OPPORTUNITY ZONES

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As part of the Tax Cuts and Jobs act, that President Trump passed on December 22, 2017, a new section of code was added that created a new Opportunity Zone program. The initial information provided more questions than answers, and many investors were timid to jump in right away while others were more opportunistic and created funds at the onset of the program. On October 19th, 2018 the IRS released some clarifications and requests for input. This article will include the clarifications that were released.

The Opportunity Zone program is meant to increase investment in distressed communities around the country. This program allows investors to defer capital gains tax and provides an opportunity for tax-free appreciation for a new investment properly made in a "Qualified Opportunity Zone" (QOZ). QOZs are located in current low-income areas. We will look at how these areas were selected, what the incentives of the plan are, the mechanics of deferring capital gains tax and then we will dive deeper into Oregon specifically.

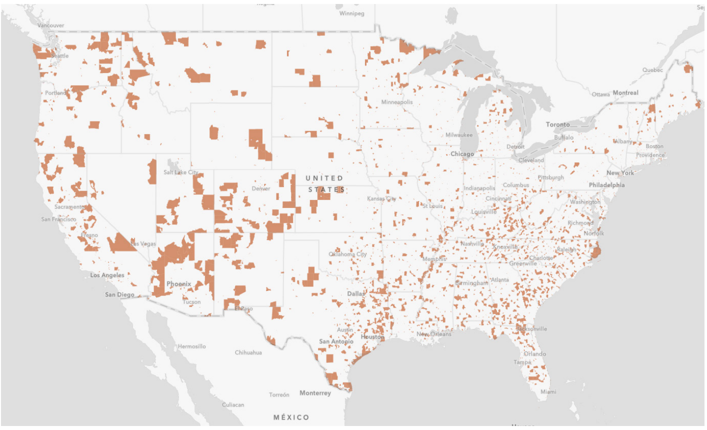

Figure 1: Qualified Opportunity Zones in the United States (Economic Innovation Group)

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OPPORTUNITY ZONE SELECTION

IRC 1400Z-1 and 1400Z-2 are the Internal Revenue Code sections behind the new regulations. QOZs are based off the 2011-2015 American Community Survey data from the Census Bureau (Haun, 2018), which identified 41,000 population census tracts that are eligible based on low-income standards.

The nomination for a QOZ was borne by the chief executive officer of each state. They had until March 21, 2018, to provide their nominations based of the list of tracts that were eligible. The nomination process was finalized in June 2018 and there were 8,761 communities nationwide designated as QOZs, according to the IRS. The federal government felt it was important to have a local lens on each state which is why the governor of each state was responsible for nominating the low-income census tracts.

The process included analysis, collaboration, and engagement to select QOZ nominees. The selection was not only just for distressed communities, but also areas that were attractive for investors to still make a successful investment regardless of the tax implications. Governors could nominate up to 25 percent of the eligible areas. Figure 1 shows the QOZ selections around the country and Figure 2 shows a survey of the selection process from the Governor's office on the nominations of QOZ.

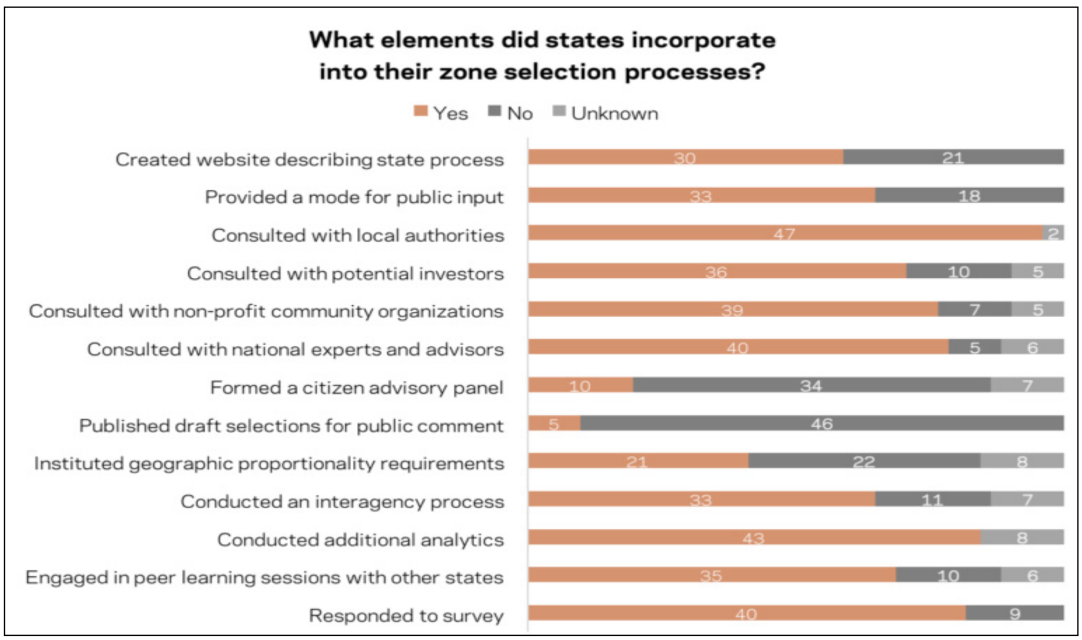

Figure 2: Factors affecting nomination for Qualified Opportunity Zones (Economic Innovation Group)

Businesses or trades that operate in a QOZ can also benefit from deferred taxes. To qualify as a Qualified Opportunity Zone Business (QOZB), substantially all the tangible property owned or leased by the taxpayer must be in the QOZ. This is to help businesses that operate in these low-income areas attract investments.

OPPORTUNITY ZONE TAX INCENTIVES

To encourage investment into the low-income communities and QOZs, the Federal government had to create an attractive tax incentive package for investors. The incentives for the investors are increased the more patient an investor is. The IRS identifies the following incentives:

- **Temporary Tax Deferral:** Capital gains from essentially all investments are eligible for tax deferral if reinvested into a Qualified Opportunity Fund (QOF). The deferred gain must be realized by the end of 2026 or when the investment is sold, whichever is earliest.

OPPORTUNITY ZONE TAX INCENTIVES

- **Step-Up in Basis:** Capital gains reinvested into a QOZ, will have the basis of the original investment increased 10 percent if the investment is held for at least 5 years. Then if held for 7 years, the basis is then increased an additional 5 percent for a total of 15 percent. Table 1 shows the holding period and basis step-up relationship. This tax can be deferred until the earlier of, the date on which the investment in a QOF is sold or exchanged, or December 31, 2026. To maximize the 15 percent basis step-up, investors must hold for 7 years before the end of 2026, meaning investments would need to be in by 2019 to optimize the program.

Table 1:Capital Gains and Holding Period

Holding Period (Years)	Basis Step-Up
5-6	10%
7-9	15%
10+	Fair Market Value

Source: IRS

- **Permanent Exclusion from Taxable Income of Capital Gains:** Once the investment in a QOF is sold or exchanged, and is held for at least 10 years, there will be no capital gains tax on that transaction.

OPPORTUNITY ZONE FUNDS

To invest, or reinvest, into a QOZ, the funds must be in a Qualified Opportunity Fund (QOF). A QOF is just the investment vehicle that is formed as a partnership or corporation that the dollars must be in to invest in a QOZ. Any partnership or corporation that is set up to be a QOF can self-certify. There are rules that a QOF must follow including:

- At least 90 percent of their capital must be in Opportunity Zones. However, if the QOF invests in a partnership or corporation to meet the qualified opportunity business requirement, only 70 percent of the tangible property of the subsidiary corporation or partnership must be held for use in qualified opportunity zone business property.[1]
- The investment into a QOF must also be an equity interest and cannot be a debt instrument. Although debt can still be used on the same investment.
- Like a 1031 exchange, the investors must follow 180-day rule for deferring gains (must invest within a 180-day period beginning at date of sale or exchange). Unlike a 1031, there is no third party holding the funds and you only have to invest the gains of a sale or exchange and not the full proceeds.
- Property must have been purchased after 2017.
- Ground-up projects (referred to as Original Use of the property) in the QOZ must commence with a QOF. Meaning the project could not have started with funds prior to the investment of the QOF.
- Renovations of existing buildings (referred to as substantially improved property) must be improved with funds from the QOF.

[1] *For example, if a QOF has $10 million in assets and wants to hold only $6.3 million in qualified opportunity zone business property, it can do so by investing $9 million in a partnership and having the partnership invest $6.3 million (i.e., 70 percent of its assets) in qualified opportunity zone business property.*

OPPORTUNITY ZONE FUNDS

- Unique to a QOF is once the capital gains are placed into the fund, the cash is safe harbored as “working capital” for up to 31 months, to take into account how long a real estate transaction and construction may take for a project. There must be a written plan that outlines the financial property is being held for the acquisition, construction or substantial improvement of tangible property in a QOZ.

DURATION

The Opportunity Zone Program expires in December 31, 2028, but even after the QOZ lose their designations, the investments will still be able to preserve their rights for basis step-ups after 10 years. This will be preserved into December 31, 2047.

Qualified substantial improvements, renovations, are determined by improving the properties basis by double within the 30-month period. This calculation does not include land. For example, say a QOF purchases a vacant building in a QOZ for $10 million; $4 million of the purchase price is attributed to the land while $6 million is attributed to the building. The QOF would need to put $6,000,000 of improvements into the building within the 30-month time frame to qualify for the substantial improvement clause.

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Turning to our region, let’s take a deeper look into the QOZs that Governor Kate Brown nominated and were selected. Figure 3 shows the whole state. Figure 4 shows the majority of the Portland MSA. Figure 5 drills deeper into the Portland Central City and Figure 6

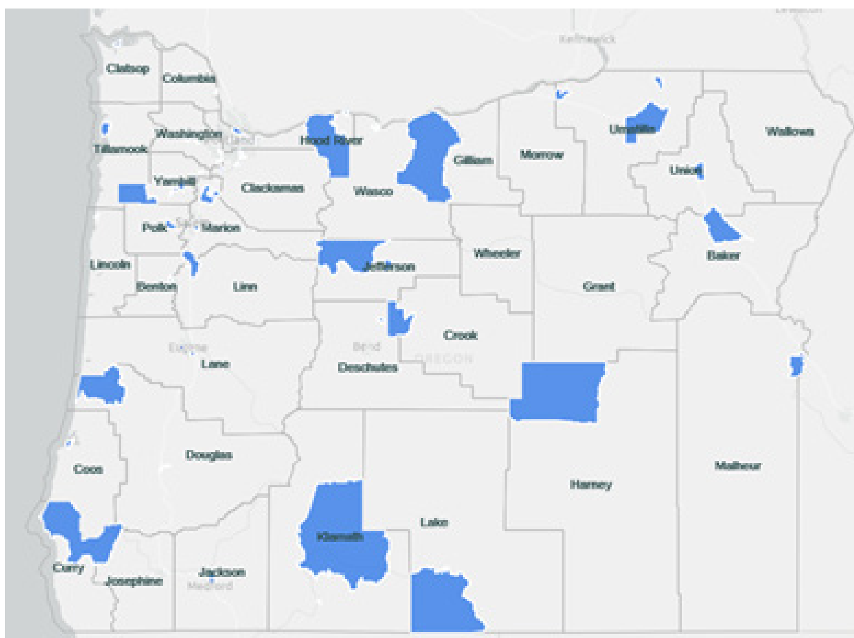

Figure 3: Oregon Qualified Opportunity Zones (State of Oregon)

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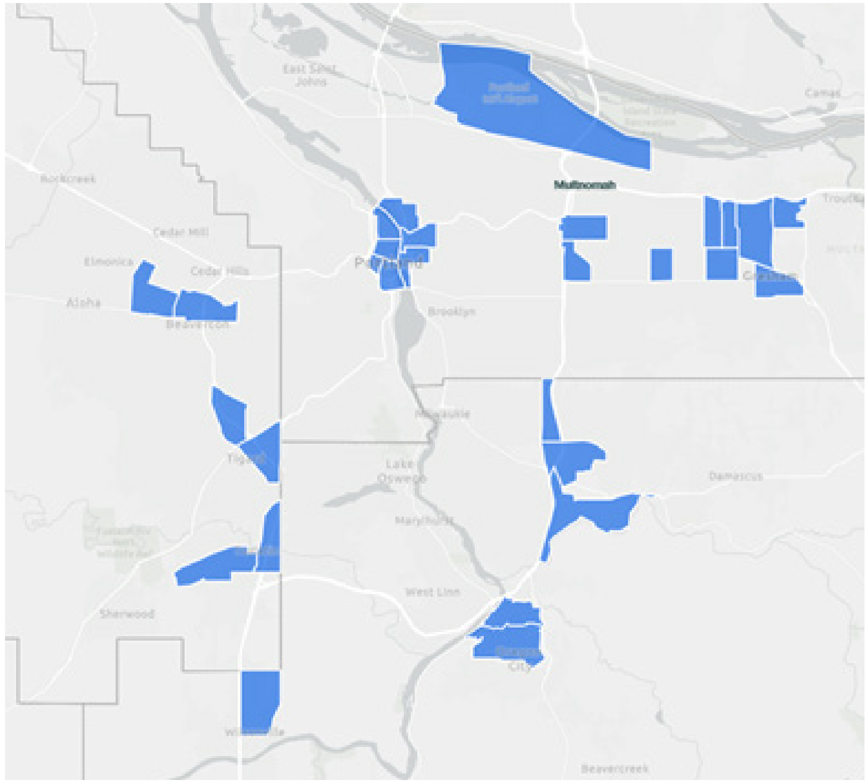

Figure 4: Portland MSA Qualified Opportunity Zones (State of Oregon)

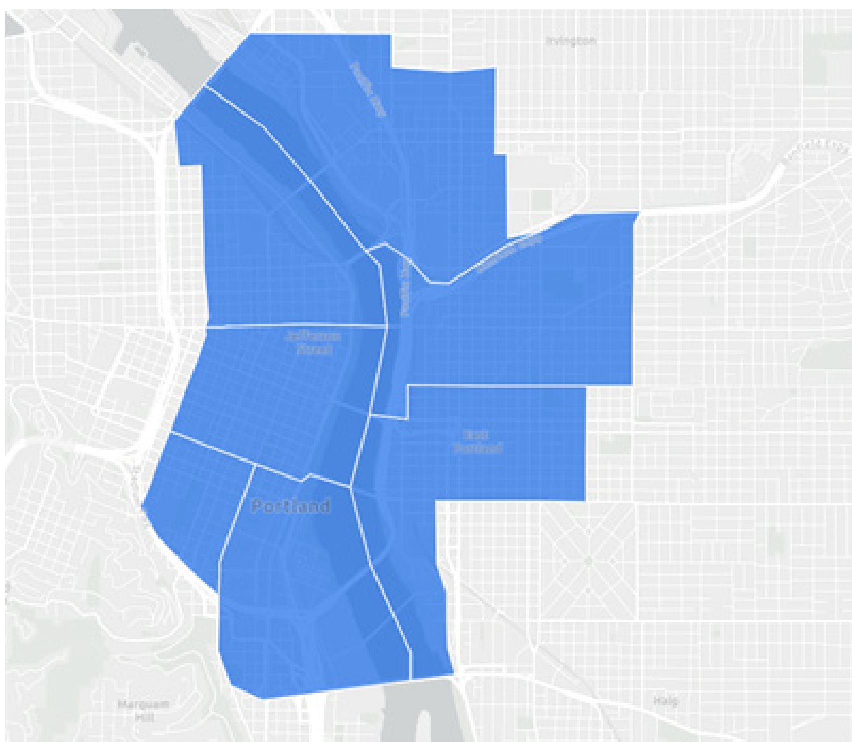

Figure 5: Portland Central City Qualified Opportunity Zones (State of Oregon)

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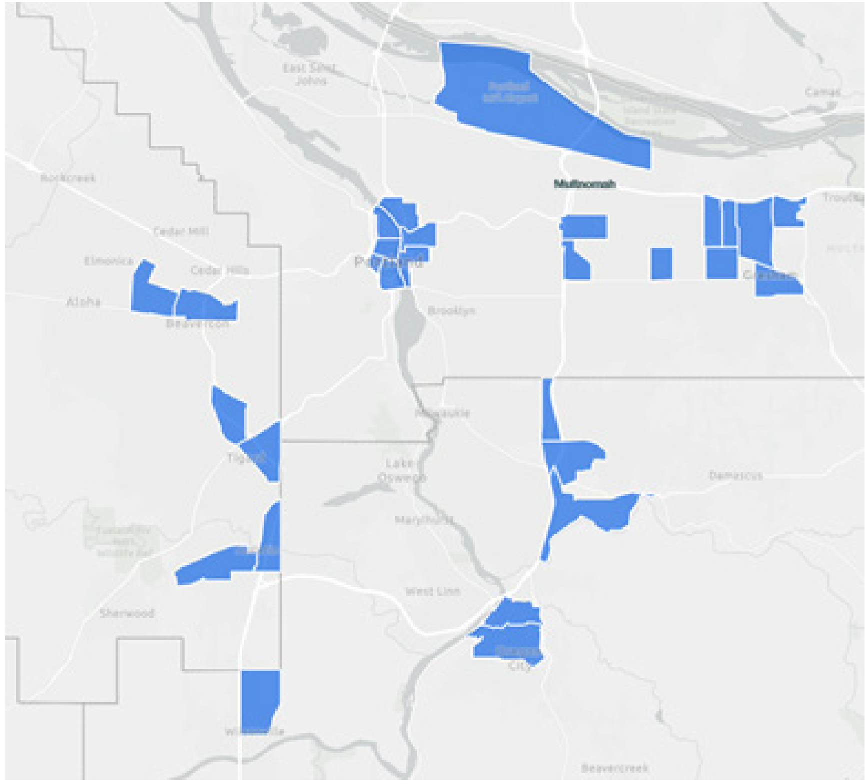

Figure 6: East Portland and East County Qualified Opportunity Zones (State of Oregon)

Table 2: Qualified Opportunity Zones by Oregon county

County	# of QOZ	County	# of QOZ	County	# of QOZ
Baker	1	Hood River	2	Multnomah	17
Benton	2	Jackson	3	Polk	2
Clackamas	6	Jefferson	2	Sherman	1
Clatsop	1	Josephine	1	Tillamook	1
Columbia	1	Klamath	2	Umatilla	3
Coos	2	Lake	1	Union	1
Crook	1	Lane	5	Wasco	2
Curry	1	Lincoln	1	Washington	8
Deschutes	4	Linn	2	Yamhill	3
Douglas	2	Malheur	2	Total	86
Harney	1	Marion	5		

Source: Business Oregon

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shows East Portland and East County. State-wide there are 800 census tracts, and 366 were eligible based on the low-income communities' designation according to Business Oregon. With an allowable nomination of 25 percent, about 91 zones could have been nominated. Oregon nominated and selected 86 zones. Table 2 shows the breakdown by county: 31 different counties have a QOZ, with Multnomah having the most at 17. Washington is second with 8 then Clackamas with 6.

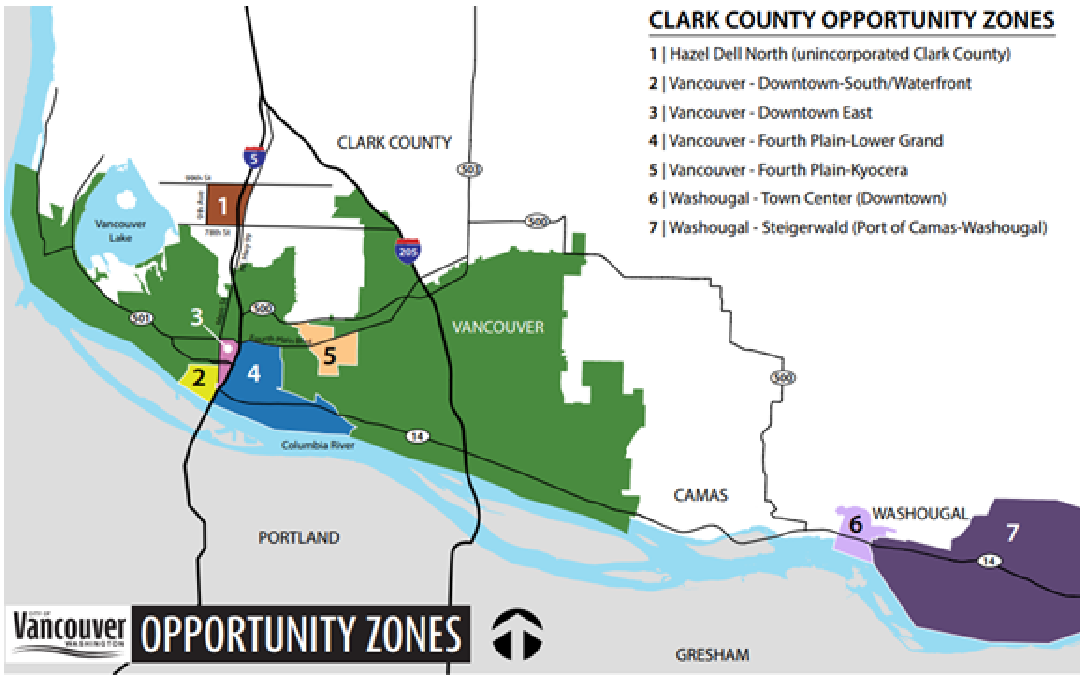

Figure 7: Clark County Qualified Opportunity Zones (City of Vancouver, 2018)

CONCLUSION

Looking at the Portland Central City QOZs, many of these areas are desirable for investments. Many real estate transactions that have occurred in this cycle would have fallen within these QOZs. These areas include the Pearl District, South Waterfront, inner Southeast and Lloyd. With more outside investors starting to infuse money into the Portland market, the opportunity to defer capital gains tax may boost the investments into Portland even more. Figure 7 shows Clark Counties QOZs, which also includes areas that have received quite a bit of investment recently. The original use projects are pretty straightforward on being able to achieve the benefits from a QOZ, since any improvements on the land will qualify. The substantial improvements are not quite as straightforward. For a substantial improvement project to qualify, the value of the improvements must be double the value of the building minus land. This is not an issue on projects where a large capital infusion is required, but on a value-add opportunity it could be more difficult.

Say QOF "A" purchases a vacant building and will be convert it to an office building. The purchase price was $10 million with land being $4 million of the costs. QOF needs to put an additional $6 million into the project to qualify. It is safe to assume the building will require a seismic upgrade, complete demolition and build back of the interior and MEP systems, exterior upgrades and potentially a new penthouse level. With all of these improvements the costs will likely be above $6 million.

CONCLUSION

Consider QOF "B" which invests in a garden style apartment with the same costs of QOF "A." QOF "B" just plans to upgrade units (paint, appliances, cabinetry and flooring), add an amenity and paint the exterior of the building. Adding $6 million of improvements would be much more difficult to incorporate while still expecting realistic rents for the apartments. Therefore, the program would likely spur more original use and office building investments than it would for small-to-medium scale apartment investment. When you look at the macro picture of the intent of the program, this could have a profound effect on how the QOZ effects the communities they reside in.

Isaac Jones, Senior Tax Manager with Perkins & Co, had this to say about the current state of the program, "With the issuance of these long awaited proposed regulations on October 19th, though there are still unanswered questions, this guidance gives us enough clarify for investors and developers to start moving forward and taking advantage of the truly unique tax benefits of these new code sections.". To Isaac's point we are now seeing many more listings from brokers labeled as "Opportunity Zone" developments sites, and many QOF are being created. We will have to wait and see if the market takes full advantage of this opportunity before the end of 2019. ■