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OPPORTUNITY ZONES

Amazon's NY HQ Meets the Opportunity Zone Program

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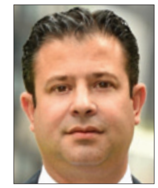

After months of speculation and national jockeying by states, cities and towns across the United States, Amazon announced on Nov. 13, 2018, that Long Island City, New York will be one half of its planned HQ2, its second headquarters (LIC HQ2). While there is an ongoing debate over the effects of the cost v. value to the taxpaying residents of Long Island City, New York City and New York State for winning the LIC HQ2, the fact remains that most of the land that is planned to make up the LIC HQ2 is in opportunity zones; as designated by Internal Revenue Code, Section 1400Z.

On Jan. 31, 2019, in the middle of a stream of protests against and negative articles on the LIC HQ2, Amazon announced that it will *not* be utilizing the hot-topic federal Opportunity Zone Program as part of its acquisition and construction of LIC HQ2. While the timing of this announcement appears to be orchestrated to act as an olive branch to local politicians, residents and protestors so as to deflect from the tax breaks that Amazon is already receiving by altruistically passing on the tax benefits of the opportunity zone program, the question remains would or could Amazon have utilized the opportunity zone program anyway?

Through an analysis of the opportunity zone regulations and public knowledge of the proposed plans for LIC HQ2, it appears that only in a narrow time period could Amazon have utilized the tax benefits of the opportunity zone program. However, local developers with shovel-ready projects in LIC and the surrounding areas are positioned to greater benefit from being in opportunity zones.

Tax Implications

The opportunity zone program is a community development program established by Congress in the Tax Cuts and Jobs Act of 2017 to encourage long-term investments in low-income urban and rural communities nationwide with less regulation found in other similar low-income focused programs; such as the New Market Tax Credits and Low-Income Housing Tax Credit Programs. The opportunity zone program provides a tax incentive for taxpayers to re-invest their capital gains into opportunity zones funds that are dedicated to investing into Opportunity Zones designated by the governors of every U.S. state and territory.

Section 1400Z of the Internal Revenue Code provides that 25 percent of the low income communities in each state are to be designated by the governors of each state as Opportunity Zones and that a direct investment of *any* capital gain through an opportunity zone fund

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(which can be simply designated by the submission of a Tax Form 8996 to the IRS along with the entity's tax returns) will receive, subject to maintaining the investment for certain timeframes, a

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deduction in the capital gain tax to be paid on such capital gain (10 percent after five (5) years and 15 percent after seven years, which is also deferred until 2026, and ultimately an exemption on any new gain realized from the investment on the capital gain initially invested after 10 years.

However, due to the rushed commencement of the program on Jan. 1, 2018, only two weeks following the passage of the 2017 Tax Bill without giving the United States Treasury any time to provide any clear guidance, many material threshold questions remained unanswered. This kept a large majority of likely participants (investors, funds and developers) waiting on the sidelines until the Treasury could provide additional explanation and guidance. Then, once Treasury issued its first set of additional guidance regulations on Oct. 19, 2018, the amount of time placed on the opportunity zones funds to put 90 percent of its funds to work before the end of the year was too short. This limited activity with the opportunity zone program for the remainder of 2018 creating further delay in true activity as likely participants and potential fund operators spent the remaining time in 2018 planning for 2019.

Developers Act While Awaiting Guidance

While the Opportunity Zone world continues to eagerly await the release of further rounds of additional guidance regulations and sub-regulatory guidance from the Treasury Department, those who educated themselves during 2018 are jumping into the opportunity zone program in 2019. Real estate developers, fund operators and investors of all sizes are announcing their intent and/or proceeding with their plans of utilizing the opportunity zone program by, respectively, (i) purchasing and developing properties in designated Opportunity Zones through Opportunity Zones Funds, (ii) setting up various sized opportunity zones funds to pool together investors with capitals gains to invest in qualified opportunity zone properties/businesses, and (iii) searching for the right fund or qualified opportunity zone property/business project to invest their capital gain within their 180-day window.

Even though there are many outstanding questions regarding the program that require additional regulations and guidance, there is enough of both in the legislation that created the program, the additional guidance already provided by Treasury and elsewhere in the tax code to allow such developers, fund operators and investors to safely proceed with proper guidance and advice from legal, tax and accountant professionals. In doing so, such developers, fund operators and investors are getting a head start with the program before the competition for opportunity zone properties and eligible investor capital gains becomes more intense and competitive.

On Dec. 12, 2018, President Donald Trump provided the opportunity zone program with a strong endorsement with a presidential executive order requiring 13 federal agencies to focus on promoting and facilitating the opportunity zone program. While the presidential executive order was not clear on exactly what actions each federal agency was required to do, it did put serious pressure on Treasury and those agencies to come up with a plan to, respectively, provide the likely participants with clearer non-restrictive guidance on the still yet answered areas of the opportunity zone program.

With any new government program comes the need for additional guidance and regulation to answer questions that taxpayers and experienced professionals have unique to their own purposes and/or their clients' purposes. As a result, the Treasury Department is holding a hearing on Feb. 14, 2019 and continues to diligently review voluminous amounts of requests from politicians, taxpayers and professionals prior to delivering several traunches of additional guidance and regulations on open issues of the program.

Amazon

But, the question remains, how could or would Amazon utilize the opportunity zone program?

With only limited public knowledge of what the plans are for the LIC HQ2, we know that Amazon is planning a large generational development project with at least several buildings that will be constructed over approximately 15 years. So, if Amazon was planning on utilizing third-party investor equity within the opportunity zone program (most likely excluding themselves as a 'related party' under Section 1400Z of the Code), they would need to compartmentalize the overall development into short-term/immediate-future and long-term/distant-future buildings.

Due to the time constraints already present in the opportunity zone regulations, the long-term buildings can be disqualified barring new regulations that extend such time constraints. In order for the short-term buildings to qualify, each building will effectively have to be constructed as its own singular project with its own three prong-safe harbor test in order to distribute its applicable working capital appropriately over 31 months, such as (i) designating a detailed plan for acquisition, construction and/or substantial improvement in writing, (ii) provide a reasonable written schedule for the project and (iii) utilize the working capital in a matter substantially consistent with the plan and schedule.

Considering the scope in size and length of time anticipated to plan, receive necessary permits and approvals for the LIC HQ2 and the control that Amazon will want over the construction of the headquarters, it seems unlikely that Amazon will bring in third-party investors' capital gain as equity that can utilize the opportunity zone program. Further, unless Amazon can structure a near-term shovel-ready construction project to utilize its own independently realized capital gain without disqualifying themselves as a 'related party,' it seems unlikely that Amazon could have utilized the opportunity zone program in building any portion of their LIC HQ2.

However, the developers and businesses nearby and in the surrounding neighborhoods that can benefit from and provide for the influx of activity will and should be able to take full advantage of the opportunity zone program as it was intended—by spurring investment in the neighboring distressed communities.

As a result of the location of the LIC HQ2, there is great interest in utilizing the opportunity zone program for developers in the direct and indirect surrounding neighborhoods of Queens, Brooklyn and the Bronx that can benefit by building projects that cater to the influx of additional employees (anticipated to reach 25,000 jobs at an average salary in excess of $150,000) and Amazon-related businesses.

Added Benefits

Aside from the major tax deferral benefits that the program provides, there are practical benefits that make this program unique and a valuable tool for the smaller real estate developer that should be noted. First, since an Opportunity Zone Fund can be any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property, the barrier to entry is low and permits developers of all sizes, not just larger institutional developers, REITs, insurance companies and funds, to create their own opportunity zone fund for which to provide their investors with such tax deferrals.

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Second, by providing an avenue for investors to receive such tax deferrals, developers with narrow margins to begin with and that are using all their resources to make one or two projects a reality, can feel less pressure to promise difficult-to-meet high returns by calculating in the tax deferral savings that the investors will receive on their initial capital gain and their future capital gain from the investment into the Opportunity Zone Fund. This will provide the same effective return/benefit to the investor at a lower cost to the project and developer.

Developers with shovel-ready, or close to shovel-ready projects, can immediately utilize the opportunity zone program to provide an additional benefit for their investors that have realized capital gains to place, or raise, equity from such investors at a discount when factoring in the quantifiable amount of the tax benefits provided to such investors from the opportunity zone program. Further, since the LIC HQ2 is a long-term generational development, there will be less of a concern over the 10-year hold period as there is a built-in growth factor simply from having the LIC HQ2 in Long Island City.

While deal structures will vary in complexity, these types of projects and businesses fit well within the intention of the opportunity zone program by providing capital to distressed low-income communities for the long term. Even if a developer elects to sell its completed project, the investor's opportunity zone fund will most likely have to promptly re-invest the received proceeds from the sale into another opportunity zone Property or opportunity zone business. It is "most likely" because the Treasury has not yet offered guidance on the effects of and requirements following the sale of an opportunity zone property or opportunity zone business during the 10-year hold period.

Conclusion

Expect a lot of building by developers to meet the demand created by the LIC HQ2, its employees and the services catering to both.