

Opportunity Zone Incentive Tax Cuts and Jobs Act

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Overview

- **History of Opportunity Zone Incentive**
- **Opportunity Zones – Qualification and Designation**
- **Tax Benefits of the Opportunity Zone Program**
- **Opportunity Funds – What are the rules; how do you qualify?**
- **Opportunity Zone Businesses and Opportunity Zone Business Property – What are these?**
- **Possible Types of Investments**

History – Investment in Opportunity Act

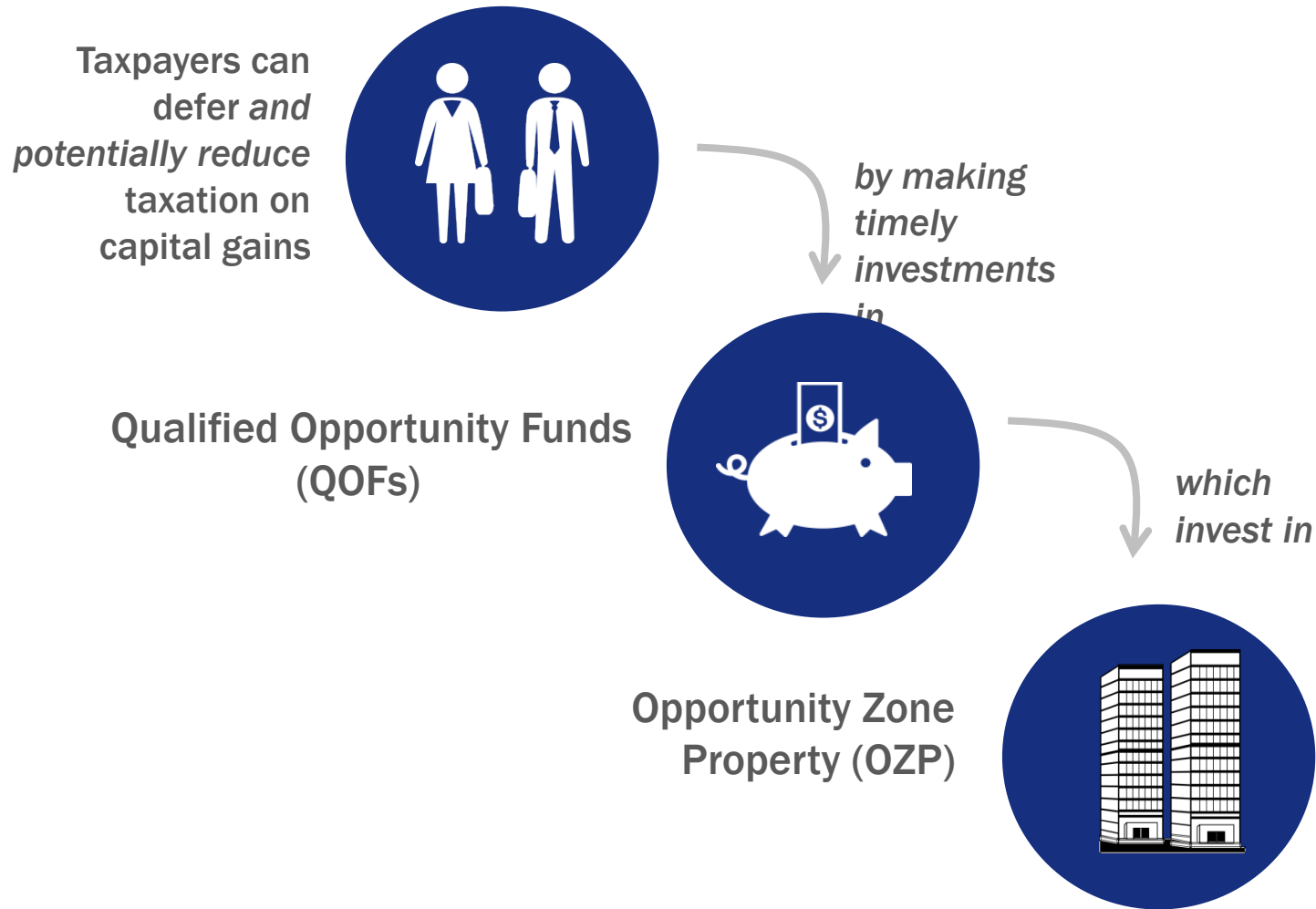
- Drafted in 2016, introduced February 2017
- Bipartisan Legislation
 - Rep. Tiberi (R)
 - Rep. Kind (D)
 - Sen. Scott (R)
 - Sen. Booker (D)
- Goal is to encourage private capital investment in economically distressed areas.

Opportunity Zone Incentive

- Opportunity Zone Incentive
 - The Investment in Opportunity Act was included in the Tax Cuts and Jobs Act.
- December 22, 2017
- New York Times and USA Today



How do Taxpayers Benefit?



3 Tax Incentive Benefits

1. Temporary Deferral of Eligible Gain

- *Applies to any capital gain from the sale or exchange of any property to an unrelated person*
- *\$6 trillion of potential eligible capital*

2. Partial Reduction of Deferred Gain

- *Income Tax is still paid on a large portion of the Deferred Gain*

3. Forgiveness of Additional Gain

- *Applies to the Appreciation in the Investment*

Eligible Gains

- **Eligible Gains**
 - **Capital Gains**
 - Long-term
 - Short-term
 - **Net 1231 Gains**
 - **Section 1250 Unrecaptured Gain**
- **Not Eligible**
 - **Depreciation Recapture (Ordinary Income)**
 - **Inventory**
- **Tax Attributes are Retained (2026)**

1231 Gains

- Only Net 1231 Gains can be Eligible Gains
 - Need to net the 1231 Gains against the 1231 Losses
- What is a 1231 Gain?
- 180-day period for a Net 1231 Gain begins on last day of the taxable year
 - Not as flexible as the 180-day period rule for partnerships

Temporary Deferral of Gain

- Applies to any Eligible Taxpayer
- Sale or Exchange of Property to an Unrelated Person
- On or before December 31, 2026
- Election is made by the Taxpayer
- Deferred Gain: The Aggregate Amount Invested that Does Not Exceed the Amount of Gain Generated
 - In a QOF as an Eligible Interest
 - Within 180 days of the sale/exchange

Eligible Taxpayers

- Individuals
- C Corporations
- RICs
- REITs
- S Corporations
- Partnerships (LLCs and LPs)
- Trusts and Estates

180-Day Period

- **Must invest in an Eligible Interest in a QOF within 180 days from the Sale or Exchange of the Property**
- **Multiple Elections are Possible within a Single Gain:**
 - Invest in different QOFs
 - Must use same 180-day period
- **Special rule for Pass-Through Entities**

Eligible Interest

- **Must be Equity**
 - Preferred Stock
 - Partnership Interest with Special Allocations
- **No Debt Instruments**
- **May acquire Eligible Interest with debt proceeds**
 - Must be equity owner for tax purposes
- **752(a) Deemed Contribution**

Qualifying Investment (New Regs)

- Qualified Investment (QI) is an **Eligible Interest** where an Election by the Taxpayer to Defer Gain Applies
- Carried Interests
 - Interests in a QOF received for furnishing services are **not QIs**
- **QI can be an Eligible Interest acquired from someone other than a QOF**
 - Allows for Investor Liquidity
- Tax-Free contribution of non-cash property to the QOF
 - **Amount of the QI (Bifurcation): Lesser of:** the Net Basis or the Net Value of Contributed Property

Pass-Through Entities (Special Rule)

- Taxpayers can be the partnership and/or the partners when a partnership generates an Eligible Gain
- Investment Period
 - Normal 180-Day Rule for Partnerships
 - **Special Rule for Partners**
 - **Commence on the last day of Partnership's Taxable Period**
 - Be careful of a partnership termination
 - Election to use Partnership's Taxable Period

Qualifying Investments (Partnership Rules)

- **Invokes the Partnership Disguised Sale Rules**
 - With Modifications
- **Distributions made to Investors within Two Years**
 - Presumption that part of the interest is not a QI
 - Exceptions for Reasonable Guaranteed Payments for use of Capital, Reasonable Preferred Returns, and Operating Cash Flow Distributions.
- **Debt-Financed Distributions**
 - Similar two-year presumption

Deferred Gain: When & How Much

When: Includable in taxable income for the taxable year which includes the earlier of (Inclusion Events):

- Investor's sale of its interest in the QOF (Regs have Expanded this); or
- December 31, 2026

How Much: Subject to income tax is based on the lesser of:

Amount of the Deferred Gain

or

The fair market value of investment in the QOF

Less

The Taxpayer's basis in the QOF

Ability to Invest Previously Deferred Gain in new QOF

Inclusion Events

- **General:**
 - Transfers that reduce the Taxpayer's Interest on the QI
 - Distributions from the QOF
 - Special Rule for Partnerships
 - Worthlessness claim regarding QI
 - Termination or Liquidation of the QOF
- **Estate Planning:**
 - Gift – Yes
 - Death – Generally Not
 - Grantor Trusts – Generally Not

Partnership Non-Inclusion Events

- Tax-Free contributions of Qualifying Investments to a Partnership
 - Like a reverse feeder fund
 - Allows for an aggregation of the QIs into one single partnership
- Tax-Free mergers involving Partnerships directly or indirectly holding Qualifying Investments

Distributions from a QOF Partnership

- Inclusion to the extent that **FMV** of the Distributed Property or amount of Cash **exceeds** the Investor's **Tax Basis in the Qualifying Investment**.
 - Applies to a “deemed” distribution
 - Re-allocation of partnership debt
- **Amount of the Inclusion:** Lesser of (1) the remaining Deferred Gain, or (2) the amount that gave rise to the Inclusion Event
- Could result in “slippage” of the Deferred Gain.
 - Debt can be helpful here

Partial Reduction of Deferred Gain (Tax Basis)

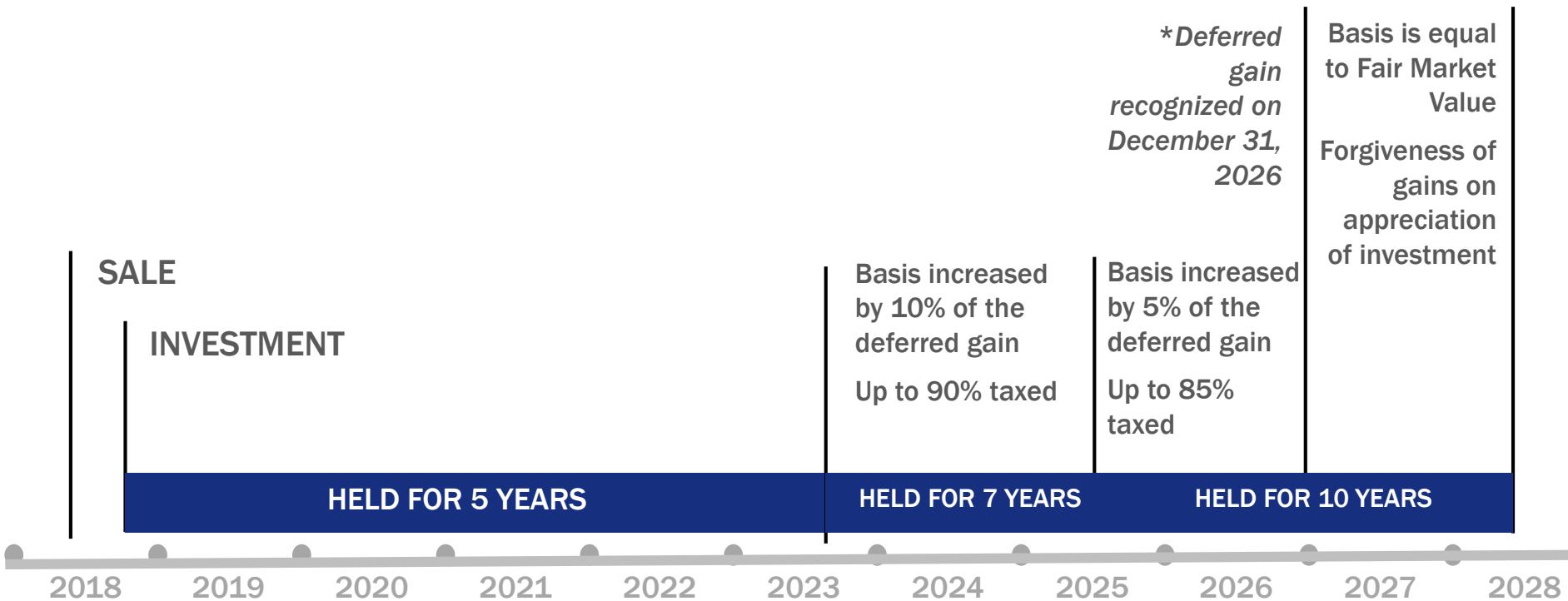
- Taxpayer has an Initial Basis in the QI of Zero
- Hold for 5 Years
 - Investor's tax basis in the QI is increased by 10% of the amount of the Deferred Gain
- Hold for 7 Years
 - Investor's tax basis in the QI is increased by an additional 5% of the amount of the Deferred Gain

Full Forgiveness

- Where Investor holds its QI in the QOF for at least 10 years:
 - Elections to step-up the Tax Basis of Investor's interest in the QOF to FMV, including debt, immediately prior to the sale or exchange.
 - *Significant benefit but must hold long term*
 - The result is no Gain on (1) the sale of the Investor's Qualified Investment in the QOF, or (2) any Capital Gain upon the sale of Opportunity Zone Property by the QOF.
 - **Disposition must occur on or before December 31, 2047 in order to make the Election**

Phantom income issue arising on December 31, 2026

Deferral, Partial Reduction, and Forgiveness of Additional Gains



10-Year Benefit (New Regs)

- Sale of a Qualifying Investment in a QOF Partnership
 - Step-up of the basis in the Investor's QI to the amount of FMV **and the Debt**.
 - **No Recapture** of Losses taken with respect to **Depreciation Involving Ordinary Income Assets** (i.e. Hot Assets).
 - **No Recapture** of Losses taken **with respect to Debt** (i.e. Negative Capital Accounts).

10-Year Benefit (New Regs)

- Sale of Assets held by a QOF Partnership
 - Exclusion of **Capital Gains** from the Sale of **Opportunity Zone Property** by the QOF.
 - Does not apply to sale of assets by an Opportunity Zone Business (OZB).
 - Does not apply to the sale of assets that create ordinary income (Hot Assets).
 - **Helpful for Multi-Asset Funds**, but still need to sell interests in the OZB.
 - OZB can have up to 30% non-OZBP tangible property.

Example*

- Investor sells stock for \$30M (\$20M of long-term capital gain) on July 1, 2019.
- Investor invests \$20M in an interest in an QOF on November 1, 2019.
 - Does not need to invest the entire \$30M
- December 31, 2026:
 - Investor's tax basis in its QI is increased by \$3M (15% of \$20M)
 - \$2M on November 1, 2024, and \$1M on November 1, 2026.
 - Investor has to pay tax on \$17M long-term capital gain
- November 2, 2028:
 - The QI in the QOF has appreciated from \$20M to \$60M (\$40M in potential gain)
 - If the QI in the QOF is sold, then there is no taxable gain on the \$40M of appreciation

* Results/outcomes may vary

What is an Opportunity Zone (O-Zone)?

- Population census tract that is a low-income community (LIC)
 - Approximately 75,000 total census tracts in the U.S.
 - 37% of the census tracts in the United States are LICs
- What is an LIC?
 - Same definition for NMTCs
 - Based upon poverty rate (20%) or median family income (80%)
- Timely nominated by each Governor
- 25% of the LICs were eligible for nomination
 - Approximately 8,700 census tracts
 - 5% of the tracts to be nominated can be contiguous tracts

What is a QOF?

- **Intermediary** Between Investors and the Investments in the Opportunity Zone
- **Statutory Requirements:**
 - Organized as a Corporation or Partnership (LLC can be a QOF)
 - An **investment vehicle** organized for the purpose of investing in **Opportunity Zone Property**
 - **90% Requirement**
- **Certification Process**
- **Penalty imposed for Noncompliance**

QOF Certification

- **Self-Certification** using Form 8996
 - Attached to the taxpayer's federal income tax return for the taxable year, taking into account extensions
- **Identify the “first taxable year” and “first month” entity wants to be a QOF**
- Investments made before the first month not eligible
- Where less than 6 months remaining in taxable year from first month then 90% Requirement is **measured on last day of year**

QOF – 90% Requirement

Must hold at least 90% of assets in Opportunity Zone Property, determined by the average of the percentage of Opportunity Zone Property held on:

The last day of the first six-month period of the QOF's taxable year

And

The last day of the QOF's taxable year

June 30th

December 31st



Measuring the 90% Requirement

- QOF can use the value of its assets reported on an “applicable financial statement” (AFS):
 - **Financial statements prepared for SEC** or other federal agency (not the IRS)
 - **Certified audited financial statement** prepared in accordance with US GAAP
- QOF can also use the **value of the assets owned** by the QOF equal to the QOF’s unadjusted cost basis under Code Section 1012
 - Special Rule for Leased Property
- Option to Disregard **Recently Contributed Property** (6 months)

Penalty for Noncompliance with the 90% Requirement

Failure to meet the 90% Requirement:

Monthly penalty for failing to meet the 90% Requirement

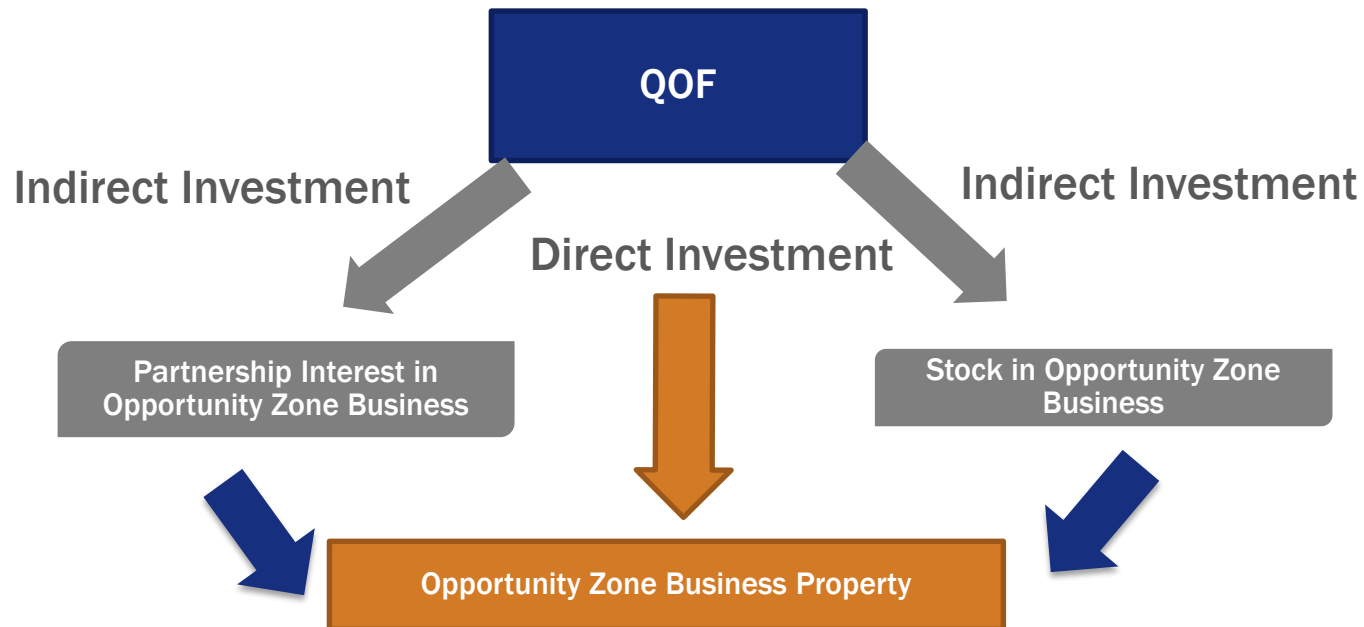
$$\frac{\% \text{ Shortfall}}{\text{Underpayment Rate}^*} \times \text{Penalty}$$

No penalty if it is shown failure is due to **reasonable cause**

*Federal short-term rate plus 3%) –
Currently 6% Annually

Opportunity Zone Property

- Broad Definition - However, no debt.
- Investments that constitute Opportunity Zone Property are:
 - Indirect Approach: Equity investment in an Opportunity Zone Business (an OZB).
 - Direct Approach: Direct purchase of Opportunity Zone Business Property (OZBP).

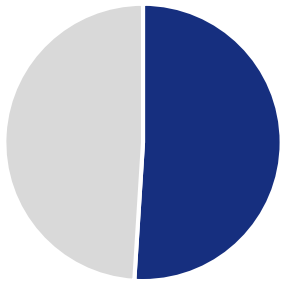


Indirect Investment

- **Original Issuance:** Stock or a partnership interest of a **qualifying entity** issued in an **original issuance after December 31, 2017**, in exchange for cash.
 - Stock could be issued through an underwriter
- **Qualifying entity:** Domestic Corporation or Partnership (including LLCs)
- **Opportunity Zone Business (an OZB):** At time of issuance, or is organized for the purpose of being an OZB (for newly formed entities).
 - No guidance here
- **Must remain an OZB:** For at least **90%** of the QOF's holding period.
 - No guidance here on how this is applied.

Opportunity Zone Businesses

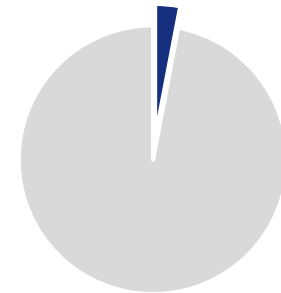
*A trade or business in which **at least 70%** of the **tangible property** owned or leased by the taxpayer is **OZBP** and:



At least 50% of income derived from active conduct of trade or business within an Opportunity Zone



At least 40% of intangible property is used in active conduct of business within an Opportunity Zone



< 5% unadjusted basis of property is nonqualified financial property (cash, cash equivalents, long-term loans)

Opportunity Zone Businesses - Regulations

- Tangible Property Test
 - “Substantially All” is at least 70%
 - Tangible Property that is Leased or Owned
 - Must be Opportunity Zone Business Property
- Intangible Property Test
 - “Substantial Portion” is at least 40%
 - Must be Used in Active Conduct of a Trade or Business in the Opportunity Zone
- Gross Income Test
 - 50% of the Income
 - Must be Derived from the Active Conduct of a Trade or Business in the Opportunity Zone

50% Gross Income Test

- 3 Safe Harbors, and a Facts and Circumstances Test
 - At least 50% of Services Performed (**based upon hours**) are in the O-Zone.
 - At least 50% of Services Performed (**based upon amounts paid**) are in the O-Zone.
 - **Tangible Property** in the O-Zone and the **Management or Operational Functions** in the O-Zone Generate at least 50% of the Gross Income.

50% Gross Income Test – NNN Leases

- Must be Derived from the Active Conduct of a Trade or Business
- Cannot “**Merely Enter**” into a Triple Net Lease
- Key - Activity in the Opportunity Zone
 - **Maintenance Functions** on the Property should be considered

Non-Qualified Financial Property Limitation

- For a taxable year, less than 5% of the average of the aggregate unadjusted bases of the assets of the entity can be attributable to Non-Qualified Financial Property (NQFP)
- NQFP: Debt, Stock, Partnership Interests, Options, Futures Contracts, Forward Contracts, Warrants, Notional Principal Contracts, Annuities, and other similar property.
 - Cash or “cash type” assets
 - Does not include Accounts/Notes Receivable
 - Exception: **Reasonable amounts of working capital (RWC)** in cash, cash equivalents, or short-term debt instruments (**Working Capital Assets**).

Reasonable Working Capital – Safe Harbor

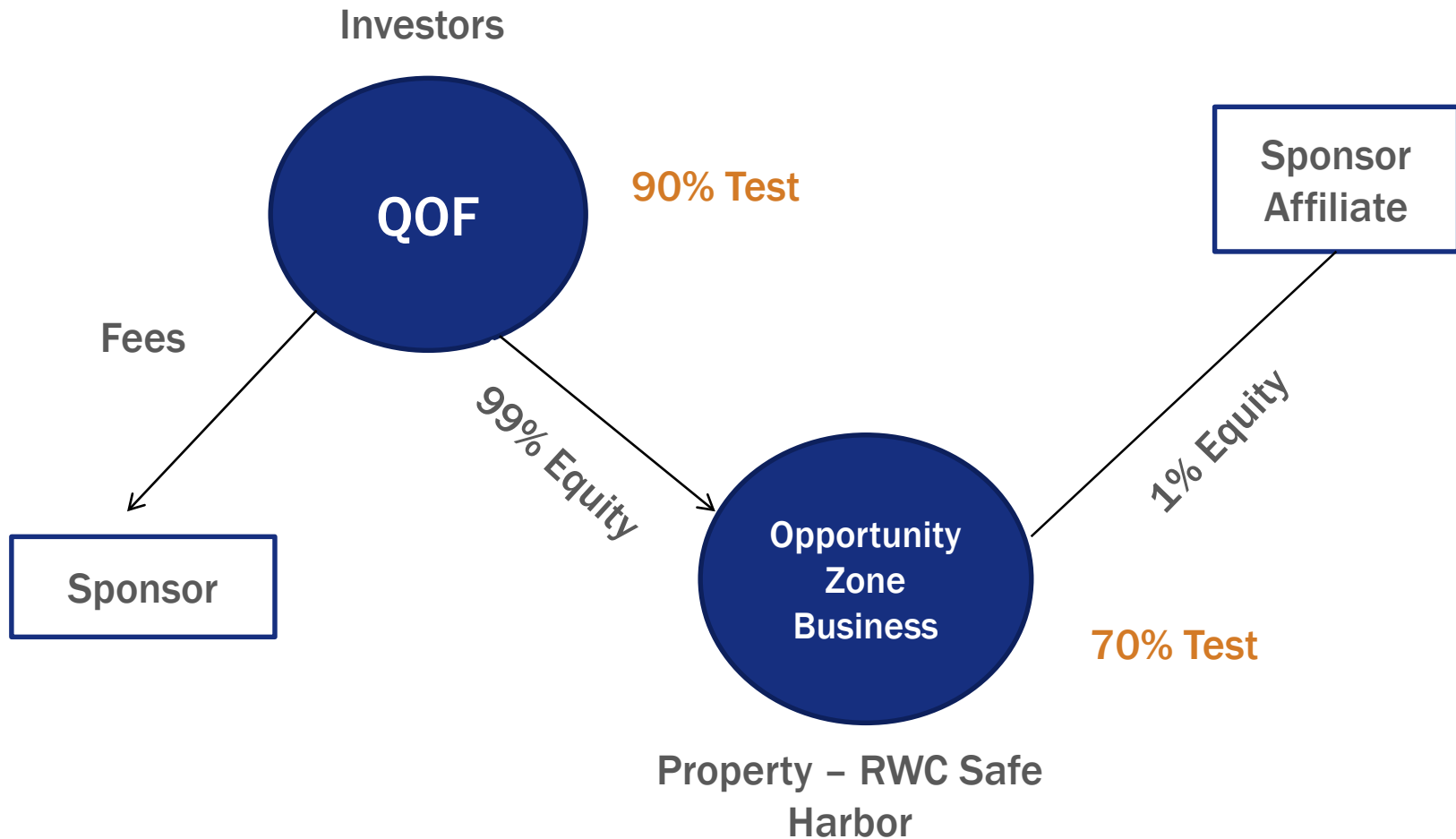
- Working Capital Assets are treated as Reasonable Working Capital (Written Plan):
 - **Amounts designated in writing** for the development of a trade or business in an Opportunity Zone, including the acquisition, construction, and/or substantial improvement of tangible property in an Opportunity Zone;
 - **Written schedule** consistent with **ordinary start-up of a business** for expending the Working Capital Assets within 31 months of receipt; and
 - Working Capital Assets are **actually used** in a manner that is **substantially consistent** with the previous provisions.
 - No failure to meet the 31-month period as a result of a delay in Government Action as long as an application was filed within the 31-month period
- Can have multiple cash contributions

Excluded Businesses

Can't be a "Sin Business"

- **Golf Course**
- **Country Club**
- **Massage Parlor**
- **Hot Tub Facility**
- **Suntan Facility**
- **Racetrack (or other gambling facilities)**
- **Any store the principal business of which is the sale of alcoholic beverages for consumption off premises**

Indirect Approach Structure



Direct v. Indirect Approach

	Direct	Indirect
% Invested in Opportunity Zone Business Property	90%	70% of Tangible Property Must be Opportunity Zone Business Property
% of Cash that can be held on measurement dates	10%	Less than 5% + RWC
% of Assets that can be intangible property	10%	Unlimited. But, a “substantial portion” must be used in the business
% of Property that must be tangible property	90%	No minimum
Ineligible businesses	No Prohibitions	“Sin Businesses” are prohibited

Opportunity Zone Business Property

- **Key Definition (Especially for Real Estate)**
 - Used in both the Direct and Indirect Approach
- **Requirements:**
 - (1) **Tangible property used in a trade or business;**
 - (2) **Acquired by purchase from an unrelated party (more than 20% standard) after December 31, 2017;**
 - (3) **Original use in the Opportunity Zone must commence with the OZB (or QOF); and**
 - (4) **During at least 90% of the holding period, at least 70% of the use must be in an Opportunity Zone**

Original Use Requirement

- Commences when first Placed-in Service (PIS) **within the Opportunity Zone**
 - Placed-in Service – What does it mean?
 - Used Property
- An Acquisition of a Building cannot be Original Use – **Exceptions:**
 - Property is Vacant for Uninterrupted Period of **at least 5 Years**; or
 - Building Sold by Merchant Builder before PIS

Alternative to the Original Use Requirement

- The OZB (or the QOF) **substantially improves** the property
 - Special Rule for Buildings/Revenue Ruling 2018-29
 - Special Rule for Unimproved Land
- What does it mean to “substantially improve”?:
 - (1) Over a **30-Month** Period
 - Statute: “During **any 30-month period** beginning after the date of acquisition”
 - With respect to such tangible property
 - (2) **Additions to basis** that **exceed** the adjusted basis of such property

Special Rule – Acquisition of a Building

- Acquiring a Building on Underlying Land
 - Substantial improvement requirement met by improving the building
 - Do not factor the underlying land in meeting the Substantial Improvement Requirement
 - Revenue Ruling 2018-29
 - 60/40 (Land/Building)
 - Re-purposing of the building
 - Adding to the basis of the building (125%)

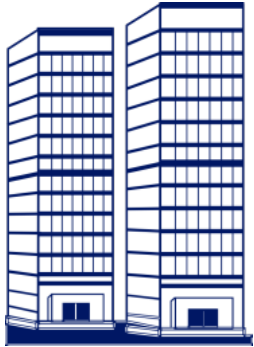
Special Rule – Unimproved Land

- Does Not Need to be Substantially Improved
- Needs to be used in a trade or business
 - Code Section 162
- **Anti-abuse rule** may make it non-OZBP
- Cannot rely on Special Rule where:
 - Purchased with an expectation, intention, or a view to *not improve the land by more than an Insubstantial Amount* within 30 months after purchase

Special Rule - Leases

- Leased Property can be OZBP if certain requirements are met:
 - Entered into **after December 31, 2017**
 - Terms of the lease are **market rate**
- Additional Terms where lessor and lessee are related:
 - **No prepayments** related to use of property exceeding **12 months**
 - Leased Tangible Personal Property: Lessee needs to **acquire OZBP** to be used in same Opportunity Zone of **equal or greater value** of the leased tangible personal property.
 - Valuation of leased property

Possible Investments in Opportunity Zones



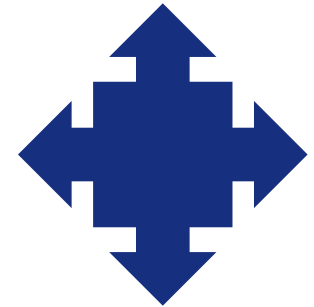
**Real Estate
Development and
Significant
Rehabilitations in
Opportunity Zones**



**Opening New
Businesses in
Opportunity
Zones**



**Acquiring an
Existing
Business and
Relocating it
(with
Expansion) in
an
Opportunity
Zone**



**Large
Expansions of
Businesses
already within
Opportunity
Zones**

Opportunity Zones – Status

- Second Tranche of Guidance addressed many important issues:
 - Grace periods for the QOF to make investments
 - Refinancing distributions
 - Vacant Land – No Substantial Improvement
 - Multi-Asset Funds – Exit Mechanics
 - Interim gains issue (Reinvestment)
 - When the QOF sells OZP
 - Avoids the Penalty while holding cash
 - 12 Months for the QOF to Reinvest in OZP (exception for delays from lack of government action)
 - Still have an allocation of taxable gain to Investors
 - Safe Harbors for the 50% Gross Income Test
 - Meaning of the term “active” (No triple net leases)
 - Meaning of the other “substantially all” and “substantial portion”
- Second tranche comments were due July 1, 2019

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