How Real Estate Developers Can Use Opportunity Zone Funds to Finance New Real Estate Projects

by Catherine DeBono Holmes and Bradford S. Cohen

Real estate developers have a new source of investment for their development projects, created by the Tax Cuts and Jobs Act of 2017

A new tax incentive for investment in low-income areas designated as “Opportunity Zones” was included in the Tax Cuts and Jobs Act of 2017, signed into law on December 22, 2017. Under this section of the Act, codified as sections 1400Z-1, and 1400Z-2 of the Internal Revenue Code, taxpayers with taxable capital gains from the sale of any asset (stock, property, etc.) who reinvest those gains within 180 days of the date of sale of the asset into “Qualified Opportunity Zone Property” will become eligible to receive significant tax benefits. These potential tax benefits are expected to result in substantial new investment by investors in real estate projects that meet the requirements of “Qualified Opportunity Zone Property.” This article explains what the requirements are for designation as Qualified Opportunity Zone Property, and discusses the structure of Opportunity Zone investments.

What are the potential benefits to persons who invest in a Qualified Opportunity Zone Property?

There are three potential benefits that investors may receive from an investment of their taxable capital gains into a Qualified Opportunity Zone Property:

Deferral of Capital Gains Tax – Investors will receive a deferral of taxation on 100% of the taxable capital gains invested in Qualified Opportunity Zone Property until the earlier of the date that their investment is sold or December 31, 2026;

Reduction of Capital Gains – Investors who invest by December 31, 2019 will be eligible to receive a 10% reduction of the taxable gain amount invested in Qualified Opportunity Zone Property if the investment is retained for at least 5 years, increasing to a 15% reduction if the investment is held for at least 7 years; and

No Tax on Capital Gains realized on Qualified Opportunity Zone Property – Investors who invest by December 31, 2019 and hold their investment in a Qualified Opportunity Zone Property will pay no tax on any capital gains realized when that investment is sold.

What are the requirements for Qualified Opportunity Zone Property?

There are four primary requirements for a real estate development to achieve the status of “Qualified Opportunity Zone Business Property”:

1. The property must be located in a designated Opportunity Zone;
2. The property must be tangible property used in a trade or business;
3. The property must be acquired by purchase for cash after December 31, 2017; and
4. The property must be either (a) new construction that is not put into use until after the purchase of the property; or (b) “substantially improved” after purchase of the property, which requires that the costs of constructing, renovating or expanding the property during any 30-month period beginning after the date of the acquisition of the property must exceed 100% of the adjusted basis of the property at the start of the 30-month period.

How do you know if a property is in an Opportunity Zone?

The governors of every state identified those low-income areas in their state that they determined should be designated as Opportunity Zones, and in June 2018, the IRS published a list of 8,700 approved Opportunity Zones, which are designated by census tracts. The entire list of approved Opportunity Zones can be found at: [https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx](https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx). These Opportunity Zone designations will remain in effect for a period of 10 years. In order to find out if any property is in an opportunity zone, a developer can review the website and determine immediately if that property is in one of the 8,700 approved Opportunity Zones. If the property is in one these Opportunity Zones, then the first criteria is satisfied, and the developer can then consider whether the other three criteria can be met.

What is tangible property used in a trade or business?

Tangible property means any physical real property or personal property (i.e., excluding intangible property such as intellectual property and contract rights). The IRS defines trade or business generally to include any activity carried on for the production of income from selling goods or performing services. For real estate developers, this would generally include real property being developed for the purpose of operating a business, such as a hotel, office, or multifamily rental property. It may also include construction of houses or condominiums for sale, but until the IRS issues regulations, which are anticipated soon, we do not know whether it will be necessary for the investment to be in an operating business.

If a developer acquired a property prior to December 31, 2017, but the property is still undeveloped, can the development be a Qualified Opportunity Zone Business Property?

If a property was acquired before December 31, 2017 by its current owner, the property may have to be sold to an unaffiliated purchaser after December 31, 2017 in order to meet this requirement. The Internal Revenue Code provides detailed rules for determining whether parties to a sale transaction are affiliated or unaffiliated. Under these rules the original owner of the property may be able to retain a minority interest in the new owner of the property. There may be other means to qualify under this requirement, such as by acquiring new tangible property that is placed on previously purchased real property if the new tangible property is worth at least 90% of the real property. A developer that wishes to explore the options for meeting these requirements should discuss this further with their tax attorney or accountant.

Can Opportunity Zone funds be used for property that is already completed and in operation?

The Code states that the “original use” of the property must commence with the qualified opportunity fund, or the qualified opportunity fund must substantially improve the property. This would generally require that a property not be completed prior to investment by Opportunity Zone investors. Alternatively, if the property has previously been completed, the property would have to be substantially improved after the investment with Opportunity Zone funds. Substantial improvement is defined as improvements that add to the basis of the property an amount at least equal to 100% of the
original basis of the property and that are completed within a period of 30 months beginning with the date of acquisition of
the property.

What is a Qualified Opportunity Fund and is it required to be approved by the IRS?

A Qualified Opportunity Fund is defined in the Code as any investment vehicle organized as a corporation or a partnership
for the purpose of investing in Qualified Opportunity Zone Property that holds at least 90% of its assets in “Qualified
Opportunity Zone Property,” as measured on the last day of the first 6-month period of the taxable year of the fund and on
the last day of the taxable year of the fund. The term “Qualified Opportunity Zone Property” is defined to include stock or
partnership interests in a company that is a qualified opportunity zone business, or a direct investment in a qualified
opportunity zone business property. There is no requirement that Qualified Opportunity Fund be approved or certified by
any governmental entity. There is a self-certification form that the sponsor of a Qualified Opportunity Fund files with the
IRS to declare that it intends to comply with the requirements to be a Qualified Opportunity Fund.

Does a developer have to set up its own Qualified Opportunity Fund or can it accept investments from other
Qualified Opportunity Funds?

A developer could set up its own corporation or partnership (and we expect this will be defined by the IRS to include a
limited liability company taxed as a partnership) that the developer controls, which is a Qualified Opportunity Fund.
Alternatively, the developer could set up a property owner entity that could accept outside investments from other
Qualified Opportunity Funds that are set up by third parties. There have already been several Opportunity Funds
established as “blind pools,” for the purpose of seeking and investing in Qualified Opportunity Zone Business Property. A
developer could potentially seek investment from these independent Opportunity Funds. Alternatively, a developer that
already has experience in raising capital could establish its own Qualified Opportunity Fund. There are no restrictions
regarding the ownership or control of a Qualified Opportunity Fund, or its relationship to the property owner or developer.

Are there any required terms that must be included in a Qualified Opportunity Fund entity?

We know some of the terms that should be included in the partnership agreement or operating agreement of a Qualified
Opportunity Fund. There are also some terms that require clarification from the IRS, and we expect that the IRS will issue
regulations that will clarify some of these issues. Here is a brief summary of the terms that should be included in the
partnership agreement or operating agreement of an Opportunity Fund:

The investors in the Opportunity Fund must invest in equity – they cannot invest in debt.

The Opportunity Fund should be authorized to invest solely in Qualified Opportunity Zone Business Property;

The Opportunity Fund should have restrictions on distributions of proceeds of sale of Qualified Opportunity Zone
Business Property, because investors are required to hold their investment in the Opportunity Zone Fund for at least
10 years if they wish to be eligible to realize the gains on their investment in the Opportunity Fund without taxation of
those gains;
The Opportunity Fund should provide authorization for reinvestment of the proceeds of sale of Qualified Opportunity Zone Business Property into one or more other Qualified Opportunity Zone Business Properties; (Whether the IRS will allow for sale and reinvestment is an open issue that we anticipate will be addressed in regulations.);

The Opportunity Zone Fund could provide for distributions of net cash flow from operations of the opportunity zone property, but the IRS has not provided guidance on distributions, so the manager or general partner of the Opportunity Fund should retain discretion to determine when distributions will be made and how distributable cash will be determined, to conform to IRS regulations.

Can a developer use debt as well as equity to fund a property and still be a Qualified Opportunity Zone Business?

Yes, a developer can still obtain a senior mortgage loan secured by the property, or other debt financing for the property. The investors in the Opportunity Zone Fund must contribute equity, not debt, but this does not limit the ability of the property owner to obtain debt as an additional source of financing for the property. In fact, a developer could obtain multiple sources and types of debt and equity financing, and still be qualified to accept Opportunity Fund investments as one part of the capital stack.

What does this mean for real estate developers seeking to use Opportunity Zone Funds to finance real estate development?

The potential tax benefits are expected to provide a substantial incentive for investors to make equity investments in new businesses located in the designated Opportunity Zones. This means that new investors will be actively seeking investments that will qualify for these benefits. In particular, a surge of new investor interest is expected to occur over the next year. This will likely expand the pool of potential investors, as well as the dollar amount of capital available, for real estate development in the Opportunity Zone areas. Real estate developers should act quickly to determine if one or more of their real estate developments will qualify for investment from Opportunity Funds, and if so, consult with their legal and tax counsel about the steps necessary to bring this new source of capital into their developments.

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