

IN THE ZONE:

A Comprehensive Opportunity Zone Outlook for 2021

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Jay Darby's Tax Briefings

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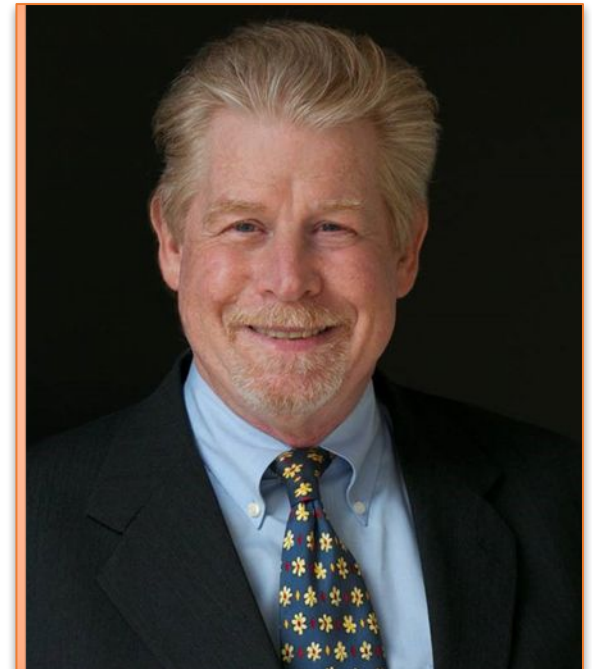


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- **Joseph (Jay) B. Darby III, Esq.**, has more than 30 years of experience in a wide range of estate planning, tax, and related business matters.
- His expertise in Opportunity Zones includes the following accomplishments:
 - Recognition as a “Top 25 Attorney” in the OZ field (named by *Opportunity Zone Expo Magazine* in 2019 and 2020)
 - A featured speaker at more than 25 national conferences on structuring Qualified Opportunity Funds and Qualified Opportunity Zone Businesses
 - An adjunct professor at Boston University Law School, teaching a graduate-level course on Opportunity Zones
 - Legal advisor for more than 50 successful QOFs, ranging from small private transactions to \$300–500 million funds

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PANEL OF EXPERTS

- Jill Homan is President of Javelin- 19, Inc. a DC-based real estate investment, development and advisory firm and a leader in the Opportunity Zone industry. Jill is a prominent voice in the OZ industry and was active in shaping OZ Regulations and subsequent guidance to make it more viable.
- Blake Christian – Senior Tax Partner at Holthouse, Carlin & Van Trigt LLP and head of the firm's Opportunity Zone Practice Group, Blake is one of the national leader's in tax and business planning for structuring OZ investments and businesses.
- Gerald Reihsen III is the founding partner of Reihsen and Associates and of Coasis Coalition, and has been actively involved both as an attorney and as a financial advisor in developing successful OZ businesses.

A. Tax Incentives in the Land of OZ

- **Opportunity Zones (“OZs”)** were added to the Internal Revenue Code by the so-called **Tax Cuts and Jobs Act** in December 2017 (the “**2017 Tax Act**”) – and immediately became part of the American tax vernacular.
- In the Internal Revenue Code (“Code”) the OZ provisions are given the very peculiarly numbered §§ **1400Z-1 and 1400Z-2**. For convenience, these provisions are referred to in this presentation as the “**OZ Act**.”
- These new Code provisions are a **BIG DEAL**. What they create is an **entirely legal (in fact, actively encouraged) form of tax-favored investment – i.e., a “tax shelter” in common parlance – that comes with full IRS approval.**
- **Literally *everyone* can benefit** from this special tax opportunity.

A. Tax Incentives in the Land of OZ

- The OZ Act encourages US taxpayers with existing “capital gains” to redeploy that capital into designated low-income areas (“Qualified Opportunity Zones”) by offering three specific tax incentives for eligible investments.
- Rather awkwardly, these OZ tax incentives are currently extended *only* to qualifying reinvestments of capital gain.
- A taxpayer can also invest other (non-gain) funds but these will *not* enjoy the tax benefits accorded to “gain” under the OZ Act.
- Comment: Legislative proposals before Congress in June 2020 would modify this rule but it is not clear the change will be enacted.

A. Tax Incentives in the Land of OZ

The OZ Act offers three specific tax incentives to an investor:

- Incentive 1 - Deferral : Capital gain that is timely invested into a Qualified Opportunity Fund (QOF) is deferred until the earlier of the 1) date that the taxpayer sells or otherwise terminates its interest in the QOF (Inclusion Event) or 2) 12/31/2026.
- Incentive 2 - Basis Adjustments: If the taxpayer invests in the QOF for at least 5 years, the outside tax basis is increased by 10% of the original gain; if the investment lasts for at least 7 years (no longer possible in 2020), an additional 5% (for a total of 15%) of the original gain is added to outside tax. This added basis reduces the gain recognized when deferral ends.
- Incentive 3 - Appreciation Exclusion: Best of all, if taxpayer's investment in the QOF is held for at least 10 years, basis in the QOF is increased to FMV on sale and gain is eliminated.

A. Tax Incentives in the Land of OZ

- Note that **Incentive 3** is by far the **most impressive** and **potentially valuable** tax benefit.
- It **applies to all appreciation** that occurs with respect to the QOF investment but does **NOT** apply to the original deferred gain, which gain will be **recognized** no later than **December 31, 2026** under **Incentive 1** noted above, **reduced (slightly)** by the **tax basis adjustment** under **Incentive 2**.
- Because the **tax basis adjustment** to fair market value under **Incentive 3 is elective**, a taxpayer **selling at a loss** can simply choose **NOT to make the election** and thus **claim the full loss** under the usual rules.
- **NOTE:** **Incentive 3** is like a **super-charged Code Section 1014** and **could become MORE important** if Section 1014 is gone.

A. Tax Incentives in the Land of OZ

D. How do the Tax Benefits Work?

- The following **highly simplified examples** illustrate the tax benefits of investing in a QOF. This example assumes that deferred gain is \$100 and that appreciation in the QOF investment is also \$100 – note that it is **NOT** the same \$100 of gain:
 - Example 1. *Investment in Fund is Held for 10 Years and Sold in 2028*

<u>Opportunity Zone Investment Held for at Least 10 Years</u>		<u>Ordinary Investment</u>		<u>Difference</u>
Deferred Gain (taxed in 2026)	\$100.00	Gain (taxed in 2018)	\$100.00	
Basis Step-Up	\$15.00	Basis Step-Up	\$0.00	
<u>Taxable Gain</u>	<u>\$85.00</u>	<u>Taxable Gain</u>	<u>\$100.00</u>	
Tax (at 23.8%)	\$20.23	Tax (at 23.8%)	\$23.80	\$3.57
Gain on Disposition of Investment in Fund	\$100.00	Gain on Investment	\$100.00	
Basis Step-Up	\$100.00	Basis Step-Up	\$0.00	
<u>Taxable Gain on Disposition of Investment in Fund</u>	<u>\$0.00</u>	<u>Taxable Gain</u>	<u>\$100.00</u>	
Tax (at 23.8%)	\$0.00	Tax (at 23.8%)	\$23.80	\$23.80
				\$27.37 TOTAL

A. Tax Incentives in the Land of OZ

- The first incentive, deferral of tax to 2026, is very hard to value at the moment thanks to ELECTION UNCERTAINTY -- -- to quantify it accurately requires a MUCH larger spreadsheet, some 2026 tax rates (who knows?) and a present value computation to illustrate the true economic value.
- The fear of higher tax rates in 2026 means the first OZ incentive may have a negative value!
- The Presenter has looked at whether it is possible to elect out of deferral (Incentive 1) and still enjoy Incentives 2 and 3 – but so far there are no promising strategies.
- The tax basis adjustments of 10% and 5% can be more complicated than a simple basis adjustment – the added tax basis may free up losses or allow tax-free distributions of cash following the adjustment date.

A. Tax Incentives in the Land of OZ

- Subject to ELECTION UNCERTAINTY, the conventional analysis has been that is a “typical” real estate investment with a conventional projected market rate of return will enjoy an after-tax yield enhancement of 300-400 basis points per year.
- Very early on a sophisticated real estate developer commented that in a typical real estate development project the developer will “scratch and claw” to get an extra 25 basis points, and that a 50-basis point enhancement was a huge accomplishment.
- That developer said that improving the yield by 300 to 400 basis points under the OZ Act was like arriving in real estate developer nirvana.

A. Tax Incentives in the Land of OZ

- However, the salient observation is that **Incentive 3 is valuable ONLY if the investment is successful.**
- The truism is that OZ incentives make a **good investment into a great investment, and a great investment into a fabulous investment, but they do not make a bad investment into a good investment.**
- Smart investors taught me early on to ask for financial projections that did not include OZ tax incentives. If the **transaction made sense economically**, then the incentives would **make it better**, but if it **did not make economic and financial sense on its own** then the **tax incentives didn't matter.**
- **OZ Act is the frosting, not the cake!**

B. The Lay of the Land in the Land of Oz

- Although the OZ tax incentives are intriguing, the **OZ Act can be astonishingly complicated**, with many strange, exotic and unprecedented concepts.
- A taxpayer can **invest “only” capital gain and not merely “cash.”**
- The eligible gain must be **“capital gain”** but this includes **unrecaptured Section 1250 gain, collectibles gain**, and also includes so-called **“Section 1231 gain.”**
- During **2019 the Proposed Regulations** provided **strangely different timing rules** depending on the type of gain.
- **Taxpayers can choose** whether to apply the **Proposed Regulations** or the **Final Regulations in 2018 and 2019.**

B. The Lay of the Land in the Land of Oz

- A taxpayer must invest this eligible gain within 180 days of recognition into a QOF. The 180-day rule is surprisingly complicated (in a good way) for partnerships recognizing gain.
- Installment sales the 180 days is measured from the date the gain is recognized under Code Section 453, so there is an ability to structure gains to meet OZ Act timing objectives.
- Qualified Opportunity Fund may accept investments that are “mixed funds,” i.e., where only a portion of the investments into the Fund are eligible for the election to exclude taxable gain.
- The OZ tax benefits apply only to the gain invested in the Fund, and a direct investment of money (meaning an investment that is not related to a timely rollover of gain) will enjoy economic benefits but NONE of the OZ tax benefits.

B. The Lay of the Land in the Land of Oz

- The Author makes the observation that “the Land of OZ is zoned for two stories.”
- This means that almost every investment will be structured with a QOF on top (where taxpayers invest capital gain) and a Qualified Opportunity Zone Business (“QOZB”) on the bottom, where the qualified business is operated.
- It is possible – but very difficult – to operate a “one story” arrangement where the QOF accepts invested gain and then operates the business.
- The challenge is that a QOF operating a business must meet the 90% Investment Standard – meaning 90% of its assets are tangible property– and few modern businesses have 90% tangible property (and no more than ten percent other assets).

B. The Lay of the Land in the Land of Oz

- Investors will generally want to invest gain in a QOF, hold the investment for at least ten years, and then sell or liquidate the investment.
- Note that the tax benefits of gain exclusion can continue for up to 30 years, until December 31, 2047!
- Thanks to the Final Regulations, the tax-advantaged sale of a QOF can be implemented flexibly, including through sales of property owned directly or indirectly by a QOF structured as a partnership or S corporation, where the sale occurs after the ten-year holding period is met.
- This 10-year waiting period leads to the “convoy” problem – the QOF must wait until the last investor reaches a ten-year holding period so everyone can enjoy the OZ tax benefits.

B. The Lay of the Land in the Land of Oz

- There are various (relatively tight) **deadlines within which money must be moved** from the taxpayer to the QOF, then by the QOF to a Qualified Opportunity Zone Business (QOZB), and then expended by the QOZB. (The Author uses the “**fresh produce**” analogy).
- The goal of the **OZ Act is to push money into investments** as promptly as possible. But **investors** by nature, instinct and experience are **cautious and don't like to be rushed**.
- Therefore, one of the **key lawyering skills** – and **one that continues** to the present day – is **advising clients** on how to “**kick the can down the road**,” namely, **delaying final investment decisions** and spending commitments for **as long as possible**.

B. The Lay of the Land in the Land of Oz

- Thanks to various **alternative** (and **sometimes anomalous**) **timing rules**, it has been **relatively easy to buy** (at least some) **extra time**, especially with time extensions granted by Notice 2020-39 related to the COVID Emergency.
- Example: Taxpayer A sells property to an unrelated person on December 31 2018, and takes back an installment note due in three days, on January 3, 2019. The 180-day period is then satisfied by investing the gain in a QOF on July 1, 2019. Money invested in the six-month test period from 7/1/19 - 12/31/19 is not subject to the 90-Percent Investment Standard until the next period, so the first testing period ends on June 30, 2020.

B. The Lay of the Land in the Land of Oz

- In turn, the COVID Emergency Relief under Notice 2020-39 waives penalties through December 31, 2020, so the investment date is now stretched to January 2021.
- In turn, an **investment into a QOZB** on January 1, 2021 is **eligible for the 31-Month Working Capital Safe Harbor** – which, in turn, is stretched to up to 55 months by Notice 2020-39.
- Thus, while the written plan is required to be “consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets,” the **gain recognized in 2018** may in theory be expended as late as **July 31, 2025**.
- That is a **lot of refrigeration time**! NOTE: In the Land of Oz it is STILL 2019! Notice 2020-39 extends reinvestment period if 180 days ends on or after 4/1/2020 to December 31, 2020.

B. The Lay of the Land in the Land of Oz

- Investments in a QOF initially have **zero outside tax basis but full inside tax basis**, until outside basis adjustments occur.
- **Basis adjustments** at **five and seven years** can be used to make **tax-free distributions** and/or **allocate losses** that are otherwise suspended because of zero outside tax basis.
- Another way to solve the **zero outside tax basis issue** (while waiting for outside basis adjustments, including 12/31/26) is to incur partnership debt allocated to the investors under Code Section 752.
- In general, the **interface** of the **OZ Act** with the **rest of the Code** is **uneasy at best**, and in a few situations is stunningly complex. (The **Accountant Full Employment Act**.)

B. The Lay of the Land in the Land of Oz

- Taxpayers must make investments in businesses located in an OZ, must meet various operating criteria designed to make the business operations “Zone centric” and must satisfy restrictions that may – or may not -- make economic sense (but for the OZ tax incentives).
- Although a QOF, in theory, can operate a qualifying business in an OZ, practical constraints generally require that the QOF, in turn, invest into a QOZB that actually operates the business.

B. The Lay of the Land in the Land of Oz

- The best **exit strategies** generally require holding the QOF investment for a **minimum of ten years**. If a **QOF accepts investments over time**, a sale of the QOF (or its underlying assets) will **need to wait for the last investor** to reach the **ten-year mark**. (This is referred to as the **“convoy” problem**.)
- The **QOF** is sometimes referred to by the Author as the **“AIV”** standing for **Awkward Investment Vehicle**. Various operating rules make it **very different** from a **“typical” investment fund**.
- Although not impossible, it is **generally difficult to structure a QOF to make multiple investments** over a period of years. The **“convoy” problem** means that the last investor in the QOF drives the timing of the exit strategy.

B. The Lay of the Land in the Land of Oz

- The QOF can accept contributions of non-cash property, but it **can only invest cash into a QOZB** in exchange for **newly issued equity** of the QOZB.
- The QOZB can be a corporation (either S or C corporation) issuing stock or a partnership issuing partnership interests (including an LLC taxed as a partnership). **No SMLLCs allowed!**
- **QOZBs**, in turn, have **specific, somewhat stringent, and often awkward** operating requirements.
- One of these is that the **QOZB** must have **less than 5%** of its assets held in “**non-qualified financial property**” or **NQFP** -- which would include equity in another regarded business entity. Hence the statement that the **Land of OZ is zoned for two stories** – a one-story “ranch” house is tough to operate and three stories is prohibited.

B. The Lay of the Land in the Land of Oz

- Although these rules are complicated and continue to evolve, the tax incentives have attracted lots of attention, and OZ transactions are moving forward at an increasingly brisk pace.
- Who can potentially benefit from this new tax incentive? Literally every person who pays US tax on capital gain.
- Meanwhile, businesses seeking to raise capital for businesses located in opportunity zones can offer deferral/reduction of current gain plus enhanced tax-free returns on long-term (more than ten year) investments.
- On the other hand, it is not made for “quick hits” or “flipping” of property. People looking for a fast turn around of capital are not generally drawn to the OZ Act.

B. The Lay of the Land in the Land of Oz

- Projects that work well in an OZ:
 - › Building new commercial or residential real estate to be owned and leased as a long-term hold of at least ten years.
 - › Buying and “substantially improving” (i.e., at least doubling the investment in improvements) existing real estate
 - › Creating a new business in the OZ by leasing space and then funding and building the business with invested funds.
 - › Buying and moving an existing business into an OZ will generally work as well. Moving an existing business is also doable with careful structuring.
 - › Buying an existing business in an OZ generally does NOT work unless you can do a “substantial improvement” to the business. However, this is possible in some cases.

B. The Lay of the Land in the Land of Oz

- Real estate is at the heart of OZ development, but it may not be the best way to leverage the incentives.
- The “ideal” investment would be a start-up company with outstanding upside – an Apple, a Netflix, a Google – and then ride the investment for at least ten years and enjoy a tax-free exit that provides tremendous leverage in the tax savings.
- But real estate may be the surest way to achieve a strong, secure upside.
- As noted above, the tax incentives for good real estate transactions have been estimated to add 300 to 400 basis points to the after-tax annual return. THAT IS A BIG DEAL.

B. The Lay of the Land in the Land of Oz

- IN SUMMARY, the OZ Act is in the process of achieving its intended purpose, which is to promote economic investment and growth in designated low-income areas. However, the OZ Act is very awkward and cumbersome because
 - 1) it is trying to move money relatively quickly in order to get businesses up and operating;
 - 2) it imposes operating rules on eligible businesses that are “Zone centric” and not always practical or efficient;
 - 3) it requires a minimum 10-year investment commitment, which is not always attractive; and
 - 4) it often requires trusting the skills of the local business entrepreneur, which is always a constraint in investing in a “local” business operation.

B. The Lay of the Land in the Land of Oz

- Ultimately, the OZ tax incentives by themselves will not make a project automatically successful -- OZ incentives make a good deal into a great deal, and a great deal into a fabulous deal, but they do not turn a bad deal into a good deal.
- The savvy investors approach an OZ investment by ignoring entirely the special tax benefits and looking at the investment as if it were outside the OZ. If it makes sense in that context, then it is investable.
- In short, the OZ tax incentives are the frosting but they are not the cake. On the other hand, if the investment has enough cake, they do add a LOT of frosting.

C. What is an Opportunity Zone?

- An Opportunity Zone is a United States census tract that qualifies as a “low-income community” under specified income criteria and that was nominated by the governor of each state (or by the mayor of Washington DC) and then certified by the US Treasury.
- Governors were allowed to nominate no more than 25% of their eligible low-income census tracts and no more than 5% of the eligible contiguous census tracts to be Opportunity Zones.
- The nomination process took place in the spring 2018, and the nominated census tracts were then “certified” by the IRS. It appears that the IRS certified all census tracts nominated. There are today over 8700 Qualified Opportunity Zones (QOZs) throughout the US.

C. What is an Opportunity Zone?

- The **nomination process happened quickly** and without as much attention as it might have received normally – thus, there was **less political lobbying than might otherwise have occurred**.
- **Census tracts are not a familiar** geographic unit or region to anyone (**except maybe a census taker**). Fortunately, a **map showing all the Opportunity Zones is available online**.
- This link is to the information page provided by the Treasury Department:
 - <https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx>.
- For a map of Massachusetts zones, go to mass.gov/service-details/opportunity-zone-map

C. What is an Opportunity Zone?

- An interesting – and **controversial** – statement that quickly **made the rounds** was that “**Not all Opportunity Zones are created equal.**”
- Some **designated zones** around the country have **drawn particular criticism**: e.g., Palo Alto, CA, and a number of other university towns.
- In Massachusetts, eligible OZs include:
 - › the Alewife area of Cambridge
 - › the Assembly Square area of Somerville
 - › Provincetown.

C. What is an Opportunity Zone?

- That said, the **2019 Menino Survey of Mayors**, conducted by **Boston University**, found the following:
- **Nearly three-quarters of America's mayors** are **happy with the opportunity zones** selected in their cities, despite criticism by some that the program will ultimately benefit wealthy developers over communities in need.
- **Six in 10 mayors** believe the program will have a **large and positive impact on their city's economy**, while **less than a quarter** say it will lead to **gentrification and residential displacement**.
- The full report can be found at:
<https://www.bu.edu/ioc/2020/01/21/2019-menino-survey-of-mayors/>

D. A Brief History of the OZ Act

- The OZ Act as drafted is relatively short (either six- or nine-pages, depending on how it was printed), but it spawned immediate implementation challenges, including interpretive uncertainty, immense complexity, and and immediately obvious (especially to the IRS) potential for abuse.
- Over the next two years and a half years Treasury and IRS struggled to implement the law, issuing FAQs, Revenue Rulings, two lengthy sets of Proposed Regulations, and culminating in a set of Final Regulations that was 542 pages long – followed by further detailed Technical Corrections.

D. Eligible Gain

- A taxpayer must recognize eligible “capital gain” from a sale or exchange of property with an “unrelated” person.
- The “related party” test relies on the familiar provisions of Code Sections 267 and 707 but substitutes 20% for 50% and thus is a very low threshold.
- Eligible gain includes Section 1231 gain, unrecaptured 1250 gain, and collectibles gain. The gain can be long-term or short-term.
- Gain must be invested into a Qualified Opportunity Fund (QOF) within 180 days.
- The “180 day” requirement is SURPRISINGLY flexible -- and complicated – but this is a good thing.

E. The QOF

- A QOF must be either a corporation or partnership that is organized for the purpose of investing in “qualified opportunity zone property” (but specifically excluding investment into another QOF) and that holds at least 90% of its assets in such qualified property (the “90-Percent Investment Standard”), as determined by averaging the ownership percentages at the mid-point and last day of the QOF’s taxable year.
- The IRS has confirmed that an LLC can function as a QOF so long as it is characterized as either a corporation or partnership for federal income tax purposes. No SMLLCs allowed.
- QOFs that fail to achieve the required minimum investment objectives under the 90-Percent Investment Standard are subject to a penalty, but not disqualified from QOF status.

E. The QOF

- An investment in a QOF can be made by contributing money or other property.
- Note that the QOF MUST in turn invest solely money into a QOZB in exchange for a newly issued equity interest (Qualified Opportunity Zone Stock or Qualified Opportunity Zone Partnership Interest, as discussed below) and so a property contribution rather than a cash contribution at the QOF level is somewhat unusual.
- For property, the eligible investment amount equals the lesser of the tax basis in the property contributed or its FMV. If the value is in excess of the tax basis, such excess is considered non-eligible investment and results in a “mixed fund.”

E. The QOF

- An **investment in a QOF** can also be made by purchasing an eligible interest from a person other than a QOF.
- **This is a remarkable** arrangement expressly permitted under the Final Regulations.
- **The purchasing taxpayer must meet all the requirements** to make a valid deferral election, including, for example, having eligible capital gain within the 180-day period prior to the acquisition of the eligible interest.

E. The QOF

- A QOF can invest in a wide variety of eligible investments, so long as the investment is in “Qualified Opportunity Zone Property” or “QOZP”.
- Eligible investments include property which is:
 - Qualified Opportunity Zone Stock
 - Qualified Opportunity Zone Partnership Interest
 - Qualified Opportunity Zone Business Property
- As a practical matter, while a QOF can, in theory, own property directly and operate a business, the 90-Percent Investment Standard would generally make this a very awkward operating structure.

E. The QOF

- A QOF can accept as much investment money as it wants (or as little as it wants) whenever it wants, but the money must then be invested timely to satisfy the 90-Percent Investment Standard.
- Managing the timing of money flowing into, and then immediately out of, the QOF is a central issue in structuring and operating a QOF successfully.
- Again, the analogy used by the Author is that invested funds are like “fresh produce” and, while there are refrigeration points along the way, once the “gain” has been “harvested” the produce has to get to market timely.

E. The QOF

- As a practical matter, it is challenging to operate a Qualified Opportunity Fund as a general investment fund where additional partners are added and additional investments are made over time.
- The more functional structure is to set up a QOF as a “single purpose” or “single investment” fund for the specific purpose of investing in a specific qualifying investment.

F. The QOZB

- A QOZB has five relatively detailed operating requirements that must be met and that generally connect the QOZB to the related Opportunity Zone. These include:
 1. Substantially all (70%) of the tangible property must be QOZBP (tangible property acquired or leased for use in the Zone);
 2. More than 50% of the gross income must be sourced to the Zone;
 3. A “substantial” (meaning 40%) portion of the intangible property must be used in the Zone;
 4. Less than 5 percent of the tax basis of the QOZB assets can be held in “nonqualified financial property” or NQFP; and
 5. The business cannot be certain types of “sin” businesses.

F. The QOZB

- Basically, to be a Qualified Opportunity Zone Business “substantially all” (defined as at least 70%) of the tangible property owned or leased by the QOZB must be “Qualified Opportunity Zone Business Property” or “QOZBP.”

F. The QOZB

- In turn, QOZBP is tangible property used in the applicable trade or business, and that is:
 - property acquired by purchase from an unrelated party after December 31, 2017,
 - the original use of such property commences with the business, or the business substantially improves the property (under the substantial improvement standards described above), and
 - during substantially all of the period that the business holds such property, substantially all the use of the property is in the Qualified Opportunity Zone.

F. The QOZB

- Early on, the single biggest area of uncertainty was the requirement that, in order to be a QOZB, “substantially all” of the tangible property owned or leased by the taxpayer was required to be Qualified Opportunity Zone Business Property.
- The Final Regulations provide that “substantially all” for this purpose means 70% or more of all tangible property.
- An obvious preference of many businesses is to lease the real property and use capital for business assets and operations.
- The Final Regulations confirm that leased property, including real estate, qualifies as QOZBP and counts as a “good asset” toward the 70% test.

F. The QOZB

- The value the leased property is determined by discounting the lease payment stream using the applicable federal rate – a very favorable outcome for taxpayers.
- Certain additional requirements must be met for leases with related parties, but the extremely favorable treatment of leased property means that, as a practical matter, the tangible property requirement should not be overly difficult to satisfy in many cases.

F. The QOZB

- The Final Regulations provide **four ways** to meet the **50% of gross income test**, and these overall are very taxpayer friendly.
- Two of the four tests are quantitative “safe harbors” based on whether more than **50% of employee time** is spent in the QOZ, or whether more than **50% of the payroll costs** are for employees working in the QOZ.
- For the intangible property use test, the Final Regulations provide that **“substantial” portion of intangible property means “40%”** and then specify that the test is met if (1) the use of IP is normal, usual, or customary in the conduct of the trade or business, and (2) the IP is used in the QOZ in the performance of an activity that contributes to the generation of gross income for the trade or business.

F. The QOZB

- The fourth requirement is that less than 5% of the **aggregate unadjusted basis of the property of such entity** is attributable to **Non-Qualified Financial Property**.
- Final Regulations provide a safe harbor such that “working capital” can be held by a QOZB for up to 31 months so long as there is **a written plan** with a **reasonable schedule** to spend the money and the taxpayer actually **spends the funds in a manner “substantially consistent”** with the plan.
- The Final Regulations allow multiple investments of cash from a QOF into a QOZB, but with a maximum total period of 62 months.
- Note that **no cash** infusion **can be held for more than 31 months**.

F. The QOZB

- The **fifth requirement** is a **prohibition on “sin” businesses**.
- Code §144(c)(6)(B) defines the ineligible “sin” businesses as follows:
 - “No portion of the proceeds may be used to provide (including the provision of land for) any **private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.**”

F. The QOZB

- The Final Regulations provide that a business engaged in commercial leasing, such as a mall, can lease space to a “sin” activity so long as the aggregate space leased to sin businesses is not more than 5% of the total leased space.
- Weirdly enough, the very specific limitations and requirements imposed on a QOZBs, including on “sin” businesses, do not apply to a QOF.
- The Final Regulations specifically acknowledge that a QOF can potentially engage in any of the prohibited business activities listed in Code §144(c)(6)(B) -- albeit subject to operating within the relatively awkward restrictions of the 90-Percent Investment Standard.

G. Estate Planning in the Land of OZ

- As with everything else related to the OZ Act, **wealth management and estate planning issues in the Land of Oz are more complicated than usual** – and they are already more-than-enough complicated in the real world.
- The OZ Act provides that “[i]n the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be includible in gross income as provided by section 691.”
- The **Final Regulations confirm that IRD concepts** generally apply on the death of a taxpayer who, prior to death, has deferred gain through a timely reinvestment of gain in a QOF.

G. Estate Planning in the Land of OZ

- **First the good news:** The Final Regulations determined that QOF interests received in a transfer by reason of the taxpayer's death continue to be a qualifying investment in the hands of the transferee for purposes OZ Act tax incentives.
- Thus, a transfer on death does not give rise to an “inclusion event” (the general OZ Act term for a gain-recognition event involving QOF interests) and instead the **beneficiary is treated as a successor to the original eligible taxpayer** that made the qualifying investment (that is, the beneficiary “steps into the shoes” of the original taxpayer investor with regard to both the benefits of the qualifying investment and the obligation to include the original taxpayer's deferred gain in the beneficiary's income).

G. Estate Planning in the Land of OZ

- The Final Regulations provide the following specific **examples of transfers that are not “inclusion events:”**
 - A **transfer** by reason of death to the **deceased owner’s estate**.
 - A **distribution** of a qualifying investment **by the deceased owner’s estate**.
 - A **distribution** of a qualifying investment **by the deceased owner’s trust** that is **made by reason of the deceased owner’s death**.
 - The **passing of a jointly owned** qualifying investment **to the surviving co-owner** by operation of law.
 - **Any other transfer** of a qualifying investment **at death by operation of law**.

G. Estate Planning in the Land of OZ

- The Final Regulations apply Code Section 691 principles to the deferred gain “inherited” from the decedent.
- Section 691 generally treats “income in respect of a decedent” as taxable income or gain to the estate or the applicable beneficiary upon later recognition.
- IRD is not reported on the decedent's final income tax return and instead is reported by the applicable party (either the decedent’s estate or the beneficiary/heir) on later recognition.

G. Estate Planning in the Land of OZ

- One very significant consequence of this **IRD treatment** is that the **QOF interest does NOT enjoy a step-up in tax basis under Code Section 1014** on the death of the original investor.
- In fact, the **Final Regulations specifically clarify** that the step-up in tax basis under **Code section 1014 is not available** to adjust the basis on an inherited QOF interest to its fair market value.
- **Example: Investor invests \$1M in QOF and dies when QOF is worth \$2M. Inclusion gain will be, at most, \$1M (less if Incentive 2 applies) but no step-up for the “extra” \$1M.**
- ACTEC, for example, **suggested that basis step-up** should apply upon death to the **extent that the value of the QOF investment at death exceeded the deferred gain amount**, but Treasury and IRS **declined to follow** that recommendation.

G. Estate Planning in the Land of OZ

- However, the whole point of investing in a QOF in the first instance is 1) deferral (and modest reduction) of original gain, which continues under this IRD regime, plus 2) a step-up in tax basis in the QOF after ten years, which substantively mimics (or better than mimics) the step up in basis under Section 1014.
- Thus, while IRD is often an undesirable asset in most estates (it can trigger double taxation, first, due to being included at fair market value in the estate and subject to estate tax, and then second, because of the inadequacy of Code Section 691(c) compared to Section 1014, as a subsequent income tax event) in the Land of OZ it often produces a big “who cares”.

G. Estate Planning in the Land of OZ

- The Final Regulations specify that the following transfers are not considered a “transfer by reason of the taxpayer’s death,” and thus trigger an “inclusion event”.
 - A sale, exchange or other disposition by the deceased taxpayer’s estate or trust, other than a distribution described above.
 - Any disposition by the legatee, heir, or beneficiary who received the qualifying investment by reason of the taxpayer’s death.
 - Any disposition by the surviving joint owner or other recipient who received the qualifying investment by operation of law on the taxpayer’s death.

G. Estate Planning in the Land of OZ

- Remember that Code section 1400Z-2(b)(2) contains a special rule that **caps the amount of the gain recognized** on the **disposition of a QOF interest** such that the **gain cannot exceed the fair market value of the investment** as of the date that the gain is included in income.

G. Estate Planning in the Land of OZ

- Although “kicking the can down the road” is a holistic component of OZ income tax and estate planning, it is important to remember that the trip down the yellow brick road ends on December 31, 2026 – or even earlier if there is an inclusion event prior to that date.
- The income tax and estate plan will need to consider that an inherited QOF interest brings IRD and does not necessarily bring liquidity to pay the deferred tax.
- Some QOF investments plan and even pledge to provide liquidity by and through the QOF, e.g., by refinancing property and distributing cash in early 2027 when the tax becomes due and payable.

G. Estate Planning in the Land of OZ

- Absent liquidity provided by the QOF investment itself, the estate plan will want to provide liquidity to accompany the QOF interest – e.g., a cash bequest to go with the QOF interest, a loan to pay the taxes, and/or life insurance to provide liquidity.
- Note that Treasury received – and rejected – recommendations from NYSSCPA and ACTEC suggesting a possible extension of the “judgment day” when death has occurred prior to December 31, 2026.
- Therefore, until further notice, the trip down the Yellow Brick Road ends December 31, 2026.

G. Estate Planning in the Land of OZ

- GIFT PLANNING -- Just to throw a combination of a curve ball and a monkey wrench into estate and gift planning, the **Final Regulations generally treat** donative transfers, aka “gifts,” as a taxable “inclusion event,” and this is true **even though property acquired by gift is specifically not a taxable event for other income tax purposes** under Code Section 102.
- This inclusion treatment applies **regardless of whether that transfer is a completed gift for federal gift tax purposes, and regardless of the taxable or tax-exempt status of the donee of the gift.**
- One notable “exception” applies in the case of **transfers to grantor trusts**, since the transfers are generally disregarded for federal income tax purposes.

G. Estate Planning in the Land of OZ

- Treasury asserted that the legislative history supported its position that a gift generally constitutes an “inclusion event” (although both the NYSSCPA and ACTEC pointed out in their comment letters that the statute itself rather unambiguously suggests a contrary conclusion).
- Remarkably, notwithstanding Code Section 1041, even transfers of QOF interests between spouses are treated as inclusion events, unless a grantor trust is involved with the transferor retaining ownership for federal income tax purposes.
- Short Summary: Everything you learned about gift planning in the Real World is wrong in the Land of OZ.

G. Estate Planning in the Land of OZ

- As a small consolation, the Final Regulations confirm that transactions involving transfers of QOF interests between the grantor and a related grantor trust will not constitute an inclusion event.
- The earlier Proposed Regulations had limited this exception solely to gifts to grantor trusts, but the Final Regulations include a much broader range of transactions, including sales by grantor to the grantor trust, the grantor's exercise of the power to substitute assets, and distributions of QOF interests to the grantor from a Grantor Retained Annuity Trust (GRAT).
- Conclusion: Grantor Trusts are a very powerful, super-charged method to transfer QOF interests to a spouse or family.

G. Estate Planning in the Land of OZ

- Finally, the Final Regulations confirm that it does not matter whether the gain that is sought to be deferred, or the funds that are subsequently invested in the QOF, belong to the taxpayer or a grantor trust with respect to which the taxpayer is taxable under the grantor trust rules.

H. Final Thoughts Before Returning to Kansas

- The Land of OZ offers better tax benefits than Kansas – and the benefits in specific cases can be spectacular.
- But the tax benefits alone will not make a bad deal into a good deal – the underlying investment must make economic sense.
- It took almost exactly two years to get Final Regulations, and this delayed implementation significantly.
- OZ investments have also been impeded by COVID and ELECTION UNCERTAINTY, but many OZ projects are still moving forward.
- The Land of OZ is unapologetically complicated – it starts with the IRC (call that OZ version 1.0) and then gets convoluted, hyper-technical, inconsistent, and downright weird, all very quickly. Right now we are up to about OZ Version 8.0.

H. Final Thoughts Before Returning to Kansas

- One should hasten to add that the **complexity is intentional and probably necessary** – this is a **HUGE tax benefit and needs careful boundaries, and strong anti-abuse provisions** in order to make sure the incentives are used to achieve the intended purposes.
- It harkens back to an old and venerable observation about tax law generally – **you can make tax law simple or you can make it fair, but you usually can't make it both.**

H. Estate Planning in the Land of OZ

- Fortunately, many OZ transactions are relatively straight-forward to structure and implement.
- In many cases, the best OZ strategy at the moment is to play the equivalent senior golf – hit the ball short and straight and keep it in the middle of the fairway.
- Or, if you prefer a non-golf metaphor, you should make sure, as you travel through the Land of OZ, to stay in the middle of the (Yellow Brick) Road.

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