Opportunity zones webinar: irs proposed

regulations for oz funds [01:05:55.2]
Korb Maxwell, Jeffrey Goldman and Patrick O'Bryan

October 24, 2018

|  |  |
| --- | --- |
| Korb | Thank you all. This is Korb Maxwell with the Polsinelli firm in Kansas City. I am coming to you as the Chair of our newly formed Opportunity Zone Practice Group and I have with me today Jeff Goldman and Pat O'Brien, both of our Tax Department to walk through and help explain the new guidance that we received on Friday from the IRS and Treasury regarding Opportunity Zones. So, the Polsinelli firm has been on Opportunity Zones since the very beginning. We were intrigued with the law and believe showed some of the greatest promise to have the biggest impact out of all of tax reform and we have been following it closely, working with EIG and others in this space all throughout its development and we were incredibly excited to see the guidance that we had all been waiting for so long to come out on Friday afternoon and between the good efforts of Jeff, Pat and many others in our Tax Department, Real Estate Group, Corporate Groups and all of the others that are involved in our Opportunity Zone Practice Group, we were able to dive in, analyze the guidance, the revenue rulings, and the forms and publish our thoughts of what we saw late that Friday evening, which I was really pleased and with the work of our team of how much they put in and how committed they are to this space. In addition to that before we roll into the guidance which I know is why most of the folks that are logged in are here, I know that there will be varying levels of expertise and understanding about Opportunity Zones from the many we have on the call. For that reason we're going to do the briefest overview of what are Opportunity Zones in the broad, broad, broad context and talk about kind of what we knew about the law prior to the guidance being published on Friday before we get into a Q&A and discussion with Pat and Jeff about what we actually saw and some of the parts that we think have the most impact. So first and foremost and I know many have seen this slide from us before or have worked through this. What are Opportunity Zones and What are the benefits? So, Opportunity Zones came about as part of tax reform while there was not a single Democratic vote for tax reform the one thing we know is that Opportunity Zones are broadly bi-partisan. You have Corey Booker and Tim Scott being the lead sponsors on this. Showing a true bi-partisan effort to create a mechanism that can flood low income census tracks across the country with capital and provide additional capital so that we can smooth this uneven recovery we've seen since the great recession. And so what are the benefits? Why are these zones going to be flooded with capital? Why do we believe as evangelists of this law that it is going to make great change out all across America in these low income census tracks and it's because of the regulatory framework that was put together and the benefits that investors and tax payers get to invest in these Zones. So the thesis behind the law is that there is Six Trillion Dollars of unrealized capital gains in America and the government is not making any money off of those because they are unrealized right now. So how do we incent the market to transact and then instead of allowing investors to just put that money in their pocket, the incentive will be for them to put it in funds and then put it down in zones. And if they do so, what are the benefits they get? I always think about this the easiest way is to get real life with examples and pretend that an investor has sold Ten Million Dollars of highly appreciated stock. If that investor sold Ten Million Dollars of highly appreciated stock, no if ands or buts, they are going to pay 23.8% or 2.38 Million Dollars to the federal government unless they look and work with the tool we have here of Opportunity Zones. So instead of doing that, if that same investor takes that Ten Million Dollars of gain and puts it into an Opportunity Fund that they create that then gets that money down into an Opportunity Zone to do a deal they can have a long term deferral of that gain. They can have now up to an eight year deferral. They would pay tax on December 31st 2026 that they have worked through and have an eight year deferral of that gain where they are able to make a return on their money. That's the first benefit. The long term deferral. The second benefit is a partial forgiveness of that gain. That Ten Million Dollars that I talked about, it was all profit and because it's profit, by definition it has no basis. The basis in that profit is zero. If instead it's put in a Fund that then works down into a Zone and it's in the Fund for five years prior to that December 31st 2026, it will get a 10% step up in basis. By operation of law we will magically create a Million Dollars of basis. If it's in the Zone for another two years prior to that December 31st 2026, it will get an additional 5% of basis or Five Hundred Thousand. So when tax would be paid on 12-31-2026, it would have a Million and a Half Dollars of basis versus the Ten Million Dollars in gain, so you would pay on Eight and Half Million Dollars and considering the tax rates are all the same at that time, you would pay Two Million Dollars of tax instead of 2.38 Million Dollars in tax. So a 380,000 reduction. This first and second benefit, the deferral and the step up in basis or partial forgiveness we believe are interesting and critical and integral parts of the law, but we don't believe so many people would be on this call or there would be so much interest across the nation but for the third benefit. The third benefit is why we believe investors, business owners, tax payers, developers are incredibly interested in the promise of this law and that is if you are in the Zone and in deals for ten years and a day and then you sell, you have a complete and total forgiveness. You exit tax free of the gain. Those are three main benefits and the three sort of building blocks of the law. We also have tons of clients that have discussed with us and asked sort of, how does the timing work right? So I've had this gain. I've this event, what do I have to do. What we were answering before Friday was that you have 180 days from the date of the event, that capital event to get down into a Fund and then after that you have to deploy the capital prior to any of the test dates and the law sets out test dates at a ½ year mark and a full year mark, June 30th and December 31st for the test dates. So we were advising clients that you needed to get into deals and create that Fund within 180 days of your event and then be able to meet the 90% asset test, possibly shortly thereafter or no longer than six months thereafter. We'd obviously heard through the grapevine and through the discussions that had been going on that we were going to get relief from that. We as an industry wrote many times that if we wanted the law to see the full promise we needed relief from that timeline. We needed additional time to deploy. We all have considered if you had a Million Dollar gain or Five Million Dollar gain that you would be able to deploy that into deals relatively quickly, but if we were truly going to get to a Fund concept and we were going to be able to aggregate pools of capital that were Fifty Million, a Hundred Million, Five Hundred Million Dollars, we were going to need additional deployment period. Thankfully as we're going to talk about in this session we got some relief on that. I still think there's parts of the law that will make those sort of large funds multi-asset funds be difficult to execute on and work through but we'll talk about that more as we dive down into the guidance. I'm not going to go into to a lot of detail, but QOZB, Qualified Opportunity Zone Business and Qualified Opportunity Zone Business Property. These are the things that the Fund needs to own 90% of that needs to have as assets in. The rules as many commentators have made and discussed are very slim. This does not have asset class designations or only certain assets that can be invested in, the tool was made to be broadly flexible to be able to encourage different business models all across the United States and importantly the tool was also made that this wouldn't just be a real estate play. The folks that were behind this law and pushed this law, they wanted real estate deals to happen, but they knew real estate would be the low-hanging fruit of this. They really wanted it to work for the "real economy" and be accessible to business. Given some of the guidance we're going to talk about, we believe that aim has been achieved. This was probably the most critical piece of guidance we got for the long term health of the program is that it's not going to be only a real estate tool. We're going to do a ton of real estate deals off of this, but we have the opportunity to make this work for tenants and businesses out there moving forward. Then just to shortly work through we also have all of the issues of Qualified Opportunity Zone Business Property. We've been talking to clients about these for months. The related party rule, the substantial improvement test or original use test and the importance that that's an ore. You could either have this substantial improvement by doubling the basis or you could end up doing original use and using original use as sort of a permanent finance vehicle. As we'll discuss at the end of the program, we didn't get any guidance on the original use point. That's still out there and something we'll need to see in later rounds of guidance. But, it was good that we've got a lot of information on substantial improvement and have improved our thinking on that and with no further ado given that component. I want to start diving into what these regulations said and importantly while we say here it was regulations, this wasn't just 80 pages of regulations that we got. It was 80 pages of regulations, but it was also a revenue ruling and it was Form 8996, the self-certification form. The IRS published a big package of material here and we've been working all throughout the weekend and early part of this week and Friday to understand it as much as we could. We believe we'll have additional insight in the days and weeks ahead as continue to work through this and apply it to particular client problems, but we wanted to get this webinar out and out early given how much interest there has been in the market in these programs. While this guidance importantly is not final, one thing Treasury did say, or the IRS said, is that if you act on this guidance, these preliminary rules, you will be able to rely on it moving forward. So we believe that we are now at the true, the gun has gone off. The market is started and we are actively working with clients every single day on deploying OZ capital into deals and/or Fund creation. So enough from me. Moving to the guidance and what we saw. One of the questions we have been scratching our head about for a long period of time is how do you treat land? How does land work for original use and/or substantial improvement? This was a component and this was actually within the Revenue ruling that we got, that was provided and Jeff Goldman, my Chicago Tax Partner, is going to speak to what did we see in this Revenue ruling.  |
| Jeff | Thank you Korb and Good Morning. The problem that this Revenue ruling and it was also included in the regs was trying to address is that what if, for example, you buy land and a building and for Ten Million Dollars and the land itself is worth say Five Million. In order to meet the substantial improvement test do you have to put Ten Million Dollars into the building in order to "double the basis." In the ruling and the regulations the Treasury has concluded that you basically ignore the land for this purpose. So, in my example, if land is worth Five Million and the building on it is worth Five Million, you only need to substantially improve the building basis. So you need to put Five Million Dollars into the property to meet the test. This should be very investor friendly. We think that this application will also assist in using vacant land because we think that vacant land will basically be ignored now for purposes of doing Opportunity Zone building. It has some people have asked whether people could basically buy land and sort of hold it to appreciate. We don't think so because that would not be an active trade or business, which of course is required. But then somebody came up with the idea, well, can you buy land you think will appreciate and put in a lemonade stand. That costs, you know, $100 or something. You have an original use, maybe or you've substantially improved that work. Interesting question. We don't really think so. The key parts of this though are that it really frees up the Opportunity to do value add rehabilitation projects. It was very difficult to see how you could buy land and a building and be able to improve the building if you had to include the land. This may also open up areas that previously we thought would not be good targets, especially the coasts where even in Opportunity Zones the land could be very expensive.  |
| Korb | Thank you Jeff. This Korb again. I guess I would just highlight and we're going to say this a lot, the piece that we saw out of this was that Treasury and IRS were being extremely investor friendly. They were being proponents of this program. They want this program to be used to maximum effect and out of that we're seeing friendly taxpayer regs. They are attempting to make this work. They are not trying to close it off. You are seeing that the administration wants this to be as big as it can be. We've talked all across the country and said before that the sweet spot for this, especially when we're talking about the real estate side was ground up development. When you looked at the rules it really was meant to work for ground up development. Given this component of taking out the land and removing the land I want to highlight one of the points that Jeff said. We believe value ad rehab is now on the table. We believe value ad rehab could be even further on the table if you look at the fact that you pull out the land, but then because the statute says adjusted basis, if you look at concepts like doing a cost seg. and pulling out from that the under 20 year property, you could be even lowering the basis of an asset or a target further and making that value ad rehab be even less substantial. We know it works for incredibly substantial value ad rehab, but this may start giving some of these rules even work for light brush rehab. That's a fact we'd have to work through with folks off the call and with specific clients on specific deals, but we at least wanted to highlight it. The other component that Jeff talked about and I do want to take a moment to mention as we've traveled all over the country talking about this is we've talked to folks in New York and California and others and they've said, we just don't think this program works for us. Our land cost is so incredibly high. We see how this is going to work in the Midwest and the South and the Rockies and otherwise, but how's it going to work in the city when you have the price of the land dwarfs often whatever can be built on top of it. That is now firmly on the table when you are able to pull out the value of that land. So we believe this was an incredibly tax payer friendly rule and shows again that the administration is trying to make this work. Continuing on with things that are tax payer friendly and was a welcome component to see was some relief that we've seen in the timelines to get down into a Fund. As I said before, we were advising clients that you had to be in a Fund within 180 days of the event and frankly given how unknown this product had been in the market, especially for those that had events in the very beginning of 2018, we have run into many clients that had sort of missed their window and would not have an ability to put their money into a deal. I'm going to turn it over to my Tax Partner, Pat O'Brien here in Kansas City with me who's looked into this and will walk through what we've seen for pass-thru entities.  |
| Pat | Real quick before I, thanks Korb. Before I go down that I have gotten several questions about the third benefit clarification on how that works. The first two benefits are initial deferral Korb's Ten Million Dollars, you do pay the tax on that depending on whether you get the 15% or the 10% discount. You will pay that tax in 2026. So if you invest now, 85% of that tax will be paid in 2026 or on April 15th of 2027 with your tax return. The additional, the big third benefit is your gain above that Ten Million Dollars you invest. So if you invest Ten Million Dollars and it's worth Thirty Million in 2027 or ten years and a day after 2020, I'm sorry, 2028, ten years and day after you invest, at that point that additional Twenty Million Dollars of additional gain is tax free.  |
| Korb | Thanks Pat, that's absolutely right, and if I was unclear on that earlier, I apologize. It is important to know in this program and we've talked about through this with folks all across the country is different then 1031 right, you will pay tax on 12-31-2026. You will pay tax on that initial gain. It's the exit on the amount over and above that later on, that appreciation that you've seen. So thanks for that Pat.  |
| Pat | And two important practice points there, 1) is to make sure you do have the availability of funds to pay that. Because the ten year hold is actually longer than that. You could get in a situation where you don't have the funds to pay that and it's not entirely clear yet at whether you can borrow money against the fund to do that. We think that you'll be able to but you're allowed to use the fund interest as collateral but there some concern there and then the second practice point there is it's actually the fair market value in 2026 so if your investment in the fund craters and it's worth nothing, you're not still on the hook for the tax. You pay tax on the greater of the deferred amount or the fair market value in 2026.  |
| Korb | Pat's absolutely right and as many know on this call, we've talked through that component of fair market value and what that can mean for various different types of deals, real estate deals, venture capital deals that could work into business and how the example I've presented of sort of paying tax on 85% right, just short-handing it to paying 85% of the tax is sort of the high side of that if you've been in the investment long enough that it could actually be much less than that depending on the valuations of those assets and Pat was smart to bring that up.  |
| Pat  | So back to the slides. So we're talking about pass-thru entities. This includes both partnerships and S corporations. The regulations are specific to partnerships but they do include, they say these will apply to S corporations as well. I do a lot of work with partnerships here at Polsinelli and we do think these are pretty favorable. As Korb noted, prior to the proposed regulations we weren't really sure how exactly these opportunities on rules would apply to partnerships, does the partnership have to invest? Does the partner invest? How do you figure that out? These proposed regulations are very favorable in a sense that they actually give you a choice as to whether the partnership or the partner ends up taking advantage of these provisions. They accomplished this by effectively creating two windows that are reinvesting the partnership capital gain. The first window, the initial one is that the partnership has 180 days from the date of the capital gain event itself to invest in a Qualified Opportunity Zone Fund. The partnership does this and none of the gain will be allocated to the partners on their K-1 and the partnership will be the one with the Opportunity Fund investment. If the partnership opts to not invest in the Opportunity Zone Fund then all the partners have 180 days from the end of the partnership's taxable year to invest in Opportunity Zone Fund. This is what Korb's talking about on how you may have thought you've missed your window and you actually haven't if your gain was through a partnership. So we've had a number of people, we were on the phone calling lots of clients on Friday telling them, hey, we thought we'd missed your window when you has a gain in January and you know, 180 days are up but actually you have fresh 180 days starting at the end of your, at the end of the partnership's taxable year and so counting your partnerships that means you have until January 1st, 180 days from that date to do it. So that's pretty favorable. On the flipside of that if you prefer, because you want to invest in a Fund now, the partners can elect to use the 180 day window from the partnership's capital gain event so if the partnership sold some property today, the partners could elect themselves to have 180 day window now. So that's important because we were really worried that people would miss the chance to have that. And another nice thing about this is because each partner can do their own investment, it makes it easier when partners want to go their separate directions with the next investment, I'm sure a lot of you are familiar with the games that get played trying to do drop and flop transactions and stuff so the partners can go their separate ways. We don't have that issue here. Each partner takes the gains and it goes on down the road and can take advantage of this without having to coordinate ahead of time with the other partners. Planning points that we recommend, we do strongly recommend adding a notice provision to your operating agreement. We think partners are going to want to have the availability to know that they can make an investment now or next year. Because if you don't find out about a capital gain event until you've received your K-1, optimistically you're not going to get that until March. You're already 75 days into your 180 day window and assuming that the partnership files on extension you might not get your K-1 until your 180 days are over. So we highly recommend going back to your partnerships and adding notice provisions that the partnership will notify partners of a capital gain event if not at the time, at least on January 1st or the day after the end of the taxable year for fiscal year partnerships so that partners are fully able to take advantage of this provision. And one other practice point here, we are referring to it here as the Donut Hole. This does create the potential that there is a window in the middle where you actually can't invest in an Opportunity Zone Fund. The example would be if you sold, if the partnership sold property on March 30th, the partnership or the partners have that 180 day period from March 30th that ends sometime in September, from the end of that date to the end of the year you're actually outside of either of the two windows. So if you reinvest in November into a Fund with your gain proceeds, we'll you've missed the initial 180 day period and your partner 180 day period hasn't started until the next January 1st. So do be careful when you're making your investments if things get deferred or pushed that you keep in mind you don't have an unlimited period here. There potential for some hole in the middle that can snag you.  |
| Korb | Great fabs Pat. I will just wrap this point up by saying, we were very happy to see that essentially when it comes to pass-thru entities you have two bites at the apple. You have sort of the first component of the 180 days and then you have sort of after you've moved past that as individual investors and pass-thru entities you could have, you have another 180 days period. We believe this puts a lot more gain on the table for folks that may have missed or not seen this law in the beginnings of 2018. The next one if one of the most discussed and talked about components from industry practitioners and it was something we heard that may be on the table and may be coming forward through our work with the EIG Group and others. It's been one of the talked about points of how do we make these timelines work? We've got all of these timelines in the law, but then we're going to have to get out and we're going to have to deploy this money and how's that going to work for construction projects and phase projects and businesses that have long-term needs for capital. How are we going to make all of these timelines sort of flow together and work between the Fund and the opportunities own business and otherwise and Treasury was responsive to that through the concept of what we saw in the statute of being able to have adequate working capital down at the business and so, Pat what did we see from Treasury about this working capital issue? |
| Pat | So the Treasury in the proposed regulations gave Opportunities on businesses a 31-month period to spend their working capital or the funds that are invested. This really does alleviate the concern that if cash or all the Ten Million Dollars of gain was put up front and planned on being deployed over that 30-month period that the cash would be a bad asset and it would count against your 70% essentially all test or 90% so these regulations really help by saying if you follow a number of rules here we will not count that as a bad asset against you. In order to meet this working capital safe harbor, the working capital must be designated in writing, so you have to identify what it is. It's not really clear exactly how far that has to go, if you have to identify specific things you invested in or what and it's noted below. Right now that's limited to cash, cash equivalent or debt instruments with a term of 18 months or less. While we're hoping future regulations kind of expand that a little bit to give you more options to invest in, but perhaps right now you have to designate that the working capital is in the following debt instrument and then will be reinvested in other ones. The second part is you must have a reasonable written schedule for the expenditures of such working capital asset and then third is, the working capital asset much actually be used in a manner that is substantially consistent with these requirements. How close and accurate you have to be for reasonable written schedule and applying these funds substantially consistent is unclear. Obviously no deal ever follows to the dollar exactly what they think they're going to spend on these so there's gotta be some flexibility there. We're hoping because of how reasonably tax payer friendly these provisions have been we're hoping that this is a little bit more broad than it sounds on paper. But as a practice point we do think this written requirement really limits the ability of blind pool to operate. We think it's going to be harder to start a Fund where you're going around gathering money and then you're going to go find an investment at a future date because that really does run the risk of not complying with these rules if you can't get the Fund invested by the asset testing date. So this particular provision is definitely favorable but favor deals with the concrete plan upfront. We will note that as written this safe harbor does not apply to direct investments by Fund, rather only applies to Opportunity Zone Businesses that the Fund itself invests in. Certain aspects of the preamble to the regulations were written kind of implying that they were going to apply to both Funds and businesses but as the regulations were written, it does only apply to Funds so if you are doing a direct investment with the Fund I'd be careful to keep cash and other bad assets under the 90% tub.  |
| Korb | Thanks Pat. The point that I took from this generally is trying to put deals together. Is this is the component that allows us to get sort of through the clunkiness of the law. The law has these aspects of 1031 rules around them about how you're going to be in 180 days and it has other aspects that have been taken from new markets tax credit law and all of these timelines have made it sort of difficult to think through for an investor or for a sponsor of a deal. How are you going to apply it to a specific deal? This component of working capital that I can move the money from the Fund down to the deal, right, the Qualified Opportunity Zone Business and I can have a written plan for it and a schedule it lets us be able to broadly apply the law for most development projects, phase development projects that we'll have out there. Businesses that we have reasonable foresight on. I still think we've got a problem for the 200-500 Million, Billion Dollar blind pool multi-asset. How do you make it work for that? We're not there yet. But for specific deals, specific projects, folks that are on this phone that have an idea of what they're going to use, this was a key component that lets us move you forward and get your deal working, get your deal done and you can go back and say to your investor or for yourself you're not going to blow your tax treatment because of this working capital safe harbor.  |
| Pat | In response to a question I just got. There's a 30 month safe harbor applied to each commitment or does it start with the inception of the Fund? We think it's likely going to be each commitment. It says the capital can be held for 31 months and so that implies that if the capital isn't going to come to 12 months you have that period from that point. So it does create the potential you can having some rolling investments if you'd want to try to expand that period, but you do have to keep in mind that 31 months is actually longer than the 30 month period you have to substantially improve the property so I'm not sure how relevant that will end up actually being in practice but we do think the period will start from the investment itself.  |
| Korb | Great. Thanks Pat. I touched on this slightly this next rule at the very beginning. But Treasury gave us a component of what does substantially all mean for tangible assets. And if you go through the slides that I put up earlier about Qualified Opportunity Zone Business and Qualified Opportunity Zone Business property. You see the word substantially all used multiple times through the statute and all of us as practitioners have been scratching our head about what is substantially all mean? That being said is sort of advocates through the economic innovation group and overcratic and others, we had been pushing on Treasury and the IRS to give a lower threshold for substantially all. The though and fear was in the industry that if substantially all meant 90% or more, you were going to foreclose the ability to do business deals. To be able to do real economy deals and the only thing that Opportunity Zones would end up funding would be real estate deals. So all of us passionately advocated for a lower threshold for substantially all. Treasury responded to that in this first round of guidance and we believe this was one of the most welcome components of the guidance that's truly going to open up OZ's to meet its promise of being broadly applicable. And for that I want to talk it through and have Jeff Goldman go through it in detail.  |
| Jeff | Thanks Korb. Given what Pat has told us about working capital, it really appears that most or many investments of Funds will be done through Qualified Opportunity Zone Businesses and as Korb has indicated, the rule is that an Opportunity Zone Business must hold substantially all of its tangible property in Opportunity Zone property and as he said it's very critical to know what "substantially all" means. The guidance tells us that 70% of the tangible property held by an Opportunity Zone Business must be Qualified Opportunity Zone property. This will be very important for operating businesses for a number of reasons we will discuss in a bit. The guidance also gives rules for valuing the property. And they are you look at what's called an applicable financial statement of the business and if the business doesn't have one because it's essentially a gap financial, you can actually use a methodology that is used by some of the Fund investors, basically those who have more than 5% of the Fund. So there's some leeway in how you value this substantially all which we think will be important. The practice points, this is a very important move by Treasury. We think it opens the door to operating businesses. There were lots of questions about when property was business property, whether things like, whether things are used in an Opportunity Zone, I mentioned there the delivery truck issue. Just one point about intangibles. The law says that a substantial portion of your intangibles must also be used in the Opportunity Zone Business and within the Zone and the guidance gives us a safe harbor for construction and real estate that says that they will just assume that you meet that rule. That one isn't as critical obviously as these others but we did want to mention it. A couple more things, valuation obviously is critical and the fact that they've given us these tests is helpful and for operating businesses there's just so many ways that this is helpful. The last thing I'll mention is that the rule is that substantially all of the property owned or leased by the Opportunity Zone Business has to be Opportunity Zone property. This gives businesses lots of flexibility and just you know, leasing existing property rather than having to make it original use or substantial improvement to conduct their business so they can truly just be operating businesses.  |
| Korb | Thanks Jeff. That was excellent from an explanation point. I would mention one thing and for most on this call they're interested in doing deals and not interested in being down in regulatory guidance or advocating to Washington. But one thing I would say on this point was, and you see this in multiple times through the regulation. The regulators actually asking for input and it was like these regulations in part were written with two voices. Sort of one, the taxpayer advocate out there trying to expand the law and make it work for deals and then sort of the IRS c\_\_\_\_\_gion sort of protecting Treasury as well at some point and this was one of those components where you could sort of feel two voices in the regs. I would say that this is an incredibly important point and for those that are parts of operating businesses and want to use Opportunity Zones for operating businesses. Let us know, bring us your examples, tell us about this because this is something we need to share, make comments on, and make sure that this reg in the final ruling stays at this 70% level as it really is the most important part for creating operating businesses to be allowed and this also could set the threshold of if substantially all means 70% for the tangible asset test, does it mean 70% for all of the other points its mentioned in there. I want to be really clear. The guidance didn't talk about that. But it's a hope that it continues to roll that way and goes through that way because that provides us the flexibility to ultimately get the point of writing tax opinions for you that this program and model will work when we apply it to your specific facts and circumstances. So this is a critical component. We look forward to talking to our clients and others in the industry about this more and making sure that this piece continues to work. I'm going to move on and talk about the part that I thought was also very important with leverage. We have had questions through this many, many times of both can leverage be applied at the Fund level and can leverage be applied down at the asset level. At the Fund level this is an important point because again, if you can do leverage it allows us to sort of smooth some of the clunkiness of the law. If you can leverage the Fund level and that leverage is sort of disregarded it can allow a Fund sort of sponsor to be able to figure out ways to aggregate capital and apply it down to specific projects and obviously we needed leverage at the asset level. For all of those in the real estate economy we all know how critical leverage is and as powerful as I think this tool is, I don't think it's going to fundamentally change how we do real estate deals out there or how we do business deals. So understanding how the IRS felt about leverage, felt about debt, was very important to making sure we had an operative tool. Pat, can you tell us sort of what the law said and then the inferences that we were able to take from the law as well about leverage?  |
| Pat | Yeah, so favorably the regulations do permit leverage. We think whether it's by direct investment through the Fund or through an Opportunity Zone Business. As you noted, it's really important for real estate deals. If we weren't able to take borrowed money then it would be really unlikely this program would take off and work. Not to get into the details or the w\_\_\_, the partnership rules that the concern was that if you, if the Fund or the Operating Zone Business borrowed money, that the portion of that money that was borrowed would be treated as a non-qualifying investment that wouldn't get the permanent exclusion after ten years. So for example if you had put 30% equity in the business, borrowed 70% after ten years the concern would be that only 30% of the gain would be eligible for the permanent exclusion. These new regulations specifically say that, that is not going to be the case. That you will not have a separate investment for amounts that are borrowed money. They did leave open the possibility of an anti-abuse rule so there is the possibility that if you are really heavily leveraged, you know, close to 100% or some threshold that they might say that doesn't qualify. They've asked comments for whether that should be there and what that should be. So it is possible we do recommend having at least some equity in the deal to make sure you don't get snagged by that. But following regular deals should not have any problems with this. The important implication that Korb mentioned is that the regulations imply that partners get outside basis for debt borrowing. Your Opportunity Zone investment itself specifically says you don't get basis for the equity you put in, but if you do get basis as a partner for borrowed money that does give you the potential ability to take advantage of losses such as depreciation and then if you follow the plain reading of the statute it's possible that such losses actually won't be recaptured when you fulfill all your Fund interest after ten years. So that as written right now, I would say you get the benefit both ways. You can take depreciation for debt financing and then after ten years you actually not stuck with the recapture. They may \_\_\_ regulations work around that but as of right now I would think that's a possibility.  |
| Korb | So Pat hit on a huge point there and this is something we've talked to real estate investors about all throughout this process is if you can use leverage, you get basis from leverage through the asset, you're able to depreciate that through time and have sort of the normal fundamentals of real estate, right. You're able to take out your rents and essentially take out your rents tax free because they're covered up with depreciation. We've always in the past had that catch up at ten years and a day. You get to sell and you get to pay a lower rate of cap gains but you do pay tax. Our belief now in seeing this regs. was what we thought from the beginning, is that if works the way we think it works, then at ten years and a day you sell, you do not have that depreciation recapture. This is an incredibly favorable point for this law of moving this forward and making this work out there and why investors, tax payers, real estate developers are going to want to take advantage of this. So early disposition. There's been a lot of talk in the industry about disposition of Fund assets and thinking through the back side of this and how do you dispose. There's also been a ton of talk about the interim gains issue and what happens through time if you're not at the Fund level but down at the specific asset level of you don't want to have a ten year hold period or your timeline isn't a ten year hold period and you're going to sell assets in the interim and we didn't get all of those questions answered. The interim gains issue which is probably the most important issue that hasn't been answered through this first package wasn't answered but we started to see moves in the right direction with some of the things we heard about disposition of Opportunity Zones interest. Jeff, can you go through in a little more detail what the regs. said about this disposition? |
| Jeff | Yes, thanks Korb. The regulation guidance says that if an investor sells all of its interest in an Opportunity Fund, it has 180 days to reinvest that amount and if it does it can continue to defer the gain that was originally deferred with the first investment. So if an investor invests a Million Dollars of gain in 2019 in a Fund and sells the Fund for a Million or even Two Million in 2023, they can, within 180 days reinvest those amounts and avoid a tax event at that time. They still will have one in 2026 when the clock runs out but for individuals who, or investors whose original investment isn't doing well or even if they get you know, a windfall because somebody comes and wants to buy their property for five times value and they'd like to avoid tax, they can invest that in the same Fund or in another Fund and continue to defer. It is an opinion question as to whether that second investment has to be held for ten years because technically the guidance requires a new election to be filed saying I'm going to defer this gain. So it is entirely possible that the second investment will have to be held for ten years. The guidance did not address what happens if the Fund itself sells property. We are hopeful that the guidance will say that the Fund can reinvest the gains at least without causing a tax [\*\*Stopped at 48:27.5\*\*] even to the investors, but we don’t know yet, Korb. We’ll just have to wait and see. |
| Korb | Thanks, Jeff. We’re getting close to the end of our presentation. We need to briefly touch on several other topics that were raised that we didn’t do full slides on and are just throwing them together here and Pat’s gonna do that, but I would encourage any in the audience to start typing in their questions as we’re getting soon, as we’ll soon be at the end and if folks want a specific question answered, we’ll try to take the end period of this time that we have together to answer those questions so, Pat, tell us about some of the other broad concepts we saw in the guidelines and regulations and things that we think are important to the audience. |
| Pat | Sure. One of the first things that’s not mentioned on this slide is that the Treasury limited the gains available to capital gains. We’ve always thought that that was going to be the answer in the regulations because clearly that was the intent based on the committee report and all the discussions forming this provision, that it was only going to be capital gains that applied. Once practice point we want to point out is that based on the language in the statute, we do think that that will include Section 1231 gains which for a lot of you in the development world and real estate, when you refer to capital gains, your gains are actually 1231 gains because you’re selling a business property – or property used in a trade or business – and you ultimately get capital gain treatment for it so a key item to consider with this is that when you do have 1231 gains, you actually net it against 1231 losses before you determine your amount of gain for the year, capital gain for the year, and so we do want to make sure that you don’t trip over selling a property for a loss in a year that you’re planning on making opportunities on investment with some other gains. You might actually reduce your gains available for investment needs and then find yourself with a split investment in an opportunity on fund so do make sure you plan your gains and losses carefully so we don’t trip up there.  |
| Korb | And Pat, before you move on, I want to highlight that component again even though we don’t have it on the slides. This is about capital gains. Opportunity zones are about capital gains. We have advocated that. We have told our clients that. We have advised folks all across the country on that. It was incredibly clear when you read the legislative history, when you understood the background, when you talked with the folks on the hill in IRS and Treasury, that this was about capital gains. Many other advisors across the country were telling folks different components there. Many other advisors have been saying you could put in fresh equity or you could put in ordinary income and you might be able to still get the 10-year exit benefits from that. We’ve been consistent since the very beginning trying to advise our clients on what the heart of this law is and how to handle their projects and handle their investments and handle their fund and we think it’s incumbent for all in the audience and all out there to make sure they’re getting good counsel on these points that have been deeply steeped in this law and understand sort of where it’s going, the genesis of it, and what are the proper funds to invest and how to invest in what the benefits are. We take that critically here as advisors. We hope the rest of the industry is doing that. There’s a lot of misinformation about this law. We hope that these regs are gonna help clear some of that up, but we’re going to keep pushing sort of right down the heart of this law to make sure that our clients are protected. Sorry, Pat. |
| Pat | Sure. So the next point that we wanted to talk about – the regulations do permit special allocations. We’re not sure exactly how far the service will permit us to run with that. We do think the best practice is if you’re going to have special allocations or a carried interest is to make sure that your carried interest has some cash equity component to it. If there’s no equity with your interest, it’s likely the service will take the position that that is entirely for services and that no aspect of that was actually based on invested capital gain and, therefore, you wouldn’t get the 10-year benefit and so we think that’s the way to go on that one is to have some equity. Otherwise, you run the risk of – we’re not sure exactly how far you can go down the road as a profit interest above your equity investment, but there is obviously some flexibility to have a little bit there. |
| Korb | This is a huge point for us in the real estate industry and in the business and investing community. As we’ve talked with sponsors of funds or sponsors of \_\_\_\_\_\_\_\_ all throughout this law and the formation, everybody is interested in their carry. Everybody’s interested in how will that be treated and what will the impact of it be and this will all help, these regulations help to move us forward in that, but we’re still gonna take the approach that if you can end up having some sort of deferred gains as a sponsor and putting those deferred gains in, you’re gonna be in a better situation than just doing a pure carry on this. So this is a point that we’re gonna have to work on. Everybody on the phone specific deals and need to get into the details on this, but it was good to see the service understood the importance of carry and how that was an incredibly important point to those of us that are out there in the deal world and making sure that it could be provided for. Pat, any other thoughts on here? |
| Pat | I’m good. Jeff, do you want to talk about the testing dates? |
| Jeff | Sure. As we’ve said, a fund has to invest 90% of its assets either in a qualified opportunity zone business or in qualified opportunity zone property and there are two testing dates for that. The first as the guidance says now is the last day of the sixth month following formation and the second is the last day of the tax year. So, for example, if a calendar-year fund is organized in March, the first testing dates will be six months later. I guess that’s October. And there’ll be a very quick second test date in December. The issue and the potential trap for people to be aware of is that if a calendar-year fund is organized in December, there is going to be a test December 31 and if it doesn’t have 90% of its assets properly invested, it would flunk the test and could be subject to penalties. We are certainly hoping that the IRS will say that that quick gate gives taxpayers what’s called “reasonable cause to avoid the penalty” because the statute does say you can avoid the penalty for reasonable cause so we’re hoping that this won’t occur, but it’s something people need to be aware of. |
| Korb | Great. Thank you, Jeff. Another point, and we got this question, we believe for a long time that limited liability companies were gonna be allowed. Partnerships and corporations was what the statute talked about, but we believed ultimately you would able to use limited liability companies, that being said to be abundantly cautioned for deals that we have been closing up to this point, we recommended our clients, particularly our real estate clients, end up using a limited partner form. We now have the guidance. We know that we can use LLCs and we’re sort of back to business as usual of being able to use limited liability companies. Pat, Jeff, any other sort of thoughts on these other regulations and/or questions we’ve seen from the audience to this point? |
| Pat | Appreciate the \_\_\_\_\_\_\_ coming in. There are a lot of them here. I'll try to see it through and hit some key ones. One of the questions is Do you have a timeline for how long these investments can be made? The opportunity zones are designated until the end of 2026 so you do have until that period of time to invest gains in opportunity zone funds. Then those designations go away so investments after that point, if this isn’t extended, are new opportunities undesignated will end then. Obviously, if you invest later than now, the further down the road you get, you lose out on the five and seven-year basis bump. But you would still get the deferral until 2026 which is fixed. That doesn’t roll so if you invest in 2024, that’s only two years of deferral and then the 10-year period starts from whenever you make that investment. |
| Korb | And Pat, one other point that we didn’t highlight in the law here, but that we have seen the actual full-on end date through the guidance and that was December 31, 2047, right? So investments that are made during the investment period, you can hold those all the way up until December 31, 2047. So we have a 30-year timeline for the law as a whole to be able to hold these investments. That’s interesting and something we’ve looked at for sort of the estate planning components of it and how those factors may work as we’re doing wealth-planning for clients, family offices, high net worth individuals as we’re working through sort of the components of this law as well. |
| Pat | Yeah, that was an area that Treasury definitely left open for comments and how to treat this because they don’t want this to be open-ended forever that you can hold this for 100 years and get that deferral so they threw out there, sort of as a starting offer almost, 2047 as an end date where your gain would be recognized and we expect they’re going to get a lot of comments on that and so as of now, you can rely on that, but we do think there might be some movement there. One of the questions is How is operating income received by the fund? That hasn’t been explicitly addressed yet. I think it’s likely that day-to-day work for the fund will be treated as though it’s a normal partnership so you’ll get a K-1 from it and you’ll have your ordinary income or loss \_\_\_\_\_\_\_\_\_ to you. We do think that’s key in the sense that, in conjunction with our thoughts that you can take losses from opportunities on fund. If they come up with some sort of rule that there is no income or loss from a fund which I don’t think is practical, but theoretically they could I guess, \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ limited too so we think that will be normal. We had a question concerning whether you can use New Market’s tax credits. I think that will work. New Market and some of the other credits shouldn’t necessarily have a problem with that. Specific to New Market, we think it will probably be more likely that this will occur as an alternate source of funds or in conjunction with the New Market’s investment so it will be another source of money directly into the \_\_\_\_\_\_ feed(?). It is theoretically possible to invest to the tax credit stack, but that would require (1) that it accepts CDE and makes a direct investment, equity investment into the fund which is not normally how it’s done so you would lose some of your safe harbors there and then also that it probably requires CDEs to amend their document how they plan on investing the funds, but we do think there’s going to be some work to twin these with tax credits. |
| Korb | Thanks, Pat. I think with that we’ve answered most of the questions we’ve had. The one other component we wanted to discuss and I sort of put this through many parts of the presentation, but to make sure the slide is talked about is what do these regs NOT cover? Well, there’s much that they didn’t cover. There’s many issues that can be further clarified. There’s lots of things they ask for comments on and we’ll see where sort of final regulations ended up, but specific points that were not discussed at all and will need further guidance and further regulatory packages is original use. We’ve been discussing with clients all across the country the facts of original use and that before a property has a Certificate of Occupancy or a temporary Certificate of Occupancy, an O-fund could be created and could come in and buy that out. It could end up being permanent financing for real estate projects all across the country and we’ve discussed a lot how this is difficult just as a real estate attorney thinking through how do you get clean title? How do you get debt? How do you end up having your lien cleared? How do you have your guaranties back from the original sponsor and the original deal to make that work? It can sort of make your head swim trying to think about how we do this in practice, but from an opportunity zone component, we think it’s a viable investment strategy and we know many clients and many funds across the country that are looking at this exact issue. This guidance did not address that in any form or fashion. There was nothing in the guidance about original use so all of us are anxiously waiting. What does original use mean and will this be an application we can use in the real estate world? Given that every month, there are projects coming on line and getting those TCOs and CFOs, we think this is an important component and one that we hope the next round of guidance or the next regulatory package ends up covering. Probably even more important than that issue is the interim gain issue. We’ve talked with many investors across the country that have funds and the funds are then going to go down into deals, but their timeline for a specific deal isn’t 10 years. It may be two years, three years, five years that their timeline is for their normal business investment or their normal real estate investment. Think about merchant builders out there. Will this law work for them? Will they be able to sell those individual assets and take the profits, bring them back up to the fund and then redeploy them so long as you’re within that 1231 2026 investment period? We don’t know. We know what the legislative sponsors believe and have heard them speak very clearly that they believe what matters is money not being pulled out of the fund. That you can end up selling individual deals and that money can go up to the fund and then be redeployed, but we also know what the statute says today and that statute’s citing the partnership tax rule that would make it run on through. We haven’t seen anything yet from Treasury on this issue and I think all of us that are working in op zones every day believe this is one of the most important components. And while we got guidance on substantially all of the tangible assets, we didn’t get guidance of substantially all means that is peppered all throughout the rest of the statute for qualified opportunity zone business and qualified opportunity zone business property. We’ll look in future regulatory packages to understand those rules and will, of course, be taking them out to market as soon as we can. With that, we’re very close to being done. I want to thank Jeff and Pat for their contributions and all of their hard work on this. We hope this was enlightening to all of the folks that are on the call. We believe opportunity zones are one of the largest part of tax reform and frankly, one of the largest things that it’s hit, the real estate and private equity market, in decades. We’re incredibly excited about it as Polsinelli. We have a cross-disciplinary team of real estate, corporate, tax, wealth planning, trusts and estates. We have 20+ attorneys that are working on this program every day and dedicating a massive amount of time to this. We believe our understanding of this law is really in the upper echelons and we’re excited to continue to work with everybody on this call and everybody out in the audience on the application of this law in the months and years ahead. With that, this would conclude all of the questions we’ve received and any of our formal program and we thank you all for spending the time with us this morning. Thank you all. |

THIS CONCLUDES TODAY’S WEBINAR. A RECORDED VERSION OF THE PRESENTATION WILL BE AVAILABLE ON THE POLSINELLI WEBSITE WITHIN 24 HOURS. THANK YOU FOR YOUR PARTICIPATION.

LP/mg/tm