Opportunity Zones Basics

May 23, 2019
Opportunity Zones present a unique opportunity to deploy capital in low-income communities.

– The Tax Cuts and Jobs Act (the “Tax Bill”) signed into law on December 22, 2017, created a new tool for economic development, designed to provide tax incentives to help unlock long-term investor capital in low-income communities through the Investing in Opportunity Act.

– The Tax Bill allowed each governor to identify up to 25% of their state’s low-income census tracts and certain contiguous census tracts to be designated as Qualified Opportunity Zones.

– The Tax Bill provides incentives for investments in projects in Opportunity Zones.
Agenda

Benefits of the Opportunity Zone Incentive
Qualified Opportunity Zone
Qualified Opportunity Fund
Qualified Opportunity Zone Business
Taxpayers can get capital gains tax deferral, possible partial exclusion of original gains, and future gain exclusion for making timely investments in Qualified Opportunity Funds (QOFs) which invest in Qualified Opportunity Zone Property.
3 Tax Incentive Benefits

Investing capital gains in Opportunity Zones through a Qualified Opportunity Fund results in **three** main tax benefits:

**Temporary Deferral of Original Capital Gains Taxes**: Elect to defer capital gains taxes until the earlier of (a) an “Inclusion Event” or (b) December 31, 2026, if those gains are properly invested in Opportunity Zones within 180 days beginning on the date of the sale or exchange that generated such capital gain (special rules for time period for partners in a partnership and net 1231 gains).

**Reduction of Original Capital Gains Taxes**: If investors hold their eligible Opportunity Zone investment for at least five years, they will owe taxes on 90% of the deferred capital gains; if investors hold their eligible Opportunity Zone investment for at least seven years, they will owe taxes on 85% of the deferred capital gains.

**Exemption of New Capital Gains Taxes**: Elect to permanently exclude incremental capital gains on eligible Opportunity Zone investment held for at least ten years.
The period of capital gain tax deferral ends upon the earlier of:

- Dec. 31, 2026,
- or...
Partial Forgiveness and Forgiveness of Additional Gains
2019 Investment

SALE
INVESTMENT Requires an election

HELD FOR 5 YEARS
Basis increased by 5% of the deferred gain
Up to 85% taxed

HELD FOR 7 YEARS
Basis increased by 10% of the deferred gain
Up to 90% taxed

HELD FOR 10 YEARS
Tax paid on deferred capital gain
Basis equal to fair market Value
 Forgiveness of gains on appreciation of investment
Requires an election
Eligibility

- **Eligible taxpayer**: any person that may recognize gain for Federal income tax accounting:
  - Individual, C corp., RIC, REIT, S corp., trust, estate, partnership

- **Eligible gains**: capital gain (net 1231 gains) recognizable before 2027 from sale/exchange with unrelated person (20% standard); no deferral for gain realized upon sale or other transfer of property to QOF or an eligible taxpayer for equity interest in QOF

- **Eligible period**: generally, 180 days beginning on date of sale/exchange
  - Special rule for partners: if partnership does not elect OZ benefit, capital gain passes through to partners and 180 days begins on last day of taxable year (optional).
  - For net 1231 gains, period begins on last day of taxable year (not optional).
Eligibility Continued

- **Eligible Investment:**
  - Taxpayer may contribute cash or other property to a QOF in exchange for equity interest in QOF.
  - Services rendered to a QOF are NOT an eligible investment (i.e., no carried interest). Equity interest in QOF received for services is considered separate investment for which OZ benefits are not eligible.
  - A taxpayer may make an OZ investment by acquiring an eligible interest in a QOF from a person other than QOF.
Amount Recognized - Generally

Tax paid on EARLIER of date of Inclusion Event or December 31, 2026 in the amount of:

THE LESSER OF:

1. Amount of gain deferred (or portion)

or

2. The fair market value of investment in QOF interest (or portion)

MINUS:

Taxpayer’s basis in the QOF interest

Note: The taxpayer’s basis in the Opportunity Fund is initially deemed to be zero, stepped up 10% and additional 5% after 5 and 7 years, respectively. Initial debt basis necessary in LIHTC transaction in order to take depreciation.
Inclusion Events

- **General Inclusion Events**
  - Transfer that reduces a taxpayer’s equity interest in a QOF eligible to which OZ benefits apply
  - Distribution of property regardless if interest reduced
  - Claim of worthlessness with respect to equity interest in QOF to which OZ benefits apply
- **Termination or Liquidation of QOF**
- **Liquidation of QOF Owner under Section 336(a) (treated as a sale)**
- **Transfer of interest by Gift**
- **Partnership Distributions**
  - Distributions of property (including cash) is an inclusion event only to the extent that the distributed property has a FMV in excess of the partner’s basis in its equity investment in the QOF to which OZ benefits apply
After At Least 10 Years

- **Must make election** → basis of interest is adjusted to fair market value (FMV of partnership interest includes debt and basis of partnership assets are also adjusted similar to 743(b) adjustment); any gain is eliminated, including effectively depreciation recapture and no “hot asset” issue of ordinary gains and capital losses.

- Applies to disposition of interest in QOF or investors may elect to exclude dispositions of property held by **QOFs** that are partnerships or S corporations (NOT assets disposed of by a QOZB)
  - Only applies to net 1231 capital gains
  - Only applies to asset dispositions occurring after required 10-year holding period of QOF interest
  - Similar election for shareholders of QOFs that are REITs

- **Must dispose by 12/31/2047**

- **PROPOSED REGULATIONS MAY NOT BE RELIED UPON**
Agenda

Benefits of the Opportunity Zone Incentive

Qualified Opportunity Zone

Qualified Opportunity Fund

Qualified Opportunity Zone Business
QOZs remain in effect for 10 years following designation.

(expiration of QOZ designation does not impair ten-year hold benefit)
Agenda

Benefits of the Opportunity Zone Incentive
Qualified Opportunity Zone
Qualified Opportunity Fund
Qualified Opportunity Zone Business Property
An investment vehicle organized as a *corporation* or a *partnership* for the purpose of investing in **Qualified Opportunity Zone Property (QOZP)**
QOF Certification Process

- An eligible taxpayer self-certifies to become a certified Qualified Opportunity Fund.
- No approval or action by the IRS is required.
- A taxpayer merely completes Form 8996 and attaches that form to the taxpayer’s federal income tax return for the taxable year.
- The return must be filed timely, taking extensions into account.
Qualified Opportunity Fund—Assets Test

Must hold at least 90% of assets in QOZP, determined by the annual average of the percentage of QOZP held on:

- The last day of the first six-month period of the fund’s taxable year, and
- The last day of the fund’s taxable year

- Failure to meet the 90% assets test incurs a monthly penalty in the amount of (90% of assets – amount of qualified assets) X federal tax underpayment rate for the month.
Valuation of Assets of QOF

- QOF may value its assets for 90% Assets Test by
  - Applicable Financial Statement Method (if has an applicable financial statement (AFS) within the meaning of Treasury Regulations Section 1.475(a)-4(h)); or
  - Alternate Valuation Method.
- QOF Must Apply Consistently Methodology Selected to All Assets in the Taxable Year
- QOF has option from test to test to exclude cash received in immediately preceding six months as partnership contribution or by corporate QOF solely in exchange for stock;
- Alternate Valuation Method***
  - Assets Owned: Value = QOF’s unadjusted cost basis of asset under Section 1012
  - Assets Leased: Value = Present value of leased asset:
    - sum of present values of each payment under the lease for the asset, including option periods for a pre-defined rent – using applicable federal rate for debt instruments
    - Calculated when QOF enters into lease
    - Once calculated, value is used for all testing periods
- AFS Method: value of each asset, whether owned or leased, has value as reported on QOF’s AFS for relevant reporting period;
  - Leased Assets: May select AFS Method to value leased asset only if AFS of QOF is prepared according to GAAP and requires an assignment of value to the lease of the asset.
- QOF has 12-month reinvestment period for cash proceeds of ROC or asset disposition.
Qualified Opportunity Zone Property

- A QOF must hold at least 90% of its assets in QOZP:

QOZBP = tangible property the original use of which in the OZ commences with taxpayer or taxpayer substantially improves (more than double basis in 30-month period)
Benefits of the Opportunity Zone Incentive
Qualified Opportunity Zone
Qualified Opportunity Fund
Qualified Opportunity Zone Business
Qualified Opportunity Zone Stock and Partnership Interests

- The equity interest must be acquired after December 31, 2017, in exchange for cash.

- Must be a **Qualified Opportunity Zone Business**, or is being organized for the purpose of being a Qualified Opportunity Zone Business.

- Must remain a Qualified Opportunity Zone Business for **substantially all (90%)** of the Qualified Opportunity Fund’s holding period.
A trade or business in which **substantially all** (70%) of the tangible property owned or leased by the taxpayer is **Qualified Opportunity Zone Business Property** (QOZBP) and which meets the following four requirements:
QOZB Requirement 1 – Gross Income Test

• At least 50% of gross income derived from active conduct trade or business (trade or business determined under Section 162).

• Any of the following criteria will satisfy the Gross Income Test:

  • At least 50% of services performed in OZ based on hours;
  • At least 50% of services performed in OZ based on pay;
  • Tangible property of the trade or business in the OZ and the management or operational functions performed in the OZ are each necessary for the generation of at least 50% of the gross income;
  • 50% income derived from active conduct of trade or business in OZ based on all facts and circumstances.
**QOZB Requirement 2 – Intangible Property Test**

*Substantial portion (40%) of intangible property used in active conduct of business* in the qualified opportunity zone

*For purposes of the rules on QOZB, the ownership and operation (including leasing) of real property is the active conduct of a trade or business, but merely entering into a triple-net-lease with respect to real property owned is not the active conduct of a trade or business.*
QOZB Requirement 3 – NQFP Test

Less than 5% unadjusted basis of property is nonqualified financial property.

Reasonable working capital is excluded.

Safe Harbor for Reasonable Working Capital:

- Amounts are designated in writing for development of a trade or business in an OZ, including the acquisition, construction, and/or substantial improvement of tangible property in the OZ;

- Written schedule consistent with ordinary start-up of a trade or business for expenditure of the working capital assets, under which the working capital assets must be spent within 31 months of receipt by the business of the assets; and

- Working capital assets are actually used consistently with the written plan (delay due to waiting for governmental action is okay, if application complete).

- May have multiple overlapping or sequential written plans, provided each satisfies all requirements.
Can’t be a “sin business”  

A private or commercial 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.
For purposes of determining whether the requirements to be a QOZB are met, if the amount of real property, in an OZ is “substantial” as compared to the amount of real property outside the OZ (based on square footage), and the real property outside of the OZ is contiguous to part or all of the real property located inside the OZ, then **ALL** of the property is deemed to be located in an OZ.