A taxpayer wants to build a $4 million commercial office building in a Myrtle Beach OZ.

He sells Wells Fargo stock he owns for $3 million and borrows $1 million. He originally purchased the Wells Fargo stock in 2012 for $1 million so he has a $2 million long-term capital gain. He is in the 20% Capital Gains tax rate. He will build a new building or renovate an existing building in a Myrtle Beach Opportunity Zone.
OVERVIEW

TAX INCENTIVES FOR BUILDING/RENOVATING IN MYRTLE BEACH OPPORTUNITY ZONE

A. First OZ Incentive: Deferral of Gain

The taxpayer sold stock in December, 2019 for a $2 million capital gain.

On April 15, 2020, he either (1) writes a check to the IRS for $400,000 for the capital gain; (2) or invest the Capital Gain within 180 days in the Myrtle Beach Qualified Opportunity Fund, LLC (and pay no taxes on it)
B. Second OZ Incentive: Reduction of Capital Gain

The taxpayer sold stock in December, 2019 for a $2 million capital gain. If he invests the Capital Gain within 180 days in his Qualified Opportunity Fund and holds for five years, then 10% of the $400,000 capital gain is permanently excluded ($40,000) and if he holds the investment for seven years, then 15% of the $400,000 ($60,000) is excluded when the taxpayer pay taxes on the $2 million capital gain on December 31, 2026 (due April 15, 2017). The investment must be done in 2019 to get the 15% reduction.
TAX INCENTIVES FOR BUILDING/RENOVATING IN MYRTLE BEACH OPPORTUNITY ZONE

C. Third OZ Incentive: Total Elimination of Second Capital Gain

The Myrtle Beach Opportunity Fund, LLC builds a commercial office building through the Myrtle Beach Opportunity Business, LLC in an Opportunity Zone and holds it for ten years. The Fund sells the office building in year 11 for a $1 million capital gain. This Capital Gain is totally exempt from income taxes (a savings of $200,000 under today’s income tax rates).
The Opportunity Zone Program was created as part of the Federal Tax Bill. It was co-sponsored by Senators Tim Scott and Cory Booker.

Purpose

- Combat geographical inequality:
  - In the 1990s, half or more of all counties grew at the national rate. Now only 25% do.
  - More than half of the country’s distressed zip codes contained fewer jobs and places of business in 2015 than they had in 2010.
- This bill should expand the geography of economic growth.
Governors of each state (and territory) were allowed to designate up to 25% of their low income census tracts.
In South Carolina, we have 1,097 census tracts

- 538 were eligible to be submitted
- Submitted 135 tracts
  - 128 Low Income Community tracts were submitted
  - 7 eligible contiguous tracts were submitted

[INSERT MYRTLE BEACH ZONE INFO]
OPPORTUNITY ZONES
WHERE ARE THEY?
PROPERTY STRADDLING CENSUS LINES

Because zones are based upon census tracts, some properties will only be partly in a Zone. The April 2019 Regs. provide that a contiguous parcel will be treated as entirely in the Zone if the square footage inside the QOZ is “substantial” relative to the square footage outside the Zone. The Preamble to the Regulations state that the parcel inside the zone is “substantial” if the unadjusted cost of the real property inside the Zone is greater than the unadjusted cost outside the Zone.
On Friday, October 19, 2018, the U.S. Treasury Department issued its first set of guidelines for opportunity zones. That guidance included 74 pages of proposed regulations, a five page revenue ruling, an updated Q&A document and a draft of Form 8996 for qualified opportunity funds.

The IRS issued a second set of Regulations on April 17, 2019. While the first set was almost entirely pro-taxpayer, the second set contained anti-taxpayer provisions.

While the regulations are proposed, taxpayers and opportunity funds may rely on the proposed regulations, presuming they apply the rules in their entirety and do so in a consistent manner.
OPPORTUNITY ZONES
REQUIREMENTS

There are three requirements:

A. A **Capital Gain** must be invested in a

B. Qualified **Opportunity Fund** which invests (in many cases through a Qualified Opportunity Business) in a

C. Qualified **Opportunity Zone**

D. Where such occurs, substantial Federal **Income Tax Incentives** are generated
As stated above, there are two forms of federal income tax incentives:

(1) A deferral and possible reduction of the ORIGINAL capital gain; and

(2) Elimination of the SECOND capital gain (if any) from the subsequent sale of the investment in the Opportunity Fund.
TAX INCENTIVES
ORIGINAL CAPITAL GAIN

The Opportunity Zones program offers two Income Tax Incentives for the underlying capital gain:

1) A deferral of inclusion in taxable income for capital gains reinvested in an Opportunity Fund. The deferred gain must be recognized on the earlier of the date on which the opportunity zone investment is disposed of or December 31, 2026; and

2) A capital gain reduction resulting from a step-up in basis for capital gains reinvested in an Opportunity Fund. The basis is increased by 10% if the investment in the Opportunity Fund is held by the taxpayer for at least 5 years and by an additional 5% if held for at least 7 years, thereby excluding up to 15% of the original gain from taxation.

3) The equity investment must be made by the end of 2019 in order to get the full 15% tax basis step-up.
TAX INCENTIVES
SECOND CAPITAL GAIN (IF ANY)

The Act provides a second tax incentive:

A permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in an Opportunity Fund if the investment is held for at least 10 years, i.e. no tax will be due on the appreciation of the Qualified Opportunity fund other than the original deferred gain that must be recognized by December 31, 2026.

After the end of the tenth year, the basis of a partnership interest owning real property will be adjusted to an amount equal to the FMV of the partnership interest including debt. Presumably, a negative tax basis capital account will not result in taxable gain to the partner and depreciation expense will not be recaptured.

The April 2019 draft Regulations exclude any carried interest received in exchange for services (e.g., management and development fees) from the ten-year complete exclusion of the second capital gain (A service provider partner’s interest can be split between qualifying and non-qualifying investments).
QUALIFYING CAPITAL GAIN

The first Requirement above requires a capital gain.

The Legislation allows taxpayers to defer short or long-term capital gains due on the sale of any investment (stocks, bonds, real estate) if the capital gain portion of the sale is reinvested within 180 days in a Qualified Opportunity Fund.

If the capital gain results from the sale or exchange of real estate it must be with an unrelated party.

TRACING: Arguably, the taxpayer that owns the Opportunity Fund Investment must be the same individual or entity that recognized the gain. So, the eligible taxpayer must directly invest into a Opportunity Fund, rather than investing the proceeds into another entity (even a pass-through) which would then invest into the Opportunity Fund.
The gain must not arise from a sale or exchange with a related person as defined in section 1400Z-2(e)(2). Section 1400Z-2(e)(2) incorporates the related person definition in sections 267(b) and 707(b)(1) but substitutes “20 percent” in place of “50 percent” each place it occurs in section 267(b) or section 707(b)(1).
QUALIFYING CAPITAL GAIN

The Proposed Regulations provide that any person that recognizes capital gain for U.S. federal income tax purposes (including any individual, “C” corporation (including a regulated investment company, commonly known as a mutual fund (“RIC”), or a real estate investment trust (“REIT”)), partnership, “S” corporation, trust or estate) is eligible to defer all or a portion of such gain by investing in an Opportunity Fund.
Any gain that is not treated as capital gain is not eligible to be deferred. In addition, any gain that is realized but not recognized for U.S. federal income tax purposes, such as gain in corporate reorganizations, certain partnership transactions and Section 1031 “like-kind” exchanges, is not eligible to be deferred.

The Proposed October 2018 Regulations allow a taxpayer to “split” the gain derived from a single transaction into multiple Opportunity Fund investments. For example, if a taxpayer realized a $100,000 capital gain on January 1, 2019 and invested $80,000 of the gain into an Opportunity Fund on February 1, 2019, the remaining $20,000 portion of the gain could be invested into an Opportunity Fund prior to the expiration of the 180-day period beginning on January 1, 2019. However, to the extent that the second investment exceeded $20,000, the excess amount would not qualify for the Opportunity Fund tax benefits.
QUALIFYING CAPITAL GAIN

The Proposed October 2018 Regulations provide special rules for the deferral of capital gain by a partnership and/or its partners. Where a partnership recognizes a capital gain and invests the gain into an Opportunity Fund, the rules provide that the deferred partnership-level gain will not be taxed at the partner level in the year of deferral. When the gain is later recognized (e.g., upon the earlier of the sale of the Opportunity Fund interest or December 31, 2026), the partnership's partners will be taxed on the recognized gain at such later time.

To the extent that a partnership does not elect to defer its eligible gain, each partner may elect to defer its allocable share of the gain. Several special rules allow the individual partner to defer its capital gain where the partnership declines to do so.
The proposed October 2018 Regs state that it is anticipated that taxpayers will defer the gain by making a deferral election on Form 8949 which will be attached to their Federal Income Tax Return for the taxable year in which the gain would have been recognized but for the deferral.
TAX INCENTIVES
STACKING OF THE CREDITS

The Opportunity Zone tax incentive can be stacked with both federal:

NMTC
Historic Rehabilitation

And state tax incentives:

Fee-in-Lieu/MCBP
Bailey Bill
Abandoned Building/Textile
Revitalization Acts
Infrastructure Credit

These are explained below.
NMTC

The federal New Market Tax Credit Program creates a 39% tax credit claimed over a seven-year period for qualified investors that invest equity in Community Development Entities (CDEs). The CDE invest in qualifying projects in low income communities, including retail and commercial projects. There are a number of qualifying Census tracts in Myrtle Beach.
TAX INCENTIVES
STACKING OF THE CREDITS - FEDERAL

NMTC

The federal Historic Tax Credit provides a 20% income tax credit claimed at a rate of 4% per year for five years of the rehabilitation costs of rehabilitating buildings listed on the National Register of Historic Places.
Fee-in-Lieu is a significant property tax incentive provided by county council. It can lower the assessment ratio on both real and personal property and freeze the millage. A MCBP can increase the Job Tax Credit and in some cases (typically large Cap X and new jobs) provide a Special Source Revenue Credit which reduces the property tax bill.
Local government may freeze for up to 20 years the value for property tax purposes at the pre-rehabilitation value of a rehabilitated Historic Property. The owner of the property must obtain the consent or the local taxing entity and the appropriate historical preservation reviewing entity.
ABANDONED BUILDING REVITALIZATION ACT

The purchaser of a building which has at least 66% of its space abandoned or non-operational for five years may get a credit for either income or property tax purposes of 25% of the rehabilitation costs, capped at $500,000. The City of Myrtle Beach has to approve the property tax credit.
INFRASTRUCTURE CREDIT

South Carolina provides an income tax credit, subject to various limitations, to a real estate developer who constructs or improves water lines, sewer lines and road projects that are eventually dedicated to public use or a qualifying private entity.
The second requirement is that the capital gain must be invested within 180 days in a qualified Opportunity Fund.

Corporate and partnership investments must be made in cash – i.e., in-kind contributions or promissory notes issued to a qualified opportunity zone business are not qualified investments.

The gain must be invested in an Opportunity Fund within the 180-day period that begins on the date on which the taxpayer would otherwise be required to recognize that gain (the “Recognition Date”). In the case of a stock sale effected on an exchange, the Recognition Date is the trade date. In the case of a capital gain dividend received from a RIC or REIT, the Recognition Dated is the date that the dividend is paid. In the case of a taxpayer that is a partner (or “S” corporation shareholder or beneficiary), seeking to defer its share of gain realized by the partnership (or “S” corporation or trust or estate), the Recognition Date is the last day of the entity’s tax year.
The Proposed October 2018 Regulations provide that any entity classified as a domestic corporation or a domestic partnership for U.S. federal income tax purposes, which should presumably include a limited liability company (LLC) or business trust, is eligible to be an Opportunity Fund. Opportunity Funds may be organized as REITs and “S” corporations.

The Proposed Regulations clarify that an eligible interest in an Opportunity Fund includes preferred stock and a partnership interest with special allocations, but not a debt instrument. Deemed contributions under section 752(a) do not qualify.

The eligible interest can be used as collateral for a loan, whether purchase money borrowing or otherwise.
“Qualified Opportunity Funds” were determined by the Community Development Institutions Fund of the Treasury Department. It was originally thought that this would be in a process similar to allocation of New Markets Tax Credits to “community development entities,” and that only CDE type organizations would qualify.

This was a substantial negative for many real estate developers, who would be reluctant to make investments in a CDE with limited real estate experience, and the process to qualify as a CDE was lengthy.
The IRS recently issued a FAQ which states in part:

Q. How does a taxpayer become certified as a Qualified Opportunity Fund?

A. To become a Qualified Opportunity Fund, an eligible taxpayer self certifies. (Thus, no approval or action by the IRS is required.) To self-certify, a taxpayer merely completes a form (Form 8996) and attaches that form to the taxpayer's federal income tax return for the taxable year. (The return must be filed timely, taking extensions into account.)

The proposedRegs confirmed the self-certification.
On October 19, 2018, the IRS issued a Draft IRS Form 8996 for qualifying as an Opportunity Fund. The draft form implies that the Opportunity Fund must own the Opportunity Zone Business Property directly. The draft Regs say that it is expected that taxpayers will use Form 8996, Qualified Opportunity Fund, both for initial self-certification and for annual reporting of compliance with the 90-Percent Asset Test. It is expected that the Form 8996 would be attached to the taxpayer’s Federal income tax return for the relevant tax years.
The statute outlines two requirements:

(1) The entity must be organized as a corporation or partnership; and (2) must maintain at least 90 percent of assets in “Qualified Opportunity zone property,” including investments in “Qualified Opportunity zone stock,” “Qualified Opportunity zone partnership interest,” and “Qualified Opportunity business property.”

Business Property is covered below.
The qualifications as “Qualified Opportunity zone stock,” “Qualified Opportunity zone partnership interest,” and “Qualified Opportunity zone business property” include real estate investments in (1) new or (2) substantially improved tangible property, including commercial buildings, equipment, and multi-family complexes.
As stated below, there is a very important working capital safe harbor for real estate projects. The safe harbor only applies to Qualified Opportunity Zone businesses – and not to Qualified Opportunity Funds. For this reason for real estate projects the QOF will need to do business through a QOZ Business. (Real estate developers will accordingly have to satisfy both the QOF and QOB rules.)
QUALIFIED OPPORTUNITY ZONE BUSINESS

A qualified opportunity zone business is a trade or business:

- In which *substantially all* of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property;

- At least 50 percent of the business' total gross income is derived from the *active conduct* of the trade or business;

- A substantial portion of the business’ intangible property is used in the *active conduct* of the trade or business;

- In which less than five percent of the average of the aggregate unadjusted bases of its property is attributable to nonqualified financial property; and

- Which is not a 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.
The great majority of real estate projects will be done by a QOZ Fund through a QOZ Business. As stated above, a QOZB must be engaged in an “active trade or business.” There was a concern prior to April 2019 Regs whether rental real estate was sufficiently “active.” The April 2019 Regs stated that rental real estate will be deemed an active trade or business.

NOTE: The Regs say that “merely entering into a triple-net-lease” is not an active trade or business!
In order for an entity to be treated as an Opportunity Zone Business (and therefore count towards an Opportunity Fund’s 90% Asset Test), “substantially all” of the tangible personal property owned or leased by the entity must be Opportunity Zone Business Property. The Proposed Regulations provide a bright-line rule that, if at least 70% of the entity’s tangible property is Opportunity Zone Business Property, the entity satisfies this “substantially all” test (the “70% Safe Harbor”).
Qualified opportunity zone business property means any tangible property used in a trade or business if:

- The property was acquired by the qualified opportunity fund by purchase after 2017;
- The original use in the qualified opportunity zone commenced with the qualified opportunity fund or QOZ Business or the qualified opportunity fund or business substantially improves the property; and
- During substantially all of the qualified opportunity fund’s holding period, substantially all of the use of the property was in a qualified opportunity zone.
QOZ business property must be (1) acquired by purchase from an unrelated person; and be originally used by the taxpayer. Does Leased (not purchased) property qualify?

The April 2019 Regulations provide very favorable treatment of leases. Leased property qualifies as QOZ business property if (1) the lease was entered into after December 31, 2017; and (2) the lease terms must be market rate. The lease maybe from a related party subject to certain conditions. Presumably, the lease should qualify as a “true lease” for federal income tax purposes.

The Leased property does not have to be substantially improved or meet the original use requirement.
The OZ Act requires that the *original use* of the property commenced with the qualified Fund/Business (or what was substantially rehabilitated).

What if a Fund/Business purchases a real estate project already under construction – does this satisfy the “original use” test?

The April 2019 Regs provide a pro-taxpayer rule that purchase of a development prior to the receipt of a Temporary Certificate of Occupancy will meet the Original Use test.
The law states that an Opportunity Fund must hold at least 90 percent of its assets in Qualified Opportunity Zone Property “Qualified Property,” which is measured as the average holding over two periods: (A) “on the last day of the first 6-month period of the taxable year of the fund, and” (B) “on the last day of the taxable year of the fund.”

The proposed Regs say, “For example, if a calendar-year entity that was created in February chooses April as its first month as a QOF, then the 90-Percent-Asset-Test testing dates for the QOF are the end of September and the end of December. Moreover, if the calendar-year QOF chooses a month after June as its first month as a QOF, then the only testing date for the taxable year is the last day of the QOF’s taxable year. Regardless of when an entity becomes a QOF, the last day of the taxable year is a testing date.”
For this purpose, the Opportunity Fund is required to use the “book” value of its assets as shown in its financial statements filed with the U.S. Securities and Exchange Commission (or another U.S. federal agency), or the value of its assets as prepared in accordance with U.S. GAAP. If the Opportunity Fund does not have applicable financial statements, it must use the cost of its assets.
Does this mean there is a strict requirement that, in just the Opportunity Fund must invest 90 percent of the fund in real estate construction or improvement six months? Construction and rehabilitation of real property typically takes longer than six months. As stated above, the Fund can hold only a maximum of 5% of its assets in non-qualified Financial Property.
The Proposed Regulations adopt a working capital safe harbor that applies to cash as well as other “financial property” (including stock, bonds and other debt, partnership interests, options and certain derivatives). Under this safe harbor, such cash and financial property counts toward the 90% Asset Test, if for a period of up to 31 months: (1) if there is a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone, (2) there is written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months, and (3) the business substantially complies with the schedule. (4) Taxpayers are required to retain any written plan in their records.

NOTE that this safe harbor applies only to Opportunity Zone Businesses – not Opportunity Funds.
Qualified Business Property must be either constructed or “substantially improved.” Substantial improvement is more complicated, but the new October 2018 Revenue Ruling and proposed Regs provide a very pro-taxpayer treatment to real estate developers.

The definition of “substantial improvement” to Qualified Opportunity Zone Business Property “Qualified Business Property” is met only if “additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the qualified opportunity fund,” i.e., the cost of the property improvements must exceed the tax basis of the property at the time of acquisition. If you purchase a property for $2 million you must expend more than $2 million renovating it.
The April 2019 Regs provide an exception similar to the SC Abandoned Building Act. If a building was unused or vacant for an uninterrupted period of at least 5 years prior to being acquired and placed in service by the QOF or QOZ Business, it is treated as if it was new construction and the QOF or QOZ Business does NOT need to satisfy the “substantial improvement test” outlined above and below.

Accordingly, a modest rehabilitation of a vacant building qualifies!

NOTE: not always easy to prove building was vacant for 5 years.
The October 2018 Proposed Regulation and Revenue Ruling provides a pro-taxpayer view that with respect to an acquisition of land with an existing building, located within an Opportunity Zone, the tax basis of the land is not taken into account in determining whether the building has been substantially improved, and that there is no separate requirement to improve the land, so long as the existing building itself is substantially improved.

You spend $3 million acquiring a building and land. The land is valued at $1 million and the building at $2 million. You only need to spend more than $2 million – and not $3 million – renovating the property.
In September 2018, QOF A purchases for $800x Property X, which is located wholly within the boundaries of a QOZ. Property X consists of a building previously used as a factory erected prior to 2018 and land on which the factory building is located. QOF A intends to convert the factory building to residential rental property. Sixty percent ($480x) of the $800x purchase price for Property X is attributable to the value of the land and forty percent ($320x) is attributable to the value of the building. Within 24 months after the date of QOF A’s acquisition of Property X, QOF A invests an additional $400x in converting the building to residential rental property.
Under § 1400Z-2(d)(2)(D)(ii), tangible property used in a QOF’s trade or business is treated as substantially improved by the QOF only if, during any 30-month period beginning after the date of acquisition of such tangible property, additions to basis with respect to such tangible property in the hands of the QOF exceed an amount equal to the adjusted basis of such tangible property at the beginning of such 30-month period in the hands of the QOF.
Because the factory building existed on land within the QOZ prior to QOF A’s purchase of Property X, the building’s original use within the QOZ did not commence with QOF A. However, under § 1400Z-2(d)(2)(D)(ii) QOF A substantially improved Property X because during the 30-month period beginning after the date of QOF A’s acquisition of Property X QOF A’s additions to the basis of the factory building ($400x) exceed an amount equal to QOF A’s adjusted basis of the building at the beginning of the 30-month period (#320x).
Many real estate projects make debt financed distributions to the LLC members. The April 2019 Regulations follow general partnership tax principals and allow distributions from QOFs taxed as partnerships up to the amount of the Member’s basis, which includes the Members share of partnership debt. The distributions cannot, however, trigger the disguised sales rules.
Section 1231 Property is real or depreciable property held for more than a year. Total gains are netted from losses so a taxpayer who sells multiple assets will not know until the end of the year if he has a long term capital gain (or an ordinary loss if the net is a loss).

The April 2019 Regulation says that the 180-day period for reinvestment of section 1231 gains is at the end of the year (rather than the date the asset was sold) in order to see if such gains are netted against losses.

This may create issues for QOF investments made in 2018 which were thought to be gains at the time of the sale.