OPPORTUNITY ZONES:
UPDATED LEGISLATION AND GUIDANCE

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Newmark Knight Frank

INTRODUCTION

The new round of legislation has strengthened the commitment of the IRS and Treasury Department to reducing uncertainty surrounding the operation of Opportunity Zone Funds and supporting the expansion of investment toward Opportunity Zone Businesses, in addition to Opportunity Zone property.

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REVISED GUIDANCE FOR
QUALIFIED OPPORTUNITY ZONE FUNDS

- Cash received/raised by funds in the last 6 months can be excluded from the 90-10 asset test
- Funds can now elect to value assets at their unadjusted cost basis (the price paid for the asset) instead of providing an applicable financial statement (typically SEC-submitted documents)
- "Interim asset sales"—defined as property, stock or partnership interest sold before the desired holding period—will not trigger deferred capital gains tax as long as proceeds from the sale are held in cash or cash equivalents, and that cash is reinvested in a qualified Opportunity Zone investment within 12 months
  - However, although the Opportunity Zone partnership is spared a tax burden, flow-through income is taxable on the investor level
- Debt finance redistributions to partners (within a partnership structure) can occur without triggering a tax event, on two conditions:
  - The redistribution is not within two years of a capital contribution to the fund
  - The redistribution does not exceed the fund's tax basis
- IRS/Treasury has proposed that the "Original Use" provision can apply to properties that have been vacant for 5 years or more
  - Original Use applies to property that previously was not in "service" (defined as property used for the purpose of amortization or depreciation)
  - The clause also applies to partially constructed buildings/development sites. Original Use commences when the purchaser of the site completes the property and puts it into service
- Unimproved land currently does not qualify as Opportunity Zone property
  - Exceptions may be made (on a case-by-case basis) for agricultural enterprises and certain businesses that utilize raw land in their normal business operations

REVISED GUIDANCE FOR **QUALIFIED OPPORTUNITY ZONE BUSINESSES**

1 At least 70% of the tangible property owned or leased by the business is located within an Opportunity Zone.

2 Business must derive at least 50% of its total gross income from the active conduct of the business within a qualified Opportunity Zone.

THE ORIGINAL
QUALIFIED OPPORTUNITY ZONE BUSINESS RULES (QOZB)

The first provision remains unchanged, although the Treasury now emphasizes that the 70% test refers only to the "use" portion of the business. The 90-10 test at the fund, "holding" level, remains unchanged.

The second provision was expanded to include four tests providing additional safe harbors for any businesses that meet at least **one** of the following qualifications:

- **50% of total gross income** must be from the active conduct of business within an Opportunity Zone (the original rule)
- **50% of total company hours worked** (by employees and independent contractors) must be within an Opportunity Zone
- **50% of total dollars paid** (to employees and independent contractors) must be for services performed within an Opportunity Zone
- The final safe harbor is **an open-ended 50% test** based on "facts and circumstances", which allows businesses to plead their special case to the IRS for inclusion as a Qualified Opportunity Zone Business

ADDITIONAL QUALIFIED OPPORTUNITY ZONE **BUSINESS CLARIFICATIONS**

The 31-month safe harbor allotted to Opportunity Zone Funds for the development of Opportunity Zone property is also given to businesses, so they may grow to satisfy one of the 50% tests as well as the 70% Opportunity Zone asset allocation.

- Newly raised capital/cash infusions from Opportunity Zone Funds lead to a restart of the 31-month timeframe
- QOZB needs to have a written plan and schedule for the deployment of this capital

Software Development in Opportunity Zones has been given the greenlight.

- As long as the software is developed by engineers and contractors working on a campus located within an Opportunity Zone, the business may sell its software licensing globally and still qualify.

Leased property is now treated as tangible owned property, lessening the burden on Opportunity Zone Funds' ability to satisfy the 90-10 asset test, while maintaining investments in Opportunity Zone Businesses.

However, there are several lease restrictions:

- The lease must have begun after December 31st 2017
- The lease must be a "market" lease
    - The IRS is still seeking guidance on what constitutes a market lease
    - NNN leases are not permitted
- The present value of the total consideration of the lease is the value counted toward an Opportunity Zone Fund's 90-10 requirement
- Substantial Improvement and Original Use clauses that apply to acquisitions of tangible Opportunity Zone property do not apply to the leasing of property in Opportunity Zones
- Rent prepayment cannot exceed 12 months

Businesses cannot sell Opportunity Zone property and receive Opportunity Zone tax benefits. Assets must be sold at the Opportunity Zone Fund level.

Qualified Opportunity Zone Business inventory that is in transit and not technically within an Opportunity Zone is still considered a valid asset under the legislation.

For an overview of the Opportunity Zone tax program, see:
http://www.ngkf.com/home/research/thought-leadership/opportunity-zones-navigating-a-path-to-investment.aspx

CASE STUDY
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AB CAPSTONE

- Local New York developer AB Capstone was represented by a Newmark Knight Frank team consisting of **Ron Solarz, Jason Shein and Jonny Yuran.**
- NKF acted as a placement agent and brought on Starwood Capital's Opportunity Zone Fund as an equity partner for the development of **425 Westchester Avenue in the South Bronx.**

Starwood, which was advised by Newmark Knight Frank's Ron Solarz and Dustin Stolly, contributed $26.5 million to the project as part of its larger, $500 million Opportunity Zone Fund launched in January of this year. The property will be a 10-story, 147,000-square-foot, Class A mixed-use office/retail property that is expected to be delivered in June 2020. Zeta Charter Schools will anchor the property with a 91,000-square-foot lease.

Starwood was drawn to the deal because of the property's approved development plans, anchor tenant and institutional-quality build, according to Ron Solarz.

Rendering courtesy of Starwood Capital

Given the 31-month development period requirement between the first and last dollar put into a project, Opportunity Zone Funds must be selective in their investments and be ready to start projects promptly. Additionally, the Starwood QOF investment will fulfill the updated Original Use provision, which allows Opportunity Zone Funds to invest in development sites and bring them into service without being obligated to fulfill the more onerous Substantial Improvement provision.

STATE **INCENTIVES**

CALIFORNIA:

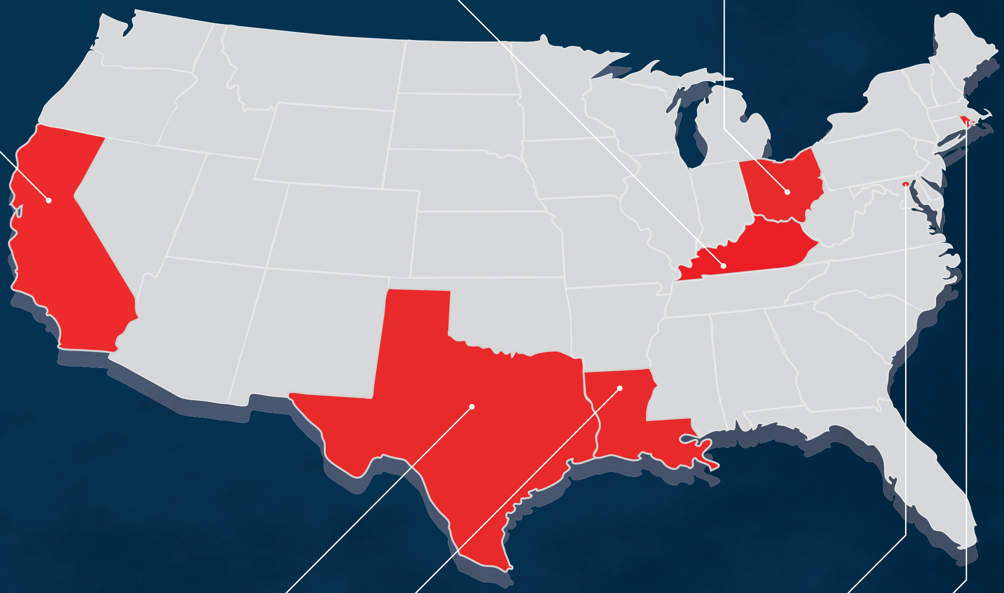
The state senate passed S.B. 25, a bill that will streamline environmental review and approval for developments, including those funded by qualified Opportunity Funds.

KENTUCKY:

The Kentucky Rural Jobs Act (H.B. 203) was introduced in the state House, which would provide tax credits in rural counties and Opportunity Zones with an annual cap of $35 million.

OHIO:

Legislation was introduced (S.B. 8) to create a nonrefundable 1% tax credit for investments of $250,000 or more in Ohio qualified Opportunity Funds, which must hold 100% of their assets in Ohio Opportunity Zones.



TEXAS:

Proposed H.B. 2397 would create a 25% tax credit for the costs of remodeling, rehabilitating or building a structure in an OZ; and of equipment or machinery purchased for a building in an OZ. Simultaneously, S.B. 826 would create the Texas Rural and Opportunity Zones Act, offering additional tax benefits to QOFs investing in rural areas.

LOUISIANA:

H.B.549 was introduced to add buildings in Opportunity Zones to the list of properties eligible to participate in the state's restoration tax abatement program. Simultaneously, H.B.274 would establish a tax credit pilot program for manufacturing industries in Opportunity Zones.

DISTRICT OF COLUMBIA:

The city committed $24 million to properties that support affordable housing, workforce development and the growth of small businesses in the district's 25 Opportunity Zones. The law also established an Opportunity Zone Community Corps to provide free legal advice and an online Opportunity Zone marketplace.

RHODE ISLAND:

Legislation was introduced (S.B. 668) that would create a 20% state tax credit for certain investments in Opportunity Zones that were more than $250,000.

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For additional information regarding state incentives for Opportunity Zones, please visit:
http://www.ngkfgcs.com/Consulting-Services/Global-Enterprise-Optimization/Economic-Incentives-Advisory

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