Five ways existing landowners can benefit from deploying land into a QOF

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Anyone in the real estate business is aware of the powerful, impactful and flexible Opportunity Zone (OZ) Program which became effective Jan. 1, 2018 as part of the Trump Administration's bi-partisan Tax Cuts and Jobs Act (2017 Tax Act). However, developers are generally required to modify their traditional game plan of contributing property, receiving equity as "carried interest" in the partnership and navigating the related-party and self-constructed asset rules in order to comply with some of the unique structuring requirements under Internal Revenue Code (IRC) Section 1400Z and related Regulations which control the OZ Program.

The OZ program currently allows up to a current five-year federal (and in all states other than CA, MS, NC, NY and MA) tax deferral on virtually any U.S. short-term or long-term capital gain, other than gains generated on related-party transactions (20% common ownership). For gains invested into a Qualified Opportunity Fund (QOF) by Dec. 31, 2021, the OZ program allows the taxpayer to increase their tax basis in the QOF by 10% after holding the QOF interest for 5 years. Provided the taxpayer has held the QOF for the required five-year holding period on the earlier of: i) Dec. 31, 2026, or ii) the disposition date of the QOF interest the taxpayer only reports 90% of the deferred tax gain. For example, a taxpayer deferring a $1 million gain will report $900,000 on Dec. 31, 2026 (or on an earlier disposition or "Inclusion Event" date).

The real impactful benefit from the OZ program comes in the form of a complete tax exemption on any post-reinvestment appreciation in the OZ investment(s) after holding the QOF for at least ten years. While seldom factored into projected investment returns, all depreciation and credits claimed on OZ projects are also exempted from recapture after meeting the 10-year hold threshold – an incredible tax benefit for OZ investors.

It is important to note that for the aforementioned real estate dispositions non-conforming states may be best suited for Section 1031/ "Like-Kind" exchanges rather than an OZ investment strategy since 1031 will generally defer both federal and state taxes. To the extent taxpayers in any state receive "boot" or cannot otherwise meet the full 1031 exclusion, the taxable portion of the incomplete 1031 transaction can still be sheltered with a QOF reinvestment.

The OZ Program is available for both real estate projects as well as most operating businesses conducting operations primarily within one or more OZ census tracts. Operating businesses wrapped in a QOF/ QOZB structure can potentially yield much greater after-tax returns than real estate projects. Other benefits of operating businesses include speed to revenue generation, sustainable job creation and overall economic sustainability – attractive results for investors as well as government agencies and OZ communities. Operating businesses may also benefit under the IRC Section 1202 Qualified Small Business Stock tax exemption/ rollover rules which can be combined with an OZ structure.

A very common fact pattern that we have encountered over the first three years of the program is real estate development projects, where a taxpayer acquired land before establishing a QOF or QOZB – which potentially disqualifies the land portion of the project from OZ benefits. When someone already owns a piece of land located in an OZ census tract, rather than selling it off to a new developer, they often want to maintain some continuing equity interest in the project. Early in the program, these owners thought they won the lottery, but then they found out this creates some OZ complexities they must navigate around with the assistance of CPAs and tax attorneys in order to secure the maximum OZ Program benefits.

When considering selling land to a QOF or QOZB, and staying in as an equity owner, the OZ “Related Party Rules” [IRC Section 1400Z-2 (a)(1) and (d)(2)(D)(iii)] present some significant complexities. A person is considered related if they (and affiliated family members/ entities) maintain greater than 20% equity interest in the project. The following five scenarios are common fact patterns and optional ways for landowner(s) to utilize previously owned land in an OZ project – each with significantly differing tax consequences.

For these scenarios, we will assume undeveloped land with a tax basis of $1 million and a fair market value of $3 million. **1. LANDOWNER OWNS LAND ACQUIRED PRIOR TO INCEPTION OF THE OZ PROGRAM**

- **Tax Ramifications to the Owner**

i. In this scenario, the land is a “bad asset” in the hands of the owner. If land is acquired prior to Jan. 1, 2018, it does not qualify as Qualified Opportunity Zone Property (QOZBP). However, improvements to the land will qualify for OZ benefits including the ultimate 10-year exemption.

- **Potential Tax Issues for the Fund**

i. In a traditional (non-OZ) development structure the landowner would contribute the property to the QOF or QOZB but both strategies create a “bad asset in the hands of the QOF/ QOZB since the land was not “purchased.” Even if the QOF or QOZB purchases the land, if the prior landowner retains more than 20% equity in the QOF the land will still be classified as a “bad asset.”

2. LANDOWNER SELLS LAND TO QOF OR QOZB AND RETAINS AN EQUITY OWNERSHIP OF GREATER THAN 20%

- **Tax Ramifications to the Owner**

i. Because the landowner retains greater than 20% equity ownership, the owner is considered a related party. Thus, any resulting gain to the landowner is ineligible to roll into the QOF that acquired the property under the "Circular Cash Flow" provisions contained in the final OZ regulations in (Treas. Reg. Section 1.1400Z2(f)-1). However, that gain can be re-invested into another unrelated QOF, allowing gain recognition to be deferred.

- **Tax Ramifications to the Fund**

i. The land would represent a "non-qualified" asset if held at either the QOF or QOZB level and the 10% bad asset test at the QOF level and the 30% bad asset test at the QOZB level can be problematic and must be carefully analyzed and monitored semi-annually based on the total cost of the project. If the land value ends up being more than 10% of the QOF's overall value (a highly likely result if retained at the QOF level) or 30% of the QOZB's asset value (if held at the sub-entity level), the entities may lose their OZ classifications and subject the QOF to penalties and eventually lose all program benefits.

Another problem of holding the land at the QOF level is that the QOF generally only has 6 months to invest the remaining proceeds into the building portion of the project in order to dilute the value of the bad asset prior to the semi-annual testing date, whereas a QOZB has between 31 and 55 months to invest the proceeds into QOZBP. See IRS Notices 2020-39 and 2021-10 which provide extensions of time to invest in light of the impact from COVID-19. The final problem in this situation is when a QOF contributes an asset down to the QOZB as a capital contribution, that portion of the equity is non-qualified since the QOF did not purchase it for cash – creating another potential 10% bad asset violation.

3. LANDOWNER SELLS LAND TO QOF OR QOZB AND RETAINS AN EQUITY INTEREST OF 20% OR LESS IN THE QOF

- **Tax Ramifications to the Owner**

i. In this scenario the landowner is no longer a "related party"; however the aforementioned "Circular Cash Flow" rules in the final OZ regulations will still preclude the gain attributable to the sale from being re-invested into the same QOF structure that acquired the land. Again - such gains can still be rolled into an unrelated QOF.

- **Tax Ramifications to the Fund**

i. If the land is purchased by the QOF or QOZB, the property is a “qualified asset,” but if it is purchased at the QOF level and dropped down to the QOZB it is a “non-qualified” asset since it is not purchased by the QOZB. Here, the land can be left at the QOF level (if 10% or less of the total fund balance) and remaining cash can be dropped down to the QOZB level and the building can be built at that level. In most cases, however, it will generally be best to have the QOZB purchase the land for maximum flexibility.

4. LANDOWNER CONTRIBUTES LAND TO THE QOF IN ORDER TO PARTICIPATE IN THE PROJECT

- **Tax Ramifications to the Owner**

i. Investors can contribute property in lieu of cash into a QOF – however if the construction costs and other planned QOZBP purchases are less than 90% of the total QOF investment, this strategy may not work. The contributing owner only receives credit for a “qualified” QOF investment to the extent of their tax basis in the property contributed (not the fair market value). In the assumed facts above, a basis of $1 million and a FMV of $3 million has a built-in gain of $2 million in the land. However, it is generally not triggered unless there is debt contributed in excess of the basis in the property. The $1 million can be a qualified investment if the investor has another capital gain from a timely sale transaction. This land contribution would create a “mixed fund” for that investor. In this scenario, one-third of the investment ($1 million tax basis) is “qualified” and two-thirds of the investment ($2 million appreciation) is “non-qualified.” Not an ideal result – since the valuable OZ benefits would only be available on just one-third of the taxpayer’s land investment.

- **Tax Ramifications to the Fund**

i. Since the QOF did not acquire the land “by purchase,” the land is a “bad asset.” To take advantage of the OZ benefits, the land will likely need to be dropped down into the QOZB instead of being held at the QOF level. At the QOZB level, up to 30% of the assets can be “bad assets,” instead of the 10% limit at the QOF level. This strategy should be employed sparingly and limited to situations where the fair market value of the assets are close to the tax basis in the contributed asset AND the land will be less than 10% of the total planned OZ investment.

ii. This leads to a construction project work-around for scenarios 2 and 4. If an additional $7.1 million of “good assets” are invested at the QOZB level, this dilutes the “bad assets” ($3 million in land) below 30%. Given that building costs are often three to five times more than the land, construction projects will often allow landowners to achieve the desired OZ benefits if the land is invested at the QOZB level and construction costs are high enough.

5. PROPERTY OWNER RETAINS THE LAND AND ENTERS INTO A GROUND LEASE ON THE LAND WITH THE QOZB

In order to leave the bad asset out of the QOF/ QOZB structure the land owner can choose to simply enter into a ground lease – preferably with the QOZB for maximum timing flexibility. If the ground lease is to a related party, under the QOF / QOZB structure, taxpayers must be aware of three requirements: (1) they

must ensure the lease terms are arm's length, (2) they must be careful when dealing with options for the other party to buy, and (3) they must not be prepaying any greater than one year's lease payments.

While the land will now be excluded from the various OZ tax benefits, including the 10-year exemption, retaining the land outside the OZ structure may benefit certain taxpayers in certain states from property tax reassessments. In addition, retaining the land outside the OZ structure may allow the current owner to get a "step-up" to fair market value upon death of the land owner(s) under the current IRC §1014 estate tax basis rules. President Biden is evaluating the elimination or modification of these highly beneficial basis provisions.

IMPACT OF BUILDING DEMOLITIONS – "ORIGINAL USE VS. SUBSTANTIALLY IMPROVED"

In general, to qualify as QOZBP, property must either satisfy the "original use" test — meaning the property had never before been used in the QOZ — or be "substantially improved." Property is substantially improved by a QOF or QOZB if during *any* 30-month period (up to 42 months w/COVID Extension under IRS Notice 2021-10) beginning after the date of acquisition of the property, the QOF or QOZB spends as much to improve the property (measured by additions to basis) as the QOF or QOZB's original basis in the property at the beginning of the 30-month/42-month period. Due to its permanent nature, unimproved land, if acquired and used in an OZ census tract after Dec. 31, 2017, will virtually always meet the "original use" test for purposes of determining if the land is QOZBP.

When building demolitions take place on a piece of land, the impact of §280B needs to be considered. This tax provision states that the owner or lessee of a demolished structure cannot deduct any expenses or losses associated with such demolition. These impacts are often overlooked, but they can have an impact on the outcome of an OZ deal.

When a building is demolished within two years of acquisition, no deductions are allowed for "any amount expended for such demolition, or any loss sustained on account of such demolition," pursuant to IRC §280B. Instead, these amounts are generally capitalized into the cost of the land on which the demolished building was previously located. The relevant impact here is that this capitalized amount is now included in the land's cost when computing the 70% asset test. Moving forward, these costs are not subsequently capitalized into new buildings constructed on the land, but rather remain in the cost of the land. Since the capitalized demolition costs are now in the land, the land should also satisfy the "original use" requirement for QOZBP.

CHOICES FOR LAND OWNERS TO CONSIDER IN OPPORTUNITY ZONES

There are many ways to get existing land into an OZ structure, but there are pros and cons with each option, and certain fact patterns may not lend themselves to either a purchase or contribution of the property in which case a ground lease may salvage the deal.

There are generally methods to get 100% OZ benefits, but occasionally the taxpayers will need to compromise on the structure and may need to forego a percentage of the future OZ benefits. In those cases where the land needs to be sold to the QOF or QOZB, but a tax gain will be generated, the seller can structure an installment sale and the gain can be deferred indefinitely – even when the sellers are related to the QOF equity owners.

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