more than \$100 billion in investments will be made in QOZs. Funds from appreciated assets outside the QOZs now may be moved to development projects inside the QOZs. Many of these QOZs already attract real estate investments due to their high potential for appreciation in value. The ability for investors to place their capital gains in areas that are significantly likely to appreciate in value is a double benefit when combined with the capital gain deferral or exclusion. Other QOZ investments may present higher risk and the incentive may make real estate investments in those QOZ that were previously seen as marginal to now become economically attractive.

WHAT REAL ESTATE PROJECTS QUALIFY FOR OZ BENEFITS?

In order for a QOZ project to qualify, the QOF or the entity through which the QOF invests, a QOZ business, must be engaged in an active trade or business. Real estate projects operating as a trade or business that may benefit from the QOZ program include offices, hotels, residential real property, manufacturing, hospitals, schools, flex spaces, mixed use, retail, and industrial projects. Mission-driven real estate projects that may qualify include investments in facilities such as charter schools, educational institutions, medical clinics, day care centers, and affordable housing projects. Certain types of "sin" businesses, including golf courses, racetracks, gaming facilities, and establishments selling alcohol for off-premise use do not qualify.

HOW DOES QOZ COMPARE TO LIKE-KIND EXCHANGES?

The QOZ program provides more flexibility and can be more expansive than the like-kind exchange program under section 1031 of the Internal Revenue Code. For example, the investments do not have to be "like-kind." Capital gains from the sale of stock can be invested in a real estate project. Like-kind exchange gains are only deferred, while capital gains from an investment in a QOF held at least 10 years completely escape federal income tax. Further, only capital gains from a transaction must be invested in a QOF compared to the entire proceeds in the case of a like-kind exchange.

CAN FOREIGN INVESTORS IN US REAL ESTATE BENEFIT FROM QOZ?

The QOZ program also provides foreign investors in U.S. real estate with a new exit strategy. Structured properly, foreign investors can sell their U.S. QOF investment that is held for at least ten years without having to pay federal income taxes on the appreciation in the QOF investment. Taxes on the original capital gain investment must be paid no later than tax year 2026.

HOW DOES QOZ APPLY TO REAL ESTATE PROJECTS?

Real estate projects are well-suited to obtain QOZ benefits. Individuals, businesses, and entities, including pass-through entities, first invest capital gains in a QOF formed to invest in QOZ property, like real estate projects. These projects could be new construction or rehabilitation of existing structures. The QOF then invests the capital directly into tangible property, or into an operating business holding tangible property, located in a QOZ. These projects could be placed on vacant land, or an existing building and land.

90% Test and QOZ Property

QOFs must invest at least 90 % of their assets in QOZ property. QOZ property is either direct ownership of tangible property (QOZ business property) acquired by a trade or business of the QOF, or an equity interest held by the QOF in a QOZ business where "substantially all" of the tangible property which is owned or leased is QOZ business property. Buildings, land, machinery and equipment, and other tangible property are examples of QOZ business property. QOZ business property must be acquired by the QOF or the QOZ business after 12/31/2017, the original use of the property in the QOZ begins with the QOF or the QOF must substantially improve the property, and substantially all the use of the property must be in the QOZ.

70% Test and QOZ Business Tangible Property

For tangible property owned or leased by a QOZ business, the Proposed Regulations provide that "substantially all" means at least 70 %. As 90 % of a QOF's assets must be QOZ property, yet only 70 % of the tangible property of a QOZ business must be QOZ business property, this means that only 63 % of a QOF's assets must be held in QOZ property. This has significant practical impact for real estate development. Up to 37% of a QOF's assets could be nonqualifying property, considerably expanding the locations and characteristics of property that can be held by a QOF investing in real estate. For example, the QOZ business could hold real estate both inside and outside of the OZ, or property acquired prior to December 31, 2017.

ISSUES TO CONSIDER WHEN ENGAGING IN A QOZ REAL ESTATE PROJECT

Real estate investors considering OZ real estate projects will need to consider a variety of issues, including the following: 1) who the investors in the QOF are; 2) what form of entity the QOF will use; 3) what the investors will receive for their investment in the QOF; 4) what the end use of the real estate project is; 5) if it is a large project, with many parcels or phases, how many QOFs will be used; 6) if the building is already in existence, what is the cost of the proposed rehabilitation is; 7) if other funds are required, how they will be obtained and from what sources; 8) how long the property is anticipated to be held; and 9) what the exit strategy is.

ISSUES PERTINENT TO REAL ESTATE QOF IN THE PROPOSED REGULATIONS

For issues pertinent to QOF investing in real estate addressed by the Proposed Regulations and the Revenue Ruling, see below and Alert: Opportunity Zone Proposed Regulations Provide the Certainty Anxious Investors, Developers, and Entrepreneurs Have Been Seeking.

Only Capital Gains Can Be Deferred - Only capital gains invested in a QOF qualify for OZ tax benefits. The capital gain must be a gain that would be recognized, if the deferral was not permitted, by December 31, 2026. The capital gain must arise from a sale or exchange with an unrelated person using a less than 20-percent common ownership test. Non-capital gains may be invested in a QOF, but they do not qualify for OZ benefits. While debt is not an eligible interest in a QOF to qualify for QOZ tax benefits, preferred stock and a partnership interest with special allocations are allowed. The eligible interest can also serve as collateral for a loan, whether it is a purchase-money borrowing or otherwise. **Eligible Taxpayers That Qualify for OZ Incentives** – Individuals; C- and S-corporations, including Regulated Investment Companies ("RICs") and Real Estate Investment Trusts ("REITs"); partnerships; and other pass-through entities, including common trust funds, qualified settlement funds, and other entities taxable under Section 1.468B of the Treasury Regulations qualify for OZ incentives. **Timing of Investment in the QOF** – In general, eligible taxpayers must invest in the QOF during the 180-day period beginning on the date of the sale or exchange that created the capital gain. A partner in a partnership has an extended period of time to reinvest the gain into the QOF, with the 180-day period beginning on the last day of the partnership's taxable year in which the gain was recognized. A reinvestment of the original interest also qualifies if the taxpayer sells the entire initial investment, allowing the taxpayer to continue to defer the previously

deferred gain. **How Is the Deferral Election Made?** – It is anticipated that Form 8949 will be used for deferral elections, to be attached to the federal income tax return for the taxable year in which the gain would have been recognized if it had not been deferred. An updated Form 8949 is anticipated to be released in the near future. OZ benefits are available only if a proper deferral election is made. **QOF Entity** – The QOF must be an entity classified as a corporation or a partnership for federal income tax purposes. It must be created or organized in one of the fifty states, the District of Columbia, or a U.S. possession. A limited liability company can be classified as a corporation or partnership for tax purposes. A preexisting entity also can qualify as a QOF if it meets all OZ requirements, including that it was formed for the purpose of investing in QOZ property. **Self-Certification of QOF** – QOFs self-certify to the Treasury that they meet requirements to comply with the OZ incentives by completing and attaching a form to the QOF's federal income tax return for the taxable year (the return must be filed timely, taking extensions into account). It is expected that QOFs will use Form 8996 for the initial self-certification and for annual reporting of compliance with the 90% asset test. It is expected that this streamlined process will eliminate long processing delays and encourage widespread use to enable private capital to seamlessly flow to real estate investments in low-income communities. This is consistent with the intent of the Act. **The 90% Asset Test** – A QOF must hold at least 90% of its assets in QOZ property or face a potential penalty. In response to concerns that a QOF may not be ready to invest 90% of capital received from investors required to meet the 180 investment period, the Proposed Regulations include a working capital safe harbor for QOZ businesses involved in the acquisition, construction, or rehabilitation of tangible property. This safe harbor allows these businesses to hold reasonable amounts of working capital, including cash, cash equivalents, and certain debt instruments, for up to 31 months if the businesses have a written plan and schedule to use the funds and comply with that plan. **Valuation Method for the 90% Test** – The QOF must use the asset value set forth on certain qualifying financial statements to determine whether the 90% test has been met. If there are no such qualifying financial statements, the cost of the assets must be used.

IN CONCLUSION

The Treasury and the IRS are seeking comments through December 28, 2018 on the Proposed Regulations. Additional proposed regulations are expected to be published in the near future. The forthcoming round of guidance is expected to address issues such as the meaning of "substantially all" as the term appears throughout the statute, administrative rules for the 90% test, how long QOFs have to reinvest proceeds from the sale of property and businesses without triggering a penalty, and information-reporting requirements. Other important questions that remain to be answered include: 1) what the trigger is for the commencement of the 30-month period in relation to the substantial improvement test; 2) if exit events will need to be structured at a QOF level (rather than the project level); and 3) how the acquisition of properties that were abandoned will be treated for the original use requirement. While such questions are still not answered, the Proposed Regulations clarify many of the questions relating to real estate investments by a QOF that investors and developers have raised over the last several months.

Our K&L Gates cross-practice OZ team is prepared to help clients understand and implement the OZ program and maximize its benefits, and provide input to the Treasury and Capitol Hill. We invite you to contact us if you need assistance.

KEY CONTACTS



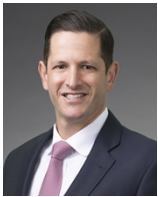
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