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OPPORTUNITY ZONES

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AGENDA

- Why invest in an Opportunity Zone fund?
- Where are the Qualified Opportunity Zones?
- How did Opportunity Zones come to be?
- Steps in the Opportunity Zone process.
- Opportunity Zone property.
- “Substantial improvement.”
- Some of the things to think about.
- Questions and (hopefully) answers.

WHY INVEST IN AN OPPORTUNITY ZONE FUND?

- The short answer . . . If the investor meets the requirements (of which there are many):
- Defer federal income tax on recognized capital gains,
- Have a portion of that deferred gain forgiven, and
- Avoid federal income tax on gain from the Opportunity Zone investment.

WHERE ARE THE QUALIFIED OPPORTUNITY ZONES?

- *Notice 2018-48*, 2018-18 IRB 9.
- Listed by State, county and census tract.
- Interactive map: Treasury's Community Development Financial Institutions Fund website.
- https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml
- Some of the locations may pleasantly surprise folks . . .

HOW DID OPPORTUNITY ZONES COME TO BE?

- Creation of the Tax Cuts and Jobs Act of 2017.
- Goal is revitalization of economically depressed geographies.
- Attempt to implement lessons learned from prior efforts . . .
  - Requisite long term investment to maximize benefits.
  - Attempt principally to capture investor’s gains from other successful investments.
  - Broad – but not unlimited categories of qualifying investments.
  - To fully benefit from the Opportunity Zone provisions, the taxpayer needs to make astute opportunity zone investments.

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STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 1: A taxpayer realizes and recognizes any capital gain.
  - Shares of stock.
  - Real estate- subject to rules relating to Section 1231 gains
  - Partnership interest that result in capital gain- be careful of hot assets under Section 751
  - Other property.
- Step 2: The taxpayer invests the gain dollars in an “Opportunity Zone Fund.”
  - Timing: Investment within 180 days for realization/recognition event. Subject to rules relating to flow through entities and Section 1231
  - Taxpayer cannot invest directly in property, even if in opportunity zone.
  - The fund can self-certify.

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STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 2: The taxpayer invests the gain dollars in an “Opportunity Zone Fund.” (continued).
  – Fund must be “organized as a corporation or partnership.”
- Step 3: Opportunity Zone Fund invests in “opportunity zone property.”
- Step 4: Opportunity Zone Fund must hold 90% of its assets in Qualified Opportunity Zone Property (“QOZP”). QOZP is:
  – Tangible property located in a qualified opportunity zone (“QOZ”)
  – Certain equity interests in a corporation or partnership
  – Twice annual testing.
  – Penalty for failure to comply.

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STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 5: If the taxpayer holds its opportunity zone fund interest for 5+ years, the taxpayer receives an increase in his/her adjusted basis of 10% of the deferred gain.
- Step 6: If the taxpayer holds its opportunity zone fund interest for 7+ years, the taxpayer receives an increase in his/her adjusted basis of 5% of the deferred gain.

STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 7: On 12/31/2026, there is a “deemed disposition,” so that all the deferred gains related to the investment in the opportunity zone fund ends and gain is recognized.
  - The gain is the lesser of:
    - The original deferred gain, or
    - The FMV of the taxpayer’s Opportunity Zone Fund investment
  - Reduced by the taxpayer’s basis in his/her Opportunity Zone Fund investment.

STEPS IN THE OPPORTUNITY ZONE PROCESS

- Step 7 (continued): Putting the “deemed disposition” rule in context . . .
  - The deferred gain is the building block for the tax on the deemed disposition.
  - So, protecting the cash on sale attributable to the adjusted basis from the originating transaction is paramount.
  - The basis adjustment (up to 15%) essentially is free . . .
  - Taxpayer has interest-free use of the adjusted basis dollars until, say, April 15, 2027.
  - What is the value of free use of that cash on a discounted present value?

- Step 8: If the taxpayer holds the Opportunity Zone Fund investment for 10+ years, the taxpayer is permanently exempt from capital gains from the sale of his/her Opportunity Zone Fund.

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TAX BENEFIT OF OZ INVESTMENT

		Federal Tax	State Tax	NII Tax	Total Tax
Gain recognized in 2019	5,000,000	1,000,000	349,500	190,000	1,539,500
Gain Dollars invested in a QOF	(5,000,000)	(1,000,000)	(349,500)	(190,000)	(1,539,500)
	-	-	-	-	
December 31, 2026					
Recognize 85% of gain	4,250,000	850,000	297,075	161,500	1,308,575
Tax Savings					230,925

TAX BENEFIT OF OZ INVESTMENT

Sale of Business in 2030			
Gross Sales Price			10,000,000
Less Basis			(5,000,000)
Gain			5,000,000
Tax			Zero
Minimum Tax Savings:			
Federal			1,000,000
State			349,500
Total			1,349,500

OPPORTUNITY ZONE PROPERTY

- Category 1: Opportunity Zone Property.
- Tangible property acquired by purchase from an unrelated party after December 31, 2017
  - Real property.
  - Land and improvements to real property.
  - Equipment and other personal property.
- The QOF must use the property in a trade or business
- “Original Use” on the QOZ commences with the QOF or the QOF “Substantially Improves” the property
- That tangible property needs to be in the opportunity zone during “substantially all” of the Opportunity Zone Fund’s holding period.

OPPORTUNITY ZONE PROPERTY

- Category 2: Opportunity Zone Stock or Partnership Interests.
  - So, the Opportunity Zone Fund is not limited to direct ownership of real estate.
  - The stock or partnership interest can be an investment in a domestic operating business.
  - “Substantially all” of the business tangible property must be:
    - Acquired by purchase from unrelated third parties after 2017, and
    - Used in the Opportunity Zone during “substantially all” of the business’s holding period.
  - Among other things, at least 50% of the business’s gross income comes from the “active conduct” of the business.
  - A “substantial portion” of the intangible property of the entity is used in the active conduct of the trade or business.

OPPORTUNITY ZONE PROPERTY

- Category 2: Opportunity Zone Stock or Partnership Interests.
- The balance sheet cannot contain too much financial property, which would imply the business's focus is investment speculation, rather than economic development.
  - Less than 5% of average aggregate unadjusted basis is "nonqualified financial property."
- By statute, certain businesses don't qualify (golf courses, country clubs, massage parlors, hot tub or sun tan facilities, race tracks, gambling, package liquor stores).

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"SUBSTANTIAL IMPROVEMENT"

- An Opportunity Zone Fund has a 30-month window to improve property.
- Amount of improvements must exceed acquisition basis in the property.
- When does 30-month period start?
- Must land be "substantially improved"? Does the basis allocable to land count?

SOME OF THE THINGS TO THINK ABOUT

- Does this make sense for a given investor or gain?
  - Incremental benefit.
  - Comparative after-tax returns.
- State law conformity/nonconformity.
- Who is the taxpayer?
  - S corporations and/or their shareholders?
  - Partnerships or their partners?
- Mixed fund investments.

SOME OF THE THINGS TO THINK ABOUT

- How does an investor think about opportunity fund investment versus a like-kind exchange?
- Does deferred gain mean roll-over investors start with an adjusted basis of $0?
  - Investor's allocable share of annual tax loss?
  - Taxation of operating cash flow distributions?
- Does partnership-level nonrecourse borrowing solve all the problems?
- What is the tax result from a distribution of refinance proceeds?
- In a mixed fund, can the partnership make special allocations?

SOME OF THE THINGS TO THINK ABOUT

- How best to structure funds with multiple properties? How does the fund structure an exit?
- How should developers and sponsors think about the related party rules?
  - Can/should the Fund purchase of assets owned by the developer?
  - Leasing of assets as an alternative

APRIL 17TH PROPOSED REGULATIONS

Section 1231 gains

Because capital gain income from Section 1231 property – that is, generally, property used in a trade or business and held for more than one year – can only be determined as of the last day of the taxable year, the 180-day investment period begins on that day – the last day of the taxpayer’s taxable year. The amount eligible to be invested is net Section 1231 gain.

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APRIL 17TH PROPOSED REGULATIONS

Carried interests

- An investment that arises from services to the QOF or an entity owned directly or indirectly by the QOF does not qualify for the QOF benefits. The taxpayer’s interest is a mixed fund with the portion of the interest related to equity contributed treated as an investment that qualifies for the QOF benefits. The balance does not qualify.

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APRIL 17TH PROPOSED REGULATIONS

- **50% gross income safe harbors**
- There are three safe harbors to document that a 50 percent gross income test for an active trade or business in the QOZ is met.
- 50 percent of the hours for services performed for the business are by employees and contractors located in the QOZ.
- 50 percent of the amount paid for services performed for the business are by employees and contractors located in the QOZ.
- Tangible property and management or operation functions located in the QOZ are each necessary to generate 50 percent of the business's gross income. Finally, the test may be documented based on facts and circumstances.

APRIL 17TH PROPOSED REGULATIONS

31 Month Working Capital Plan

The 31-month window for use of working capital by a trade or business now includes the development of a trade or business, not just the acquisition or construction of substantial improvement of tangible property. If the 31-month period is exceeded due to government delays, the trade or business is still in compliance with the safe harbor requirement.

APRIL 17TH PROPOSED REGULATIONS

Hot assets and depreciation recapture

If the taxpayer’s basis in the QOF is increased to fair market value because the 10-year hold election has been made, the basis of the underlying assets is also increased just prior to the sale. This mechanism avoids the potential for ordinary gain related to depreciation recapture and other hot assets while creating an equal capital loss.

APRIL 17TH PROPOSED REGULATIONS

Active business

The ownership and operation (including leasing) of real property is an active trade or business. However, this does not include triple-net-leased property.

APRIL 17TH PROPOSED REGULATIONS

Leased property can qualify as QOZ business property (QOZBP) if the property is:

- Acquired under the lease after Dec. 31, 2017
- The terms are arm’s-length, market rate (by applying so-called “section 482” criteria)
- If the lease is from a related party, there are two additional requirements that must be met:
  - Rent cannot be prepaid by more than 12 months; and
  - If original use of leased tangible personal property in the opportunity zone does not commence with the lessee, the lessee must purchase other tangible personal property that is QOZB equal in value to the leased tangible personal property

APRIL 17TH PROPOSED REGULATIONS

Liquidity

In a significant positive change, the new proposed regulations allow an investor to make an eligible investment in a QOF by purchasing an ownership interest from an existing QOF investor. (That selling investor then will have an inclusion event.)

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APRIL 17TH PROPOSED REGULATIONS

Reporting

- Treasury is expected to revise Form 8996 to require the employer identification number (EIN) of the QOZB owned by the QOF and the census tracts where investments are being made.

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