Investing in Qualified Opportunity Zones in New Jersey

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In October 2018, the U.S. Department of the Treasury released its initial set of proposed regulations and commentary concerning the opportunity zone program (OZ Program), a key component of the federal Tax Cuts and Jobs Act (TCJA), enacted in 2017. The purpose of the OZ Program is to encourage development within qualified "Opportunity Zones" (QOZs) through various tax incentives. Developers, investors and property owners alike may be able to take advantage of the numerous tax benefits and development opportunities that can arise from the OZ Program. In order to do so, however, it is critical to understand the OZ Program's time sensitivities and development requirements as the Treasury continues its efforts to finalize OZ Program regulations.

QOZs are designated census tracts with a poverty rate of 20% or a median family income of up to 80% of the median income of the metropolitan area or of the statewide median income. There are 169 census tracts (in 75 municipalities) in New Jersey that were designated by Governor Murphy (and approved by the Treasury) as QOZs - the maximum number allowed in New Jersey under the TCJA. Accordingly, no additional QOZs will be created or designated in New Jersey without further action by Congress.

Under the OZ Program, any capital gains (i.e., short or long term capital gains) timely invested into a Qualified Opportunity Fund (QOF) could receive three primary tax benefits:

TAX BENEFIT #1: The investor defers payment of taxes due for the capital gain invested into a QOF until the earlier of (i) the sale of its QOF interest, or (ii) December 31, 2026, when taxes will be due for the deferred capital gain.

TAX BENEFIT #2: 10% of the deferred capital gain will be forgiven if the QOF interest is held for 5 years or more (the capital gain was invested into a QOF prior to December 31, 2021). If the QOF interest is held for 7 years or more (the capital gain is invested in a QOF before December 31, 2019), an additional 5% (15% total) of the deferred capital gain will be forgiven.

TAX BENEFIT #3: If the QOF interest is held for at least 10 years after investment there will be no tax on the gain realized from its initial QOF investment (i.e., the initial capital gain investment) upon sale.

Under the OZ Program, at least 90% of a QOFs assets must be qualified opportunity zone property (QOZ Property). QOZ Property is property: (1) purchased after December 31, 2017; (2) whose "original use" commences upon acquisition or is substantially improved upon acquisition; and (3) that is used/located in a QOZ. QOZ Property can include partnership interests or stock in a qualified opportunity zone business (QOB). Thus, if acquiring an existing building, the building must be "substantially improved" within 30 months after acquisition (i.e., double the basis of the building), as measured by the additions/

improvements made thereto (note: the land need not be "substantially improved"). Notably, the proposed regulations also provide a "Working Capital Safe Harbor" qualifying cash/financial property as QOZ Property so long as (i) there is a written plan designating the funds for the acquisition, construction or substantial improvement of QOZ Property; (ii) there is a written schedule for the planned use of the funds within 31 months; and (iii) the funds are actually used in accordance with the schedule.

For a trade or business to qualify as a QOB, substantially all (i.e., 70% per proposed regulations) of the tangible property owned or leased by the business entity must constitute QOZ Property. Moreover the entity must be a QOB both (a) when the QOF acquires its equity interest in the entity and (b) during substantially all of the QOF's holding period of that business.

A QOF is defined in Section 1400Z-2 of the Internal Revenue Code as "any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property." The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization. Under the proposed regulations, QOFs may also be organized as a limited liability company as long as it is classified as a corporation or partnership for federal tax purposes. Therefore, it is potentially possible to form a New Jersey limited liability company and qualify as a QOF as long as it is properly organized. Also, an existing entity may qualify as a QOF even if it was formed prior to the QOZ legislation, provided that the asset will not be considered QOZ Property for purposes of the 90/10 test. Those wishing to use existing entities should therefore proceed with significant caution.

Parties wishing to invest in a QOF must be "Eligible Taxpayers" - individuals, C corporations (including real estate investment trusts), partnerships, S corporations, trusts, and estates.

Joint ventures will be common under the OZ Program. QOFs will likely seek to partner with a company that has experience in developing projects within New Jersey in order to use that knowledge and local resources to maximize profit. In setting up such a joint venture, it is critical to have an operating agreement that supports the management and profit structure and divides responsibility between the QOF (s), other equity partners, and the developer partner, and contemplates the maximum benefit of the tax structure under the OZ Program.

Notwithstanding significant interest in the OZ Program, it remains a substantial "work in progress" and numerous unanswered questions therefore remain. The recent shutdown of the federal government temporarily delayed the Treasury's public hearing concerning the initial proposed regulations and the promulgation of additional/revised regulations. With the federal government now reopened, it is anticipated that the Treasury will quickly act to finalize the OZ Program regulations and promulgate additional revenue rulings to provide further clarity in light of given of the OZ Program's many time sensitivities. Moreover, here in New Jersey it remains to be seen whether the state legislature will act to conform the state's tax regulations with the benefits of the OZ Program in order to help maximize investment opportunities within the state.