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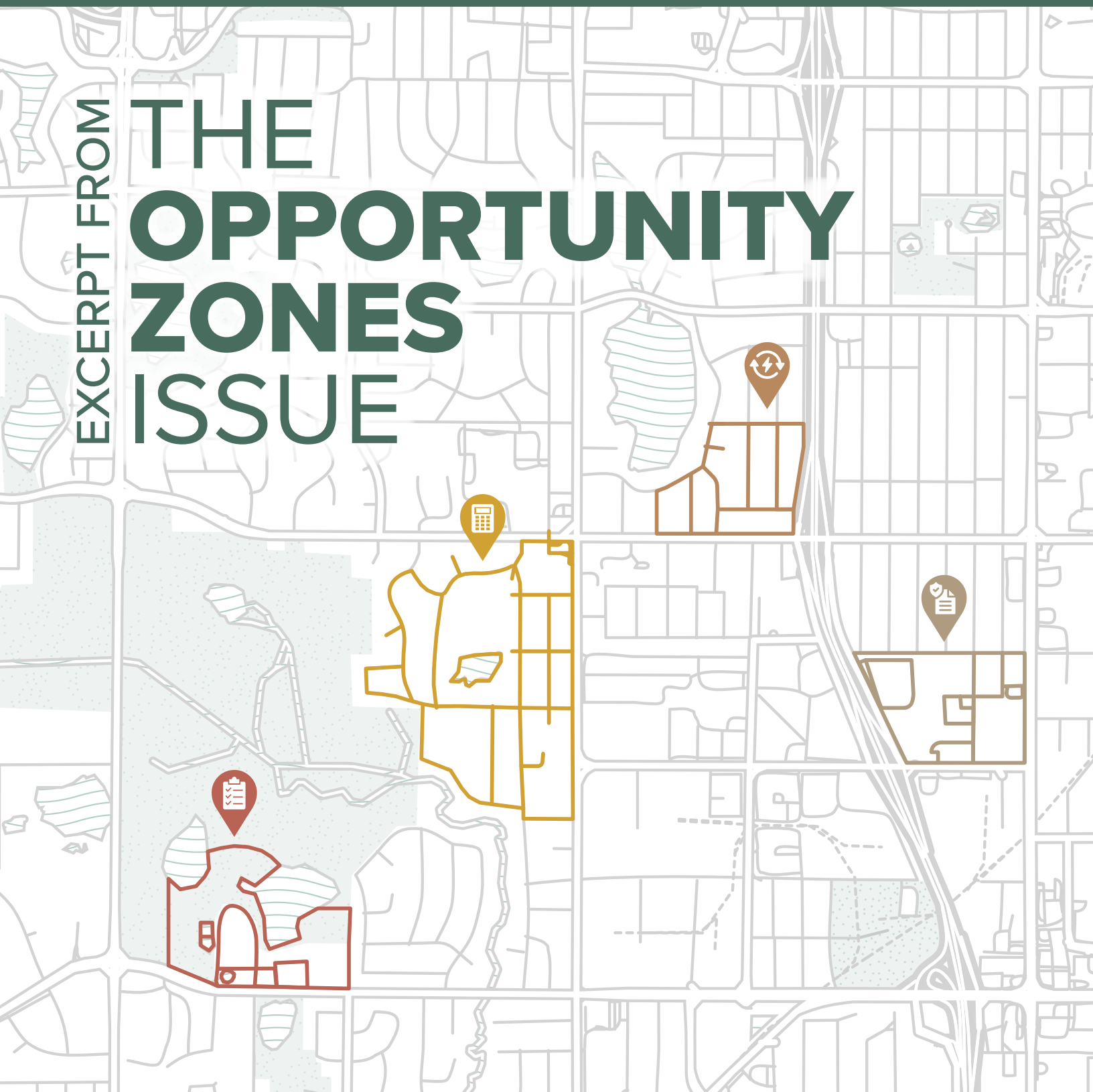

Avoiding Pitfalls in Opportunity Zone Investments

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While the opportunity zones (OZ) incentive and its generous tax benefits provides significant opportunities for investments in low income communities, careful planning is required to make sure that an investment qualifies for these tax benefits.

This article will touch on some of the lesser known practical considerations involved in structuring such investments and is designed to highlight some of the pitfalls that may not be evident to the untrained eye.

Disguised Sale

Most OZ investments are structured using a two-tier partnership structure in which investors invest in a qualified opportunity fund (QOF), which then invests in a qualified OZ business, and both are treated as partnerships for federal income tax purposes. Under the OZ incentive, the membership interests in the qualified OZ business must be acquired "solely" from the business and not from any other member in the qualified OZ business. Presumably, this rule was intended to encourage an infusion of new money into the business (increasing the balance sheet of the business) rather than "replacing" existing equity capital (without affecting the balance sheet of the business). While there are arguments to the contrary, because a partner is generally treated as having only a single partnership interest in a qualified OZ business, the more conservative view is that any acquisition of even a small amount of equity from another member in the business could potentially taint and disqualify the whole investment in the business under the OZ regulations.

Under certain circumstances, federal tax law treats a cash contribution to the qualified OZ business (which presumably qualifies as a good investment for OZ purposes) as an acquisition of equity interests in a qualified OZ business from another member (which does not qualify for OZ benefit) if that cash is distributed to such other member. This is because such an investment is economically equivalent to acquiring the membership interests in the business directly from such other member.

In 2004, the Treasury Department issued proposed regulations on such disguised sales, but has since withdrawn them, leaving investors with limited guidance on disguised sales of partnership interests. Absent clear guidance, qualified OZ businesses should avoid making distributions to other equity owners using the proceeds of the investment from the QOF (and generally within two years of such investment). This includes, for example, using the proceeds of the QOF's investment (i) to return capital to a sponsor or other members for their prior investments in the qualified OZ business; (ii) to repay debt where there is a material risk that the debt could be treated as equity for income tax purposes, and (iii) to make equalizing payments, i.e., the QOF invests at a later time and its contribution includes an interest component that is distributed to the other members. Notably, a repayment of bona fide indebtedness should avoid some of these problems.

Circular Cash Flows

A QOF's or qualified OZ business's qualifying property must be acquired by purchase in 2018 or later from an unrelated party. Accordingly, qualifying property

does not include property contributed to a QOF or qualified OZ business in a tax-free transaction, such as a contribution in exchange for a partnership interest.

A seller of appreciated property to a QOF or qualified OZ business sometimes may want to reinvest the sales proceeds into the QOF and defer some gains. Longstanding IRS rulings and more recent OZ regulations, under certain circumstances, have treated "circular flow of cash" transactions as potentially subject to recharacterization and as a contribution of part or all of the property instead of a sale.

For example, an existing property owner has $400,000 of tax basis in a piece of land. The property owner sells the land to a qualified OZ business for $1 million. The seller later attempts to defer $100,000 of its $600,000 capital gain by investing $100,000 in the QOF that owns the qualified OZ business. The $100,000 investment constitutes 10% of the QOF. If the circular flow of cash doctrine applies, the property owner is deemed to contribute 10% of the land to the QOF, which further contributes the 10% of the land to the qualified OZ business. The QOF owns a nonqualifying asset that may disqualify the QOF entirely or subject it to monthly penalties. The qualified OZ business also owns a nonqualifying asset that may disqualify the qualified OZ business. The property owner does not defer any capital gains under the OZ regime and is subject to tax upon exit at any time. If the circular flow of cash doctrine applies, it will not matter that the property owner owns less than 20% of the QOF and is considered unrelated to the QOF under the OZ rules. Careful planning should therefore be taken to avoid such potential circular cash flows, for instance, by reducing the interdependence between the various steps.

Nonqualified Financial Property

To be eligible for the OZ benefits, a qualified OZ business must meet certain requirements, one of which is that no more than 5% of the assets of the qualified OZ business are nonqualified financial property (NQFP). NQFP is defined broadly and generally includes cash, debt instruments, stock, partnership interests, options, forward contracts, warrants and similar property. Reasonable amounts of working capital and trade account receivable are specifically excluded from the definition of NQFP, including amounts covered by the working capital safe harbor described below.

While this requirement may sound benign for real estate development and operating businesses, its scope is far from clear. A few examples that the authors have encountered over time include refundable deposits given by a qualified OZ business for the acquisition of real property, or security deposits held in cash by a qualified OZ business that could be treated as NQFP. Reserves required by lenders may be NQFP. Where a qualified OZ business sells property and the purchase price is paid in several installments, such installments could be an installment note that is a debt instrument treated as NQFP.

Another potential situation involves a qualified OZ business that prepays rent that is treated for tax purposes as a loan. Other situations include construction projects that take longer than 31 months to complete and that are financed entirely from equity contributed upfront–in those situations, the part of the cash that is not used within the working capital safe harbor (described below) may be NQFP.

Using Special Purpose Vehicles to own Property

Under the two-tier partnership structure described above, the qualified OZ business will own the qualifying property directly. Alternatively, the property can be owned by one or more single member limited liability companies that are wholly owned by the qualified OZ business and are treated as disregarded entities for federal income tax purposes. In no circumstance will a qualified OZ business be able to own its qualifying property through subsidiary joint ventures, corporations or any other entities that are regarded for tax purposes. This is because NQFP includes, among other things, stock in corporations as well as partnership interests.

The requirement that all entities below the level of the qualified OZ business be wholly owned is one of the more rigid features of the OZ rules and often poses vexing challenges for taxpayers looking to properly structure OZ ventures. For example, a qualified OZ business cannot itself enter into a joint venture partnership with a developer, sponsor or any other third party, whether or not that third party seeks the benefits of the OZ rules. Instead, the qualified OZ business itself must serve as the joint venture vehicle, typically held by one or more QOFs as well as other investors. Furthermore, qualified OZ business cannot generally hold promote rights, since these are often structured for tax purposes as equity instruments and will be NQFP in the hands of the qualified OZ business, subject to a 5% limit.

In other scenarios, more complicated financing arrangements can raise issues under this rule. A qualified OZ business may own several properties, each in its own special purpose vehicle intended to be disregarded for federal tax purposes. In addition to senior debt, the qualified OZ business may seek more subordinate or mezzanine financing with respect to one of its projects. Mezzanine debt is sometimes equity-like, and under certain circumstances may not be respected as debt for tax purposes. The stakes are immense in the OZ context, because a recharacterization of mezzanine debt as equity causes the special purpose vehicle to be treated as a tax partnership, and thus interests in the special purpose vehicle turn into NQFP, thereby disqualifying the qualified OZ business.

Governmental sellers such as municipalities may seek to participate in the upside of property that they transfer to qualified OZ business with a hope to improve the fortunes of a particular community. These participation rights may be treated as equity interests and must be structured in a manner that considers these NQFP restrictions. In addition, consideration should be given as to whether the property was, in part, contributed by the government in exchange for equity interests in the qualified OZ business rather than acquired by purchase.

Qualification during the Construction Period

A qualified OZ business generally must have at least 70% of its tangible property consist of qualifying property, which is generally tangible property purchased in 2018 or later from an unrelated party and that satisfies either a substantial improvement test or an original use test. Due to special rules about what is the numerator and denominator of the 70% test, a qualified OZ business with contributed assets may find itself in violation of the 70% test as a result of market fluctuations.

The 70% test is generally applied as follows:

1. The qualified OZ business's purchased or constructed property is valued at its unadjusted cost basis, i.e., the initial purchase price or construction cost.
2. Any other property of the qualified OZ business is valued according to its fair market value as of each applicable testing date (special rules that apply to leased property and to entities that use certain financial statements).

In other words, the qualified OZ business's purchased assets (which are typically good assets) uses a fixed number, while the qualified OZ business's contributed assets (which are always bad assets) uses a fluctuating number for the 70% test.

For example, a qualified OZ business is funded with $6 million of cash. The qualified OZ business receives a capital contribution of land worth $2 million, and the qualified OZ business spends $6 million on the purchase and construction of qualifying assets by the next applicable testing date. The business satisfies the 70% test on the testing date, because the $6 million of qualifying assets is 75% of the $8 million of total assets.

A few years later, the local real estate market has appreciated by 50%. The nonqualifying contributed land is now worth $3 million, which is the relevant value for the 70% test. The purchased and constructed qualifying assets have fair market value of $9 million but are still

valued at $6 million for the 70% test, because their unadjusted cost basis is constant at $6 million. The qualified OZ business fails the 70% test because the $6 million of qualifying assets is only 67% of the $9 million of total assets. Further clarification of these results would reduce taxpayer uncertainty.

Treatment of a Business During the Working Capital Period

The OZ rules feature a helpful working capital safe harbor, pursuant to which a qualified OZ business with a reasonable written plan may hold working capital under that plan, without running afoul of the NQFP limitation described above. The safe harbor period is generally 31 months, however the final OZ regulations introduced a "second" 31-month period that can be stacked on top of the first. The period may also be extended by certain declared emergencies (including the COVID-19 pandemic) and delays in governmental permitting. Importantly, qualified OZ business that are in the process of deploying capital under their written schedule are not subject to the full complement of "trade or business" and gross income tests otherwise applicable to qualified OZ business.

One area of uncertainty is how a qualified OZ business applies (or whether it must apply) the 70% test during the pendency of a working capital safe harbor period. This is especially important in cases where a qualified OZ business receives contributed property (typically, undeveloped land), or acquires such property from related persons. In these situations, without any relief from the asset test, the qualified OZ business may flunk the 70% test even though its newly constructed property, when built, will eventually dwarf the value of the contributed property. Correcting amendments to the OZ regulations issued in April 2020 may be read to suggest that the 70% tangible property test is suspended during the working capital period. Although it is surprising that such a substantive and impactful rule would be enacted in the context of corrections without any explanation in the preamble, informal and off-the-record conversations by some practitioners with governmental representatives have apparently confirmed this result. Nonetheless, the amendments lend themselves to different interpretations, and further official clarification would be welcomed by practitioners who desire a higher level of comfort for compliance with the OZ rules. ❖

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