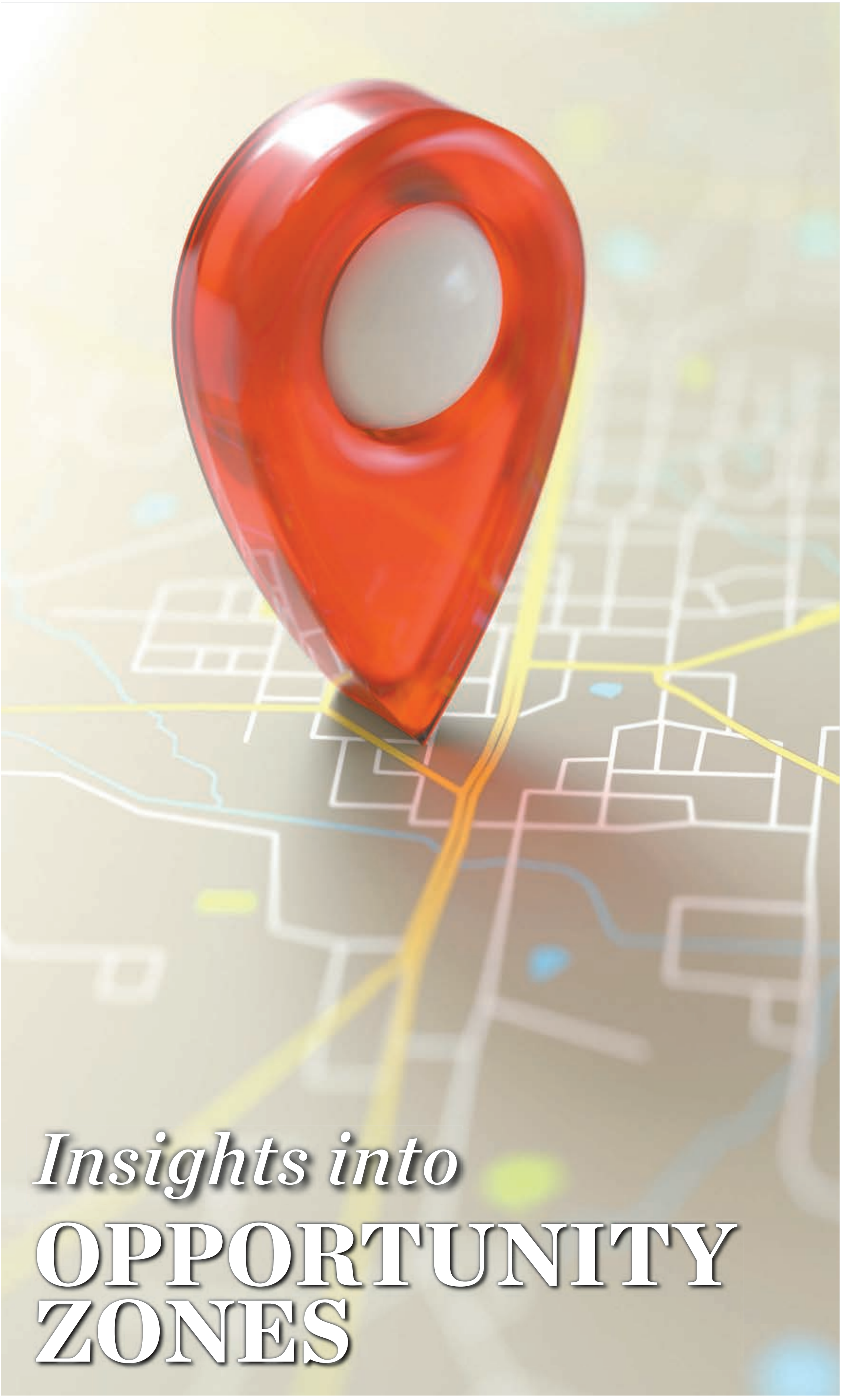
BIRMINGHAM BUSINESS JOURNAL

TABLE of EXPERTS Series



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THE EXPERTS

Lee Johnsey
Partner, Balch & Bingham

Lee Johnsey focuses on the acquisition, development, ownership, management and disposition of real estate, unsecured and secured lending, corporate matters, gaming finance and operation, and tax sales. Lee understands that clients are looking for solutions, and his experience allows him to structure deals to anticipate future issues and to assist clients with responding to any issues that do arise before they become problems. When problems do arise, Lee's transactional and litigation experience uniquely positions him to view the big picture and nuances of an issue, and to counsel clients about the implications of a course of conduct. Lee understands that results are sometimes best achieved through litigation avoidance and others through litigation. Lee helps clients balance efficiency and desired results as he works through issues alongside them.

Sylvester Lavender
Interim President and CEO, Birmingham Airport Authority

Sylvester Lavender serves as the Birmingham Airport Authority's Interim President and CEO, overseeing the operations of the Birmingham-Shuttlesworth International Airport (BHM). During his tenure with the Authority, he has helped strengthen the financial position of the organization and increased economic development opportunities. He helped establish a cost-reduction plan, an airport incentive program increasing nonstop routes to unserved cities, and a terminal space maximization program to increase nonaeronautical revenue. Lavender is a Birmingham native and a graduate of the University of Alabama. In 2000, he earned his Certified Public Accountant (CPA) designation. Birmingham is one of a few cities to have its airport established as an Opportunity Zone with 440 acres available in the designated zone for advanced manufacturing and maintenance, repair, and operating (MRO) operations. BHM is Alabama's largest airport serving the Greater Birmingham area and surrounding Southeastern cities with more than 100 daily flights.

C. Randall Minor
Shareholder, Maynard Cooper & Gale

Randall is a Shareholder and member of Maynard Cooper's Public Finance, Real Estate and Economic Development practice Groups. He focuses his practice on leading developers, sponsors, investors and other clients through the complexities of the emerging Opportunity Zone Program and structuring transactions to take advantage of Opportunity Zone tax incentives. Randall also counsels lenders and borrowers in a variety of commercial real estate transactions and tax credit finance transactions, including New Markets Tax Credits, State and Federal Historic Tax Credits, and low-income housing tax credits. In addition, Randall represents governmental and nonprofit entities in connection with the issuance of taxable and tax-exempt bonds, notes, warrants, and other debt instruments. Randall is a graduate of Yale Law School and the University of Alabama.

THE DISCUSSION

Q: Can you give a brief overview of the Opportunity Zone program and its benefits?

C. Randall Minor: The Opportunity Zone program is a place-based tax incentive program designed to attract private investment into certain census tracts – mostly low-income communities – that have been federally designated as Opportunity Zones. The program is intended to tap into the reservoir of unrealized capital gains by providing two different tax incentives for reinvestment of capital gains proceeds: deferral of gains taxes and tax-free treatment for additional appreciation on the investment. Expanding upon the first incentive, if a taxpayer realizes capital gains and reinvests those gains in a Qualified Opportunity Fund within 180 days, under current law those capital gains are generally not taxed until Dec. 31, 2026 unless the investment is sold prior to such date. The taxpayer may also receive a discount of up to 15 percent on the taxes due, through basis adjustments at the end of year five and year seven of the investment. With respect to the second incentive, if a taxpayer holds his or her investment in the Qualified Opportunity Fund for 10 years or more, the taxpayer may elect to step up the tax basis of the investment to fair market value and will not be taxed the additional appreciation of the investment when it is sold. While the deferral of gains taxes certainly has value, from conversations with many of our clients across the country, this 10-year hold incentive has the most potential upside and has been a more significant motivating factor for investors.

Sylvester Lavender: The Opportunity Zone program allows both individuals and institutions the ability to reinvest capital gains into projects located within the zones, while waiving either a portion or all of the original capital gains tax along with realized capital gains tax on the investment, depending on the length of time the investment is held. The program's main benefit is that it creates a vehicle in which investors not only can waive tax liabilities, but also create value and jobs in neighborhoods that need both. The airport is different in that it sits entirely within an Opportunity Zone, and is also surround by Opportunity Zones on all but one side. Our goal is to leverage this designation to bring jobs and development to the neighborhoods surrounding the airport.

> *"Additionally, if the investment is held for five years, the investor will receive a 10 percent step-up in its basis in the investment."*
>
> \- Lee Johnsey

Lee Johnsey: The OZ Program was created by Congress as part of the Tax Cuts and Jobs Act of 2017. Congress provided the criteria that a census tract must meet in order to be eligible for designation as an Opportunity Zone. The governor of each state/territory and the mayor of Washington D.C. were then tasked with recommending to the U.S. Treasury Secretary proposed tracts to be designated as opportunity zones that met the Congress-established criteria, which could not exceed more than 25 percent of the eligible tracts within such state/territory. In Alabama, 629 tracts were eligible to be designated as Opportunity Zones, and all 158 tracts recommended by Governor Ivey were approved by the U.S. Treasury Secretary. Qualifying OZ investments include the following: housing, commercial real estate, retail, manufacturing, distribution, hospitality, startups, incubators, research, energy, day-care, farming, and other active trades or businesses. To receive the tax deferral and reduction benefits under the OZ Program, an investor must invest capital gains in a qualifying project. If the investment is timely made, then the investor can defer paying capital gains tax on the invested amounts until the liquidation of the investment or Dec. 31, 2026, whichever is earlier. Additionally, if the investment is held for five years, the investor will receive a 10 percent step-up in its basis in the investment. Similarly, if the investment is held for seven years, then the basis step-up will increase from 10 percent to 15 percent. In addition, capital gains on investments in the OZ Funds can be tax-free if an investment is held for at least 10 years.

Q: What should an entity know before setting up an opportunity zones fund?

Lavender: An entity should know what type of projects they are interested in and their desired rate of return. Opportunity Zones are spread out across the country and encompass every type of economic and geographical characteristic you can imagine, from city centers to airports to farm land. Every single zone is going to offer a different host of projects. Urban zones may be great for riskier high-growth tech startups. Airports may be great for low-risk, low-growth logistics/warehousing projects. When starting a fund, it's important to set your goals and determine which projects are best to help you achieve them.

Johnsey: Prior to forming an Opportunity Zone fund, an entity should consult its accountant and counsel. The formation documents must provide that the purpose of the fund is "to engage in the transaction of investing in Qualified Opportunity Zone Property." The entity needs to be taxed as a partnership or a corporation. Because of this, single-member LLCs are permitted, but the owner must elect to be taxed as a corporation. To receive the tax benefits under the OZ Program, the invested capital must qualify as capital gains. Funds that are not capital gains can be invested into a project. However, gains attributable to those funds do not receive the tax benefits of the OZ Program. Additionally, there are timing considerations for the investment of capital in the project. The entity should pay careful attention to its capital needs and make sure its pro forma lines up with the timing requirements of investments under the OZ Program.

Minor: Setting up a Qualified Opportunity Fund is relatively easy in some ways but very difficult in other ways. From a filing and administrative standpoint, minimal work is required to set up a Qualified Opportunity Fund. Any entity that is taxed as a corporation or partnership, which includes multi-member LLCs, may certify as a Qualified Opportunity Fund simply by filing IRS Form 8996 with the entity's income tax return for the year it first qualifies. However, with respect to technical qualification of an entity under the numerous rules of the program, significant complexities can arise. There are a host of asset tests, business activity requirements, related party rules, and other issues that must be evaluated in order to comfortably assert that an entity meets all the requirements to be a Qualified Opportunity Fund. Anyone looking to set up a fund should be familiar with these requirements before an investment is made and a fund is set up, as failure to comply with certain rules of the program upfront could cause an investor to lose the ability to utilize the Opportunity Zones tax incentives for an investment.

"Urban zones may be great for riskier high-growth tech startups."

- Sylvester Lavender

Q: The federal government recently published some additional guidelines about Opportunity Zones. What are the most important facets or changes of that guidance?

Johnsey: The guidance produced several important rulings, but some of the biggest are for investments into OZ business property such as real estate, and OZ businesses. For OZ property, the proposed regulations require the OZ property to be purchased, but the substantially all test for qualified OZ businesses refers to tangible property owned or leased. The new guidance addressed this issue by providing specific rules for leased property: the leased tangible property must be acquired under a lease after Dec 31, 2017; substantially all of the leased tangible property must be used in a zone during substantially all of the holding period; and the leased property does not need to meet the original use or substantial improvement requirements, but must be a market-rate lease. For OZ businesses, the proposed regulations require that at least 50 percent of the gross income of a qualified OZ business be derived from the active conduct of a trade or business in the OZ. The IRS provided three safe harbors for meeting the 50 percent gross income test: based on the hours worked in the OZ, the compensation paid for services performed in the OZ, and the business property that is in the OZ.

Minor: In proposed regulations published in April, there are numerous new concepts and clarifications to existing guidance. Check out our firm's blog for a more detailed discussion on those topics. At a very high level, some of the significant takeaways of the April 2019 proposed regulations include the following: (1) The path is much clearer for operating businesses to use the Opportunity Zone program. A critical component of the new regulations is the expansion of the 31-month working capital safe harbor, which was previously available only for real estate projects. (2) Service businesses and sellers of products are afforded a greater degree of flexibility than initially expected in locating in an Opportunity Zone. The new regulations provide considerable clarity regarding the requirement that business operations be performed in an Opportunity Zone. Companies such as software businesses or remote service businesses now have the ability to qualify as Qualified Opportunity Zone Businesses. (3) Many of the most significant issues surrounding the use of leased property were resolved. The new regulations provide that leased property does not have to be substantially improved or originally used by the Qualified Opportunity Zone Business, unless the leased property is with a related party. It was also made clear that the leasing of property subject to a triple-net lease will not be considered an active business. (4) Several of the mechanics and tax and structural questions regarding incoming investments and exit possibilities were answered. Among the changes to existing guidance is the additional flexibility for Qualified Opportunity Funds to qualify for the 90 percent asset test with the ability to ignore contributions made to the fund within the prior six months, and the allowance of a 12-month reinvestment period for proceeds received by a Qualified Opportunity Fund following sale of an asset.

Lavender: The most important facets of the new guidance are those surrounding investment in currently operating businesses within an opportunity zone. My hope is that this guidance will encourage new investment into companies operating in and around the Birmingham Airport.

Q: How do the rules differ for investing in a real estate project versus investing in an opportunity company?

Minor: Generally, the compliance rules are the same for any type of Qualified Opportunity Zone Businesses, whether real estate or not. They are all subject to the same asset percentage tests and basic requirements to be considered qualifying Opportunity Zone investments. However, the application of the rules can take shape in various forms, and the primary concerns may differ between real estate projects and operating businesses. For real estate projects, significant issues may include completion of the project in a timely manner, having sufficient capital expenditures in an amount to meet the substantial-improvement test, complying with guidelines for properties that straddle multiple census tracts, avoiding triple-net leases, passive activity limitations associated with certain leasing structures, use of currently owned land or vacant buildings, and structural complications on exit. For operating businesses, important considerations may include the amount and location of goods and services utilized in the operations, the purchase and sale of operating assets, qualification of used equipment, satisfying asset tests for intangible-heavy businesses, and reinvestment of proceeds upon an early exit.

Johnsey: One area where real estate investors should be aware is leveraged deals. In the proposed regulations, the IRS was vague as to whether debt-financed distributions would trigger recognition of the deferred gain, or affect qualification for the 10-year hold fair-market-value step-up election. The new guidance clarifies that a distribution of cash by a OZ Fund to its investors – taxed as a partnership – will not trigger gain to the extent the distribution does not exceed the investors' bases in the OZ Fund, including the debt. However, any distribution of cash or property from the OZ Fund to an investor will disqualify the investor's original transfer to the OZ Fund from beneficial treatment to the extent the overall transaction is a disguised sale if the cash contributed to the QOF partnership had been non-cash property and the exception from disguised sale treatment for certain debt-financed distributions were ignored. Ordinarily, disguised sale treatment would be presumed for distributions made within two years of the contribution, and no disguised sale treatment would be presumed for distributions made more than two years after the contribution.

Q: With the new guidance from the federal government, are there any red flags that businesses should be aware of?

Lavender: I wouldn't look at it as a red flag, but an opportunity. Companies should be very well versed on the new regulations surrounding investment, and what that means to their operations. There are several guidelines that must be met for them to qualify, and these must be monitored and adhered to.

Johnsey: The proposed regulations require that a substantial portion of the intangible property of a qualified OZ business be used in the active conduct of a trade or business in the OZ. In the initial guidance, the IRS was vague on: the meaning of the term "substantial;" the meaning of the phrase "used in the active conduct of a trade or business;" a method for measuring the portion of intangible property used in a business; and a method for determining whether intangible property is used in the OZ. The new guidance defines a "substantial portion" as 40 percent. The regulations defer to Internal Revenue Code Section 162 for defining "active conduct of a trade or business" – an oft-litigated phrase by the IRS – and, unfortunately, do not address how to measure the portion used in a business. Taxpayers should be mindful of these gray areas.

Minor: There were not many new red flags that were introduced since the regulations were intended to eliminate or narrow concerns and clarify open issues. However, I find that the extensive leasing rules and restrictions place additional emphasis on the level of caution and preparation that should be used when dealing with related-party transactions. Another area in which additional caution is encouraged is with respect to the treatment of land, which may qualify for the asset tests if it is used in an active business. The IRS is serious, however, about not allowing a Qualified Opportunity Fund or a Qualified Opportunity Zone Business to engage in land banking, and anti-abuse rules to that effect could be on the horizon. Finally, with the introduction of inclusion events by the new regulations, any significant transaction that takes place throughout the investment structure should be carefully analyzed.

Q: Are there any cases when a deferred gain that was invested in an Opportunity Zone could become taxable?

Johnsey: Yes, particularly with respect to the step-up in basis after 10 years. The exit is tax-free only upon the sale of the investor's interest in the OZ Fund, not upon the sale of the fund's actual assets. As a result, to enjoy the benefit most of the exit transactions will be structured as a sale of equity interests instead of an asset sale, in order to keep the deferred gain from being taxed. Further, particular care needs to be taken to ensure that the transaction is a sale instead of a redemption, since a redemption of an investor's interest would not qualify for tax-free treatment.

Minor: In addition to the taxpayer's sale of his or her investment prior to Dec. 31, 2026, which was clear in the initial Opportunity Zone legislation, the new regulations provided extensive guidance surrounding the direct and indirect transactions that will cause deferred gains to be immediately taxable. The new regulations refer to these direct and indirect transactions as inclusion events, and include distributions in excess of basis, transfers by gift, redemptions, liquidations, and certain corporate mergers and acquisitions, whether taxable or nontaxable. Although the use of debt and debt-financed distributions are clearly permitted in the proposed regulations, the most common trap will likely be inclusion events associated with distributions. The critical takeaway is that any transaction or restructuring that may affect a Qualified Opportunity Fund or Qualified Opportunity Zone Business should be closely considered in advance of the transaction.

Q: Are there any misconceptions about opportunity zones that people should be aware of?

Lavender: The biggest misconception I see is when people view this program as a simple tax shelter, and that you can just plug in funds and avoid taxes. This program is not designed like that. It is designed to attract meaningful investments that investors are willing to hold long term for the improvement of the area invested in. The payoff of the investment is a tax exemption, but only after you have put in the time and confidence in the project.

Minor: First, there is no such thing as an Opportunity Zone tax credit or grant. It still takes an investment of capital gains to utilize the program's tax benefits. Second, the Opportunity Zone incentives do not turn a bad deal into a good deal. An investment should still be made based on the fundamental strength of the project and, because of the long-term nature of the major tax subsidy, most investors will be looking for investments that have significant appreciation potential over the long run. Third, the complexity of the underlying program rules and restrictions are consistently underappreciated and understated. In many transactions, deal participants tend to get started on a real estate project or a new business and want to call their attorney or accountant later in the process to paper up the deal. This can lead to significant or even fatal obstacles to qualifying an Opportunity Zone investment for the tax benefits under the program. I also continue to see confusion about investing in Opportunity Zones without capital gains or by providing services in exchange for equity. Although the program is intended to create jobs and business activity, it is crystal clear that freeing up capital gains to be reinvested was the other component of how the program was designed. The rules and regulations reflect such notion, and the regulations unequivocally provide that only capital gains investments are afforded any tax benefits of the Opportunity Zone program.

Johnsey: The Opportunity Zone program is an investment opportunity just like any other investment. This means that each investment carries its own inherent risks, which the investor should consider prior to investing its funds. The opportunity zone program won't make bad projects good, but it will make good projects great by improving the economics of the transaction through the injection of additional capital.

Q: What are the rules about timing with regards to holding real estate involved in an Opportunity Zone project?

Minor: In order to maximize the benefits of the program, Opportunity Zone investments need to be held at least 10 years from the date of the initial capital gains investment in a Qualified Opportunity Fund. If it is held less than 10 years, then a sale of the asset will cause the appreciation to be taxable, thereby eliminating the 10-year benefit. This is the default rule in this regard, but there may be other timing concerns depending on specific situations. In addition to the overall holding period, there are several timing considerations for the initial investment. The construction, substantial improvement and development of real estate will typically need to be completed in a manner to take advantage of the 31-month working capital safe harbor. Further, for the rehabilitation of an existing building, the 50 percent substantial improvement test must be satisfied within 30 months. Navigating these requirements can become significantly more difficult for phased developments or projects with an extended construction period.

Q: What about investing in an operating business within an Opportunity Zone? Are there specific time guidelines that companies must follow?

Johnsey: In order for investments in corporations and partnerships to qualify as OZ property, the statute requires that as of the time such interest was acquired, such corporation/partnership was a qualified OZ business. Or in the case of a new corporation/partnership, such corporation was being organized for purposes of being a qualified OZ business. The new guidance did not further address how long a new business has to become a qualified OZ business. The guidance did make two changes to the 31-month safe harbor for working capital. First, the written designation for planned use of the working capital includes the development of a trade or business in the OZ as well as acquisition, construction, and/or substantial improvement of tangible property. Second, exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action, such as environmental permitting, obtaining city licenses, etc.

Minor: Primarily due to the expansion of the 31-month working capital safe harbor to operating businesses under the proposed regulations published in April, the same time guidelines that apply to real estate companies also apply to operating companies. The introduction in the proposed regulations of the ability to utilize multiple, overlapping 31-month periods should be particularly meaningful for operating business as they continue to raise capital for growth. Yet, in some instances, the timing limitations may be significantly more constraining for investors in operating companies if those investors have a short investment horizon. Although the proposed regulations enable reinvestment of sale proceeds, if a company has an exit opportunity that arises prior to the 10-year anniversary of the Opportunity Zone investment, the significant tax benefit on any appreciation could be neutralized as a result of the sale because the general income tax consequences still apply to a sale transaction. Again, this is a complicated program and there may be other timing factors depending on the specific situation.

> *"If a company has an exit opportunity that arises prior to the 10-year anniversary of the Opportunity Zone investment, the significant tax benefit on any appreciation could be neutralized as a result of the sale..."*
>
> - Randall Minor

Q: In terms of federal guidance, what's the next step? Are there more details to be published or a final ruling?

Minor: Most of the industry expects that both sets of proposed regulations will be finalized and published later this year. Of course, there are still plenty of questions and open issues even after the release of two sets of proposed regulations. In particular, the Treasury has pinpointed tax treatment of interim events as an area on which they are open to further comments, in addition to soliciting suggestions regarding the information reporting requirements that should be imposed on Qualified Opportunity Funds. I do anticipate a third set of proposed regulations, or potentially some other form of guidance, to be issued sometime this year. The third set of regulations is expected to impose additional informational reporting requirements for Qualified Opportunity Funds and anti-abuse rules related to several portions of the Opportunity Zone program requirements. In terms of other important updates, at the beginning of May, a bipartisan congressional bill was introduced to establish reporting requirements, so we could see legislation to address those concerns. In addition, there has also been speculation that the deferral expiration date, currently statutorily set as Dec. 31, 2026, could be extended.

Johnsey: The IRS has not indicated whether additional regulations will be produced, but is asking for public input as the department continues to develop guidance to address lingering technical questions and establish administrative procedures. A hearing is scheduled for July 9 for Treasury and the IRS to hear public remarks on these issues.