

The Tax Joys of Opportunity Zones

Schuyler (Sky) M. Moore | Partner

The information in this eBook incorporates the opportunity zones regulations issued in May 2019.



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I. Introduction

The 2017 Tax Cuts and Jobs Act provides significant tax benefits to any taxpayer that recognizes capital gain and that invests an amount equal to the gain to acquire an interest in a “Qualified Opportunity Fund,” which in turn invests in certain low-income areas designated by each state. This article provides a summary of the Opportunity Zone legislation and proposed regulations. Although the regulations are only proposed, they state they can be relied on now if they are applied in their entirety and in a consistent manner. To make the complex regulations somewhat understandable, I have left off a number of details, simplified the discussion, used my best judgment to fill in some missing gaps, and added a number of my own defined terms that do not match the terms used in the regulations. It is thus critical to consult with a tax advisor based on your particular facts before relying on this summary.



II. Definitions

Here are the definitions used in this article:

- “**Deferred Gain**” means the Gain that is deferred by investing in a Fund.
- “**Electing Taxpayer**” means any individual or entity that elects to convert Gain to Deferred Gain by investing in a Fund.
- “**Fund**” means an entity that is a Qualified Opportunity Fund meeting certain requirements, as discussed in the “**Requirements for Funds**” section below.
- “**Fund Interest**” means equity ownership (including preferred equity) in a Fund.
- “**Gain**” means all capital gain, including (1) short-term capital gain, (2) capital gains on collectibles (normally taxed at a special rate), (3) distributions and allocations from entities that are treated as capital gains to the owners, and (4) net gain on all Section 1231 Property sold during the year. Gain does not include recapture income, which is taxed as ordinary income.



II. Definitions

- “**Section 1231 Property**” means property held for more than one year that is used in a trade or business.
- “**Sub-Fund**” means an entity that a Fund invests in that meets certain requirements, as discussed in the “Requirements for Sub-Funds” section below.
- “**Sub-Fund Interests**” means equity ownership (including preferred equity) in a Sub-Fund by a Fund.
- “**Zone**” means certain designated low-income areas, as discussed in the “Zones” section below.
- “**Zone Property**” means tangible property that meets certain requirements, as discussed in the “Zone Property” section below.
- “**Zone Working Capital**” means cash, cash equivalents, or debt instruments of less than eighteen months if there is a written plan and written schedule for the use of such assets to develop a trade or business in a Zone or to buy or substantially improve Zone Property within thirty-one months and such assets are spent in substantial accordance with the written plan.



III. Benefits of Investing Gain in a Fund

Investing in a Fund provides significant tax benefits to any Electing Taxpayer, namely:

1. Tax on the Gain (including the 3.8% net investment income tax) is deferred until the earlier of (i) an “inclusion event” or (ii) December 31, 2026. IRC § 1400Z-2(a)(1) and Prop. Treas. Reg. § 1.1400Z2(b)-1(b). An “inclusion event” is one of the following events under Prop. Treas. Reg. § 1.1400Z2(b)-1(c):
 - a. If the Fund Interest is disposed of in any manner (even by gift or in a tax free transaction), other than (i) upon death (because the estate is subject to tax on the Deferred Gain as income in respect of a decedent upon the earlier of an inclusion event with respect to the estate or December 31, 2026), (ii) a contribution to a grantor trust or wholly owned LLC, (iii) a contribution to a partnership, in which case the partnership inherits the Deferred Gain, and any later recognition must be allocated to the contributing partner; or (iv) a merger of two partnerships.



III. Benefits of Investing Gain in a Fund

- b. If the Fund makes a distribution to the Electing Taxpayer in cash or the fair market value of property that exceeds the Electing Taxpayer's basis in the Fund Interest.
- c. If the Electing Taxpayer claims a loss for the Fund Interest being worthless.
- d. If the Fund ceases to exist for tax purposes.
- e. If the Electing Taxpayer is an S corporation, any aggregate transfer of more than 25% of the shares of the S corporation triggers an inclusion event with respect to all of the S corporation's Fund Interest.
- f. If the Electing Taxpayer is a partnership, an inclusion event with respect to a partner in the partnership triggers recognition of that partner's share of the Deferred Gain of the partnership, and the partner is required to give notice of the inclusion event to the partnership. Prop. Treas. Reg. § 1.1400Z2(b)-1(h)(2).



III. Benefits of Investing Gain in a Fund

Happily, an inclusion event does not include the Electing Taxpayer taking out a loan against the Fund Interest. If an Electing Taxpayer does have an inclusion event, the basis in the Fund Interest is increased immediately before the inclusion event by any recognized Deferred Gain.

2. Upon an inclusion event, the recognized Deferred Gain is capped at the value of the Fund Interest at that time. IRC § 1400Z-2(b)(2)(A)(i). The character of the Deferred Gain when ultimately recognized is the same as in the year of the original sale, but the tax rate depends on the tax rate in the year of recognition.
3. Ten percent of the Deferred Gain is excluded entirely if the Fund Interest is held for five years, and 15% of the Deferred Gain is excluded entirely if the Fund Interest is held for seven years. IRC § 1400Z-2(b)(2)(B). This result is achieved by a deemed increase in the basis in the Fund Interest, which applies for all purposes, including the ability to deduct losses against it.



III. Benefits of Investing Gain in a Fund

4. There is no tax at all to an Electing Taxpayer on a sale of the Fund Interest (other than the Deferred Gain) if the Fund Interest is held for at least ten years and the entire Fund Interest is sold, and there is no recapture of depreciation, even if the Fund holds “hot assets” under IRC § 751 or there is debt in excess of basis. IRC § 1400Z-2(c) and Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i). The proposed regulations expand this tax benefit to the Electing Taxpayer’s share of capital gain recognized by the Fund on Zone Property after ten years, but the taxpayer in that case would have to recognize ordinary income items, such as recapture income. Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii)(A)(1). The literal wording of the regulation only applies to the sale of property by a Fund, not a Sub-Fund, but it seems that the intent would permit the rule to apply to sales by a Sub-Fund as well.



III. Benefits of Investing Gain in a Fund

The Electing Taxpayer must give notice to the Fund when this benefit occurs. Prop. Treas. Reg. § 1.1400Z2(b)-1(h)(3). Critically, it does not appear that all “inclusion events” are treated as dispositions of the Fund Interest, so the exemption of gain after ten years may still apply to the Fund Interest, even if the Deferred Gain has been triggered by an inclusion event. On the other hand, the 10% and 15% step-up in basis of a Fund Interest discussed in item 3 above do not apply to the assets held by a Fund, so a sale of assets by a Fund or Sub-Fund prior to the ten-year holding period will be fully taxable to the Electing Taxpayer.

This benefit applies even if the relevant area is no longer designated as a Zone for any reason for dispositions before December 31, 2047. This benefit does not apply to any interest in a Fund acquired for services, such as a “promote” or “profits interest.” Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(9)(ii).

Whenever a Fund Interest is bifurcated into a qualified portion and non-qualified portion (such as if the investment in the Fund exceeds the Deferred Gain), the two portions are treated as separate interests, and the tax benefits and rules outlined above apply only to the qualified portion, and normal tax rules apply to the non-qualified portion.



IV. Technical Requirements

The technical requirements for obtaining the tax benefits of investing in a Fund are as follows:

1. The benefits apply to the reinvestment of any Gain recognized from 2018 through 2026 by all individuals and entities on sales to unrelated parties (not more than 20% overlapping ownership for sales to or by entities), including any Gains recognized on a sale of a Fund Interest, including Deferred Gain. Prop. Treas. Reg. § 1.1400Z2(a)-1. The benefit appears to apply to Gain that would otherwise be offset by capital losses or net operating losses, but only to the net gain on Section 1231 Property sold during the year. The benefits do not apply if the taxpayer held an offsetting position that substantially diminished the risk of holding the property that was sold, whether or not either of the positions were publicly traded.



IV. Technical Requirements

2. The taxpayer must elect these benefits on IRS Form 8949, Sales and Other Dispositions of Capital Assets (OMB No. 1545-0074) (available at <https://www.irs.gov/pub/irs-pdf/f8949.pdf>) filed with the tax return for the year the Gain is recognized. For Gain recognized by pass-through entities, either the entity or the owners may make the election. Prop Reg § 1.1400Z2(a)-1(c). If a pass-through entity makes the election, it must give notice of the election to its owners. Prop. Treas. Reg. § 1.1400Z2(b)-1(h)(1). If the owners make the election, they must give notice of the election to the pass-through entity. Prop. Treas. Reg. § 1.1400Z2(b)-1(h)(1).



IV. Technical Requirements

3. The Fund Interest must be acquired within 180 days after the Gain is recognized. IRC § 1400Z-2(a)(1)(A). An investment in a Fund prior to Gain being recognized does not work, but it may be possible to effectively achieve that result by the taxpayer first loaning money to a Fund (perhaps through an affiliate) and later making the investment and paying off the loan after Gain is recognized. If property is sold for a note and Gain is reported on the installment method, it appears that the 180-day period runs from receipt of each payment on the note. Because only net gain on all Section 1231 Property sold during the year qualifies, the 180-day period for such net gain does not start until the end of the tax year. Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(iii).



IV. Technical Requirements

If a pass-through entity does not make the election, the owners may elect to start the 180 days from either the end of the entity's tax year or when the entity recognizes the Gain. Prop. Treas. Reg. § 1.1400Z2(a)-1(c). The proposed regulations apply this rule to trusts, but this rule probably does not apply to grantor trusts. Gain allocated to shareholders of a real estate investment trust (REIT) is considered to occur on last day of the year. Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(4)(i). A difficulty for owners of pass-through entities is that they may not be advised of a sale by the entity until they receive their K-1s, and they may not have sufficient time to acquire a Fund Interest.

4. The Fund Interest may be acquired either (a) directly on original issue from an entity that is a Fund at the time of the investment or (b) from a current owner of a Fund Interest. Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(9)(iii).



IV. Technical Requirements

5. All the benefits (including the exclusion of tax on the sale of a Fund Interest) apply only to the extent of the lesser of (a) the Deferred Gain or (b) the “amount invested” to acquire an interest in the Fund. IRC § 1400Z-2(b)(2)(A). If more than this amount is invested, the Fund Interest is allocated pro rata between the qualifying portion and non-qualifying portion for purposes of calculating the tax benefits to the qualifying portion. Tracing of cash from the Gain to the Fund Interest is not required. The “amount invested” appears to include debt (even non-recourse debt) that is borrowed by the investor to acquire an interest in the Fund, but not any portion of the debt of the Fund that is allocated to the investor under IRC § 752.



IV. Technical Requirements

The “amount invested” can also include any non-cash property contributed to a Fund (as long as the transaction is not recharacterized as a disguised sale), but it is unlikely that Electing Taxpayers will contribute non-cash property to a Fund, because the property could not qualify as Zone Property, which requires that the property be purchased by a Fund. Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10)(ii)(B).

The “amount invested” is reduced by any cash distributed by the Fund within two years that is not matched by an allocation of debt to the investor for calculating basis. Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10)(ii)(A)(2). If the Fund Interest is acquired from a current owner of the Fund Interest, the “amount invested” is the cash and net fair market value of any property transferred by the Electing Taxpayer for the interest. Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(10)(iii).



V. Zones

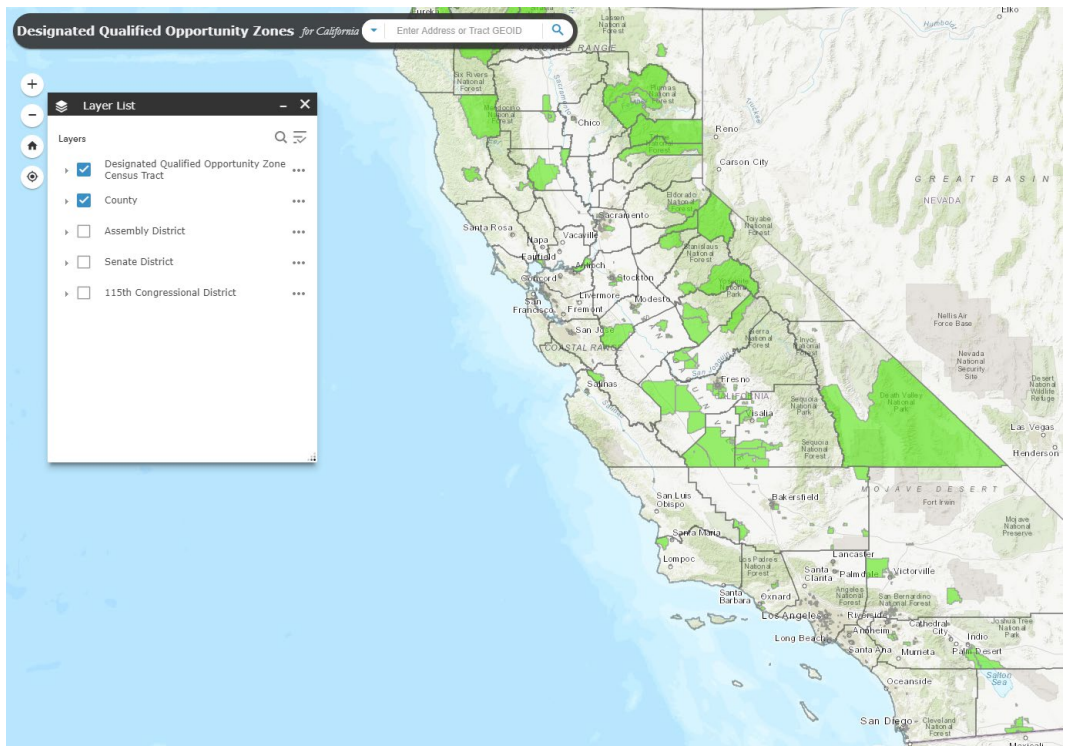
Zones are located in the United States and its possessions.

The designation of an area as a Zone remains for ten years.

IRC § 1400Z-1(f). The map of Zones in California can be found at:

<https://cafinance.maps.arcgis.com/apps/webappviewer/index.html?id=do68b90cb97f4b429f3b180593036b7e>

The locations of national zones are listed in IRS Notice 2018-48, 2018-28.



VI. Requirements for Funds

The principal requirements to qualify as a Fund are as follows:

1. A Fund must be a corporation (even an S corporation or a REIT) or a partnership (including an LLC) for tax purposes. IRC § 1400Z-2(d)(1). As a practical matter, a Fund will almost always be formed as an LLC with multiple owners, to provide limited liability and pass-through partnership characterization for tax purposes. The proposed regulations provide extensive rules applicable only to Funds formed as corporations, but those rules are not discussed in this article, because most Funds will be formed as partnerships for tax purposes.
2. The “organizing documents” (probably the articles) for the Fund must state that the purpose of the entity is to invest in a Zone and the description of the business. IRS Form 8996. The Fund must be formed in the U.S. or in a U.S. possession if it invests in a Zone that is in that possession.



VI. Requirements for Funds

3. The entity must elect to be a Fund on IRS Form 8996 and must file this form annually. On this form, the entity designates the first month that it is a Fund, and if it does not make this designation, it is a Fund for that year from the first day the entity was formed.
4. The Fund must hold 90% of all its gross assets in the form of (a) Sub-Fund Interests acquired directly upon original issue from an entity that is a Sub-Fund (and not also a Fund) at the time of acquisition and for 90% of the Fund's holding period of the Sub-Fund (Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(5)) or (b) Zone Property (which, as discussed below, must be tangible property). IRC § 1400Z-2(d). Critically, this test is applied to all assets of a Fund, so intangible assets, such as patents, copyrights, and, most importantly, cash, which do not count as Zone Property, could disqualify an entity from being a Fund. The one exception is that a Fund may exclude Zone Working Capital for six months if it is attributable to the issuance of a Fund Interest. Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(4).



VI. Requirements for Funds

For any period that the Fund does not meet this test, the Fund must pay penalty interest (currently 6% per year) on the amount of the shortfall. IRC §§ 1400Z-2(f) and 6621(a)(2). It is not clear what happens if the Fund continues to fail to meet this test; presumably at some point it is disqualified as a Fund, at which point the investors must recognize the Deferred Gain.

5. The assets must be acquired after 2017, so entities with substantial retained pre-2017 property cannot qualify, even if the property is in a Zone. IRC § 1400Z-2(d)(D)(i). The test is measured each year based on the average of the value of all assets at end of (a) the first six months of the tax year (or the first six months from commencement as a Fund for its first year) and (b) the end of each tax year, as reported on IRS Form 8996 each year. IRC § 1400Z-2(d)(1). Thus, new Funds have some time to invest in Sub-Funds or Zone Property, but the timing of formation of the Fund becomes critical.



VI. Requirements for Funds

6. Critically, there is no look-through to the assets of a Sub-Fund, even if it is a pass-through for tax purposes, so many Funds will be forced to meet the 90% test by holding interests in Sub-Funds, because the requirements for the assets of Sub-Funds are more lenient than for Funds, as discussed in the “Requirements for Sub-Funds” section below. This means the typical structure will be a Fund that is an LLC with multiple owners (to be treated as a partnership for tax purposes), owning interests in one or more Sub-Funds that are also formed as LLCs with multiple owners (to also be treated as partnerships for tax purposes).



VI. Requirements for Funds

7. A Fund is allowed twelve months to reinvest in a Sub-Fund or in Zone Property if it sells a Sub-Fund Interest or Zone Property (Prop. Treas. Reg. § 1.1400Z2(f)-1(b)), but the sale is taxable to the owners of the Fund if it is a pass-through for tax purposes, unless (a) they make a further election to defer the Gain by investing that amount in the same or a different Fund (which probably requires a distribution and recontribution of the sale proceeds) or (b) the Fund or Sub-Fund makes a IRC § 1031 exchange into other Zone Property.



VII. Requirements for Sub-Funds

The principal requirements to qualify as a Sub-Fund are as follows:

1. Like a Fund, a Sub-Fund must also be a corporation or a partnership (including an LLC) for tax purposes. As a practical matter, a Sub-Fund will almost always be formed as an LLC with multiple owners, to provide limited liability and pass-through partnership characterization for tax purposes. It does not appear that the organization documents for a Sub-Fund must state the purpose of the entity is to invest in a Zone and the description of the business (as is the case with Funds), but it would be prudent to do so. The Sub-Fund must be formed in the U.S. or in a U.S. possession if it invests in a Zone that is in that possession. Prop. Treas. Reg. § 1.1400Z2(d)-1(e).



VII. Requirements for Sub-Funds

2. At least 70% of the gross tangible assets of the Sub-Fund must be Zone Property. Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(3). The property remains Zone Property for five years even if it is moved out of the Zone (as long as the entity owns it). IRC § 1400Z-2(d)(3)(B). Note that this test is more lenient than the 90% asset test for a Fund and is applied only to all tangible assets, but it is also all or nothing, as opposed to the interest charge imposed on Funds while they do not meet the 90% test. IRC § 1400Z-2(f) (by negative implication, because the penalty rate only applies to Funds).
3. As with Funds, the property must be acquired after 2017, so entities with substantial retained pre-2017 property cannot qualify, even if the property is in a Zone.



VII. Requirements for Sub-Funds

4. As opposed to Funds, Sub-Funds do not have to file IRS Form 8996 each year, so it is not clear how the IRS will monitor compliance with the 70% test. It is probably safe to assume that the same test applicable to Funds will apply, i.e., measured each year based on the average of the value of all assets at end of (a) the first 6 months of the tax year (or the first six months from commencement as a Sub-Fund for its first year) and (b) the end of each tax year.
IRC § 1400Z-2(d)(1).
5. The following requirements all apply to Sub-Funds but (oddly) not to Funds:
 - a. At least 40% of intangible property (such as trademarks, patents, copyrights, and working capital) of the Sub-Fund must be used in connection with an active trade or business that is conducted in the Zone.
Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(ii). Zone Working Capital is treated as meeting this test.



VII. Requirements for Sub-Funds

- b. At least 50% of the gross income of the entity must be from an active trade or business conducted in the Zone. Income from Zone Working Capital counts as qualifying income for this purpose. Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(i). In determining whether other income qualifies, Sub-Funds can apply any of the tests below:
 - i. Income can be allocated based on the location of employees and independent contractors based on hours worked.
 - ii. Income can be allocated based on the location of employees and independent contractors based on compensation paid.
 - iii. The test will be met if the operations in the Zone and Zone Property are necessary for the generation of at least 50% of the gross income of the Sub-Fund.
 - iv. The Sub-Fund can make the allocation based on all the facts and circumstances.



VII. Requirements for Sub-Funds

- c. Less than 5% of the assets of the Sub-Fund can be comprised of investment property (including stock, partnership interests, and debt) other than Zone Working Capital. IRC § 1400Z-2(d)(3)(A)(ii).
- d. The Sub-Fund may not operate a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. IRC § 1400Z-2(d)(3)(A)(iii).



VIII. Valuation of Property

For purposes of the 90% of all assets test for Funds and the 70% of tangible assets test for Sub-Funds, the test is based on an annual election by the Fund or Sub-Fund to use either (a) the values stated on certified audited financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) or (b) original cost. Prop. Treas. Reg. § 1.1400Z2(d)-1(b). Under this approach, the asset values include debt (even non-recourse debt) incurred in connection with acquiring the assets.

In the case of leased property, the test can be based on certified audited financial statements prepared in accordance with GAAP only if those statements include the value of leased property based on the present value of the rent due under the lease. Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(2)(ii). In all other cases, leased property is included based on the present value of the rent due under the lease calculated upon commencement of the lease (including all extensions at the lessee's election at a pre-defined rent) discounted at the applicable federal rate in effect under IRC § 1274 (based on the length of the lease). Prop. Treas. Reg. § 1.1400Z2(d)-1(b)(2)(iii).



IX. Zone Property

Zone Property must meet the requirements set forth in Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(4), as follows:

1. The property must be tangible property, including land, buildings, and personal property.
2. At least 70% of the use of the property must be within a Zone during 90% of the Fund's or Sub-Fund's holding period of the property. Inventory outside the Zone is treated as being in the Zone if it is being shipped to or from the Zone.
3. The property must be acquired or leased after 2017.
4. *Other than leased property*, the property must either be constructed by the Fund (including improvements to leased property) or acquired by purchase by a Fund or Sub-Fund from an unrelated third party (not more than 20% common ownership).



IX. Zone Property

5. In the case of leased property, the lease must provide for arm's-length rent. In addition, if the lease is for anything other than unimproved land, there cannot be any plan or intent for the lessee to acquire the property for any amount other than the value of the property at the time of purchase. If the lease is from a related party, (i) the lessee cannot prepay more than one year's rent and (ii) if the property is personal property that was used in the Zone before the lease, the lessee must purchase other Zone Property with a value at least equal to the value of the leased property within thirty months of commencement of the lease.



IX. Zone Property

6. *Other than land and leased property*, the property must either be (i) placed in service in the Zone for the first time by the Fund or the Sub-Fund (including used property previously used outside the Zone or constructed property that has not yet been placed in service in a trade or business) or (ii) already in the Zone but either vacant for at least five years or the Fund or Sub-Fund invests in the property an amount equal to at least 100% of the Fund's original gross cost of the property within thirty months ("100% of Cost Test"). IRC § 1400Z-2(d)(2)(D)(i); Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(8). This last clause can apply only to buildings on real estate as a practical matter, and only the cost allocated to the acquired buildings is included for purposes of the 100% of Cost Test. The acquired buildings and all investments in them count as Zone Property during the thirty months. Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(viii).
- The calculation of the investment in the buildings presumably includes all costs that would be capitalized to the buildings, such as the cost of new fixtures and costs relating to getting permits or plans to use the buildings for a different purpose.



IX. Zone Property

7. The property must be used in a trade or business (or for Sub-Funds, in an active trade or business) in the Zone. Any lease of real property is treated as meeting this test, unless it is triple net leased, so the lessor should retain liability for at least either property taxes, insurance, or maintenance. Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(ii)(B)(2). It appears that property being constructed or improved is treated as meeting this test even before it is placed in service for tax purposes.
8. *Other than for leased property*, unimproved land (presumably including due to tearing down any existing buildings) or minimally improved land (such as agricultural land) is included as Zone Property only if the Fund or Sub-Fund has the intention to improve the land by more than an insubstantial amount within thirty months after acquisition, although it does not appear that the improvements must be completed by that time. Prop. Treas. Reg. § 1.1400Z2(d)-1(f).



X. Conclusion for Real Property

In most cases, Funds will be a real estate play, so putting it all together, the rules for real property are as follows:

1. The property must be acquired or leased after 2017.
2. The property must be used in a trade or business (or for Sub-Funds, in an active trade or business) in the Zone, which includes leasing other than a triple net lease. It appears that this test is deemed satisfied during construction on, or improvement of, the property.
3. Property leased to the Fund or Sub-Fund qualifies even if (a) it is leased from a related party, (b) the property is already improved and used in the Zone, and (c) the lessee merely subleases the property other than on a triple net basis.



X. Conclusion for Real Property

4. In the case of purchased property:
 - a. It must be acquired from an unrelated party.
 - b. If the property is unimproved (presumably including due to tearing down any existing buildings) or minimally improved, the Fund or Sub-Fund must improve the land by more than an insubstantial amount within thirty months after acquisition, although it does not appear that the improvements must be completed by that time.
 - c. If the property is improved, the buildings on the land will not count as Zone Property unless the 100% of Cost test is met with respect to such buildings.



XI. Contact Information



Schuyler (Sky) M. Moore
Greenberg Glusker LLP
smoore@ggfirm.com
310.201.7559

Schuyler (Sky) Moore, best known in Los Angeles for closing high-dollar, cross-border deals, is highly valued among dealmakers for his concise communications, willingness to quantify risk, and ability to get complex deals to the finish line as fast as possible.

Specializing in tax in law school, Sky has deep expertise in taxation and tax consequences and has been a tax expert his entire career. Sky is a recognized tax authority, having written a leading tax treatise and writing numerous articles and giving seminars on a wide variety of tax issues, including on tax issues relating to real estate, partnerships, and cross border transactions.

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