Opportunity Zones: Two Years In

Ellen Aprill, Moderator
January 2020 ABA Tax Section Meeting
Teaching Taxation Committee
The Take on Opportunity Zones

- Urban Institute blog:
  - “Over the past two years, Opportunity Zones have become the most discussed piece of federal economic development history.”
- 12% of census tracts are OZs.
- Enormous amount of attention from media and think tanks as well as investors.
- Others on panel will explain how and how well OZs work.
- I will give some context.
- See, e.g., JCT new estimate.
We have been here before, or at least in the neighborhood

- 1993 Enterprise Zone legislation
  - 20% employer wage credit for first $15K of wages of zone residents
  - Expensing of up to $35K of capital equipment by qualifying businesses.
  - 2001 Renewal Community legislation
  - Expired at end of 2009.
  - Congress authorized only 40 empowerment zones and 40 renewal communities
  - As of 2009, only $1.8 billion in total tax credits expended.
States have enacted their own EZs

- Most states (33/50) have enterprise zone laws of some type.
- State programs vary considerably.
- Academic studies of effectiveness have been mixed.
New Markets Tax Credit established in 2000

- Treasury Department allocates tax credit authority to intermediaries - community development entities - that select investments.
- Investors get the credit.
- Since 2003, credits total over $57 billion.
- $5 billion approved for 2020.
- More later in session.
And now, we have TCJA’s Opportunity Zones

- Megan Christensen (Manatt)
  - Summary (and Commentary)
- Jeff Koonce (Bernhard Capital)
  - Financial model
- Michelle Layser (Illinois Law)
  - Reporting issues and comparisons
- Edward De Barbieri (Albany Law)
  - Impact on small business
Some key issues

• Much discussion of how Opportunity Zones got certified.
  – See handout
• Much discussion of need for greater reporting
  – Many legislative proposals
• Proposed regs Oct. 28, 2019 and May 1, 2019
• Final regs: Dec. 19, 2019
Opportunity Zones - Two Years In

Presented by Megan Christensen for
Teaching Taxation
ABA Tax Section
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January 31, 2020
Megan Christensen is a tax partner resident in the firm’s Washington, D.C. office. Megan concentrates her practice in federal income taxation. She advises both taxable and tax-exempt clients in a broad array of areas, including the New Markets Tax Credit and Investment Tax Credits; Opportunity Zones; obtaining, maintaining, and retaining tax-exempt status; nonprofit governance; Subchapter S corporation formation and operation; partnerships and limited liability companies; and federal, state, and local civil tax controversies, including audits and administrative appeals.
Basics

- Tax Deferral
- Qualified Opportunity Fund
- Qualified Opportunity Zone Property
- Qualified Opportunity Zone Business Property
- Gain Inclusion
- Investments Held for at Least 10 Years
- Consolidated Groups
- Anti-Abuse
Introduction

Taxpayers can elect capital gains tax deferral, possible partial exclusion of original gains, and exclusion of future gains within 180 days 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 optional rules for time period for partners, S corporation shareholders, and owners of other pass-through entities, and shareholders in RIC or REIT).

**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 (limited benefit after 2019).

**Exemption of New Capital Gains Taxes**: Elect to permanently exclude incremental capital gains on eligible Opportunity Zone investment held for at least ten years.
Partial Forgiveness and Forgiveness of Additional Gains
2019 Investment – No Inclusion Event

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
- Tax paid on deferred capital gain

HELD FOR 10 YEARS
- Basis equal to fair market Value
- Forgiveness of gains on appreciation of investment
- Requires an election

2019 2020 2021 2022 2023 2024 2025 2026 2027 2028 2029

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Partial Forgiveness and Forgiveness of Additional Gains
2020 Investment – No Inclusion Event

**SALE**

**INVESTMENT** Requires an **election**

- **HELD FOR 5 YEARS**
  - Basis increased by 10% of the deferred gain
  - Up to 90% taxed

- **HELD FOR 7 YEARS**
  - Basis increased by 5% of the deferred gain

- **HELD FOR 10 YEARS**
  - Basis equal to fair market Value
  - Forgiveness of gains on appreciation of investment
  - Requires an election

Tax paid on deferred capital gain

2020 2021 2022 2023 2024 2025 2026 2027 2028 2029 2030

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Brief History


- **October 29, 2018 & May 1, 2019** - Proposed regulations published in Federal Register.

- **December 19, 2019** – Final regulations released.
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Eligibility

- **Eligible taxpayer**: any person that is required to report the recognition of gains during the taxable year under Federal income tax accounting principles (includes RICs, REITs, TEOs (§ 511), partnerships, other pass-throughs).

- **Eligible gains**: gains treated as capital gain for Federal income tax purposes (after application of any treaty) recognizable before 2027 from sale/exchange with unrelated person (20% standard).
  - Includes gross Section 1231 gains.
  - No deferral for gain realized upon sale or other transfer of property to (1) a QOF or (2) an eligible taxpayer, in exchange for an equity interest in a QOF

- **Eligible period**: Generally, 180 days beginning on date of sale/exchange
  - Special optional rules for shareholders of RICs/REITs, partners, S corporation shareholders, and owners of other pass-throughs, and installment gains.
Eligibility Continued

- **Eligible Interest**: equity, incl. preferred stock or partnership interest w/ special allocations

- **Qualifying Investment**:
  - TP may contribute cash or other property in exchange for eligible 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 = separate investment → No OZ benefits.
  - A taxpayer may make an OZ investment by acquiring an eligible interest in a QOF from a person other than QOF, if all requirements for making deferral election are satisfied.

- **Amount Invested in a QOF**:
  - **Transfer Cash** = amount of cash;
  - **Property in Non-Recognition Transaction** = lesser of adjusted basis in equity interest (without application of OZ basis rules) or FMV of equity interest received;
    - If FMV exceeds adjusted basis (w/o application of OZ basis rules), taxpayer has mixed investment and excess is a separate non-OZ interest;
  - **Property in Taxable Transaction** = FMV of transferred property immediately before transfer;
  - **Special Rule for Partnership**: must be treated as a contribution; no disguised sales;
  - **Acquisition of equity interest from person other than QOF** = amount of cash or net FMV of other property exchanged immediately before exchange.
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Qualified Opportunity Fund

- A domestic investment vehicle classified as a corporation or a partnership for the purpose of investing in Qualified Opportunity Zone Property (QOZP) that meets a 90% assets test.
- Must self-certify with timely filed tax return and identify first month in first taxable year in which self-certification takes effect.
- Pre-existing entities eligible.
- May self-decertify (effective at beginning of month after month specified, but not earlier than when self-decertification is filed).
- Involuntary decertification is reserved in final regulations.
Qualified Opportunity Fund—90% 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.

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Valuation of Assets of QOF

- QOF may value its owned or leased property for 90% Assets Test by (1) Applicable Financial Statement Method (if has an applicable financial statement (AFS) within the meaning of Treasury Regulations Section 1.475(a)-4(h)) or (2) Alternate Valuation Method.

- QOF must apply consistently the methodology selected to all assets in the taxable year.

- **Exclusion for Recent Investments**: QOF has option from test to test to exclude cash received as a partnership contribution or solely in exchange for stock in the past 6 months, held continuously in cash, cash equivalents, or debt instruments with a term ≤ 18 months.

- **Alternate Valuation Method**
  - **Assets Owned**: QOF’s unadjusted cost basis under Sections 1012 or 1013; or FMV.
  - **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 short-term AFR for debt instruments, semi-annual compounding (month of lease).
    - Calculated when QOF enters into lease & calculation 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 is prepared according to GAAP and requires an assignment of value to the lease of the asset.
90% Assets Test - Reinvestment

- If QOF receives proceeds from (1) return of capital or (2) the sale or disposition of some or all of its qualified opportunity zone property, it has 12 months from date of distribution, sale, or disposition to reinvest in qualified opportunity zone property.

- To the extent reinvested, proceeds are considered qualified opportunity zone property for purposes of the 90% Assets Test.

- Proceeds must be continuously held in cash, cash equivalents, or short-term debt instruments (18 months or less).

- Delays due to government action do not cause a failure of the 12-month reinvestment rule, provided the application for such government action is complete.

- Additional 12 months to reinvest for delays due to federally declared disaster, provided invest in manner originally intended prior to disaster.
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Qualified Opportunity Zone Property

- A QOF must hold at least 90% of its assets in QOZP:
Qualified Opportunity Zone Stock and Partnership Interests

Generally,

- 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 in OZ (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

- Use must be normal, usual, or customary in the conduct of the trade or business; and
- Must be used in OZ in performance of activity that contributes to gross income.

*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.

However, 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); additional 24 months for federally declared disasters.

- Business may have multiple overlapping or sequential written plans, provided each satisfies all requirements; property may get addition 31-months with certain infusions of working capital assets.
QOZB Requirement 4 – Excluded Businesses

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.

* Leasing more than de minimis amount (<5%) of net rentable square feet of real property or value of other tangible property to sin business not ok

* De minimis amounts (<5%) of gross income attributable to sin business ok (e.g. hotel spa)
For purposes of determining whether the requirements to be a QOZB are met, if real property straddles an OZ, an OZ is the location of services, tangible property, or business functions, if

1. the trade or business uses the portion of the real property located in an OZ in carrying out its business activities,
2. The trade or business uses the real property located outside the OZ in carrying out its business activities,
3. Amount of real property located in an OZ is substantial compared to amount of real property located outside of an OZ (more square footage in than out at acquisition or unadjusted cost in is greater than out), and
4. Real property located in OZ is contiguous (share common boundaries) to part, or all, of the real property located outside the OZ.
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Qualified Opportunity Zone Business Property (QOZBP) - Owned

- **Tangible property** used in a **trade or business**

- Acquired by **purchase from an unrelated party** (20% standard) after **December 31, 2017** (manufacture, construction, or production after 12/31/17 & materials/supplies = QOZBP)

- **Original use in the QOZ** commences with the taxpayer (i.e., placed in service for depreciation; minimum 1- calendar year rule for vacant/unused property beginning prior to OZ designation through purchase date) or

- Taxpayer **substantially improves** the property
  - During any 30-month period after acquisition, additions to basis exceed an amount equal to the adjusted basis of such property at the beginning of such period
  - Substantial improvement requirement only applies to basis attributable to an existing building, but not to basis attributable to land on which the building is situated (or to vacant land)
Qualified Opportunity Zone Business Property (QOZBP) - Leased

- **Tangible property** used in a **trade or business**;
- Acquired by **Lease** entered into after **December 31, 2017**;
- Terms of lease were **market rate** in locale (rebuttable presumption of FMV if lease with unrelated person); and
- If lessee and lessor are **related**:
  - (1) No prepayment relating use of the property greater than 12 months;
  - (2) If original use of **leased tangible personal property** in an OZ does NOT commence with the lessee, property is NOT QOZBP unless, during the **relevant testing period**, the lessee becomes the owner of tangible property with a value at least equal to that of the leased property (same original use rule as for owned property);
  - (3) Must be substantial overlap of the OZ(s) in which the owner of the property acquired uses it and the OZ(s) in which that person uses the leased property; and
  - (4) **Relevant testing period** – period beginning on the date that the lessee receives possession under the lease of the leased tangible personal property and ends on earlier of (1) the date 30 months after possession, or (2) the last day of the term of the lease.
Qualified Opportunity Zone Business Property (QOZBP) -
General

- **Value** of owned or leased property is determined using one of the same methodologies available to QOF (i.e., AFS Method or Alternative Valuation Method).
  - Value of leased tangible personal property is determined on date the lessee receives possession of the property under the lease

- During substantially all (90%) of the holding period of the holding period for the tangible property, substantially all (70%) of the use of the tangible property was in a qualified opportunity zone.

- **Exclusion of Certain Leased Real Property**: If at the time the lease for real property (other than unimproved land) is entered into, there was a plan, intent, or expectation for the real property to be purchased for an amount of consideration other than the FMV of the real property (determined at time of purchase without regard to prior lease payments) the leased real property is not QOZBP at any time.

- **Trade or Business** = a trade or business within the meaning of Section 162 regarding deductions for ordinary and necessary business expenses

- **Safe Harbor for Inventory in Transit** = inventory/raw materials of a trade or business does not fail to be used in an OZ solely because it is in transit (either from a vendor or to a customer)

- **Unimproved Land**: acquired by purchase is not required to be substantially improved.
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Amount Recognized – General Rule

Deferred gain included in gross income in taxable year that includes the **EARLIER** of date of Inclusion Event or December 31, 2026 in the amount of:

**THE LESSER OF:**

- Remaining deferred gain
- The fair market value of investment in QOF interest on 12/31/26

**MINUS:**

- Taxpayer’s basis in the QOF interest as of 12/31/26

*Note: The taxpayer’s basis in the Opportunity Fund is initially deemed to be zero, with 10% and 5% increases after 5 and 7 years, respectively.*
Amount Recognized – Inclusion Event

Tax paid for year when Inclusion Event occurs in the amount of:

THE LESSER OF:

- Proportion of remaining deferred gain disposed of
- FMV of portion of investment disposed of

MINUS:

- Eligible Taxpayer's basis in the portion of the QOF interest disposed of in the inclusion event

Note: The taxpayer’s basis in the Opportunity Fund is initially deemed to be zero, with 10% and 5% step ups after 5 and 7 years, respectively.
Amount Recognized – Special Rule for Partnerships/S Corps

For a QOF partnership or S corporation (inclusion event or 12/31/26)

THE LESSER OF:

Percentage of investment that gave rise to inclusion event
* remaining deferred gain (less and basis adjustments)

or

Gain recognized on fully taxable disposition at FMV of qualifying investment that gave rise to inclusion event

Note: The taxpayer’s basis in the Opportunity Fund is initially deemed to be zero, with 10% and 5% step ups after 5 and 7 years, respectively.
Inclusion Events

- **General Inclusion Events:**
  - Event that reduces an eligible TP’s direct equity interest in a QOF to which OZ benefits apply;
  - TP receives property in the event with respect to equity interest in a QOF to which OZ benefits apply; and event is treated as a distribution;
  - Claim of worthlessness with respect to equity interest in QOF to which OZ benefits apply.
  - QOF loses status as QOF.

- **Termination or Liquidation of QOF (ceases to exist or converts status)**

- **Liquidation of QOF owner under Section 336(a) (treated as a sale), but not liquidation under 337(a) (80% distributee)**

- **Transfer of interest by gift (even incomplete gift or to TEO)**

- **Transfer incident to divorce**
Inclusion Events – Continued

- **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.
  - Distribution from a partnership that directly or indirectly owns a QOF is inclusion event only to extent distribution is a liquidating distribution.

- **Remaining Deferred Gain Reduction** - Transaction has effect of reducing
  - Amount of remaining deferred gain of one or more direct/indirect partners or
  - Amount of gain that would be recognized to less than remaining deferred gain

- **Changes in Grantor Trust Status**
  - Change in income tax status of existing trust owning equity investment in QOF to which OZ benefits apply, whether termination of grantor trust status or creation of grantor trust status
  - Conversions of QSSTs to ESBT not inclusion event under certain circumstances

- **Distributions by QOF S Corporation** – to extent is gain from sale/exchange
Non-Inclusion Events

- **Generally NOT an Inclusion Event**
  - Transfers by reason of death (e.g., by reason of death to deceased owner’s estate, distribution of equity investment in QOF to which OZ benefits apply by deceased owner’s estate, distribution of equity investment in QOF to which OZ benefits apply by deceased owner’s trust by reason of deceased owner’s death, passing of jointly-owned equity investment in QOF to which OZ benefits apply to surviving co-owner by operation of law, other transfer of investment at death by operation of law)
    - But (1) sale, exchange, or other disposition by deceased owner’s estate or trust; (2) Any disposition by legatee, heir, or beneficiary who received investment by reason of taxpayer’s death, or (3) Any disposition by surviving co-owner/other recipient who received by operation of law on deceased owner’s death, is an Inclusion Event.
  - Transfer to grantor trust, if owner of investment is deemed owner of trust (and vice versa).

- **Partnership Non-Inclusion Events**
  - Tax-free contribution of equity investment in QOF to which OZ benefits apply (Section 721)
  - Tax-free merger or consolidation
  - But there can be no reduction in amount of remaining deferred gain that would be recognized by transferring partner on a later Inclusion Event
  - Inclusion rules apply to any portion of transaction treated as sale or exchange
Non-Inclusion Events

- **S Corporations**
  - Election of S Corporation status
  - Revocation of S Corporation status
  - Termination of S corporation status
  - Conversion of ESBT to QSST where QOF investment is held in grantor portion of ESBT and QSST beneficiary is deemed owner of the grantor portion of the ESBT
  - Valid modification of trust agreement of an S corporation shareholder (amendment, decanting, judicial reformation, or material modification)
Partnership Rules for Mixed Funds

- Partner treated as holding 2 separate interests
- Basis of each interest as if each interest held by different taxpayers
- Allocations of income, gain, loss, and deduction, and all section 752 allocations of debt, and all distributions to mixed-funds partner treated as made to separate interests based on “allocation percentages” (relative capital contributions)
- Allocations percentages with respect to a profits interest for services based on the share of residual profits the mixed-funds partner would receive with respect to that interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application
A partnership that makes a deferral election must notify its partners of the deferral election and state each partner’s distributive share of the deferred gain.

If an indirect owner in a QOF that is a partnership for federal income tax sells/disposes of all or a portion of its indirect partnership interest causing an inclusion event, the indirect owner must provide the QOF owner notification and information sufficient to enable the QOF owner to recognize an appropriate amount of deferred gain, in a timely manner.

A partner in a QOF must notify the QOF of a 10-year hold election.

Similar rules apply to S corporations.
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After Minimum of 10 Years

- Must have made a deferral election, recognized gain on December 31, 2026 (to extent of inclusion event, is no longer a qualifying investment), and held investment in QOF for at least 10 years to be eligible;

- Must make election on the sale/exchange of interest → 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 depreciation recapture and no “hot asset” issue of ordinary gains and capital losses;

- Applies to disposition of interest in QOF;

- Investors may elect to exclude dispositions of property held by QOFs and QOZBs that are partnerships or S corporations -
  - Only applies to asset dispositions occurring after required 10-year holding period of QOF interest;

- Must dispose by 12/31/2047
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Application to Consolidated Group – Selected Rules

- A member of a consolidated group may use capital gains of another member of the consolidated group to invest in QOF
  - Treated as if member with gain made the investment then sold it to the other member for FMV – group must treat deemed transactions as having occurred for all federal income tax purposes

- A C Corporation QOF may be a member of a consolidated group, subject to certain conditions.

- The consolidated group member that makes the direct investment in the QOF member must be wholly owned, directly or indirectly, by the common parent of the consolidated group.

- If one member transfers its qualifying investment to another member, the transaction is not an intercompany transaction → may have an inclusion event.
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- **General**: If, based on all the facts and circumstances, a significant purpose of a transaction is to achieve a tax result inconsistent with the purposes of the OZ incentive, the IRS can recast the transaction(s) for federal tax purposes as appropriate to achieve tax results consistent with the purposes of the OZ incentive.

- **Special Rule for Partnerships**: If a partnership is formed or availed of with significant purpose of avoiding the requirement that a gain be subject to federal income tax in order to be an eligible gain, the partnership will be disregarded to prevent creation of a qualifying investment by the partnership with respect to any partner or partners that would not satisfy such requirements.

- **Purchased Real Property**: Not QOZBP if there was plan, intent, or expectation for the real property to be repurchased by the seller for an amount other than FMV.

- **Leased Real Property**: Not QOZBP if there was a plan, intent, or expectation to purchase the property for other than the FMV of the property without regard to prior lease payments.

- **Land as QOZBP**: Not QOZBP if land is improved or minimally improved and is purchased with expectation or intention not to improve by more than an insubstantial amount within 30 months after date of purchase, unless it is substantially improved.
Financial Models of Opportunity Zone Tax Benefits
General Comments on Financial Models

- These models make a variety of assumptions that may be drastically different than a specific Opportunity Zone investment. Investors should ensure they make accurate assumptions when forecasting the tax benefits of an Opportunity Zone investment, as modified assumptions will obviously impact the results of this analysis.

- Each model assumes:
  
  - An individual timely invests $10 million of capital gain into a qualified opportunity fund ("QOF").
  
  - The individual is taxed at the highest marginal federal income tax rate of 37%, capital gain rate of 20%, net investment income tax rate of 3.8% and state income tax rate of 8%.
  
  - The individual’s weighted average cost of capital ("WACC") is 5%. The WACC is the the assumed return the investor would earn with an investment outside of the QOF, and it is used to calculate the “time value of money” of tax savings where appropriate.
  
  - No other tax benefits are available for the QOF investment, such as historic tax credits or new market tax credits.

- For simplicity, each model also assumes that either the investment does not generate tax depreciation or, if it does, it generates 100% bonus depreciation that the investor can immediately utilize.
  
  - Importantly, the models also assume that the investment is held for 10 years at which time the investor sells the investment in the QOF, so that depreciation is effectively not recaptured upon the sale. See Int. Rev. Code §1400Z-2(c) and Treas. Reg. §1.1400Z2(c)-1.

- The primary variables between the models are the date the investment is made, the growth obtained on the investment and the portion of the investment eligible for bonus depreciation.
Model #1 – Base Case

- This model assumes the QOF investment is not made until 2022, so it does not receive the 10% basis increase under Int. Rev. Code §1400Z-2(b)(2)(B)(iii).
- This model further assumes the investment does not produce any depreciation.
- Finally, this model assumes the investment does not produce a financial return, so there is no benefit to electing a fair market value basis adjustment under Int. Rev. Code §1400Z-2(c).
- So this model is essentially a “worst case scenario” where the only benefit is a deferral of capital gains.

### Model Assumptions

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<th>Value</th>
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<tbody>
<tr>
<td>Capital Gain Amount</td>
<td>$10,000,000</td>
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<tr>
<td>Federal Capital Gain Tax Rate</td>
<td>23.8%</td>
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<tr>
<td>Federal Ordinary Income Rate</td>
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<td>State Tax Rate</td>
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<td>WACC (Weighted Average Cost of Capital)</td>
<td>5.0%</td>
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<td>Year Investment is Made Into QOF</td>
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<td>Year QOF Investment is Sold</td>
<td>2032</td>
</tr>
<tr>
<td>Investment Growth</td>
<td>0.0%</td>
</tr>
<tr>
<td>Portion Eligible for Bonus Depreciation</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

### Present Value of QOF Tax Benefits

<table>
<thead>
<tr>
<th>Permanent Exclusion of Portion of Taxes on Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanently Excluded Capital Gain</td>
</tr>
<tr>
<td>Permanently Excluded Taxes on Capital Gain</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Deferral of Taxes on Remaining Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Remaining Capital Gain</td>
</tr>
<tr>
<td>Taxes on Deferred Capital Gain</td>
</tr>
<tr>
<td>Present Value of Taxes</td>
</tr>
<tr>
<td>Value of Deferring Taxes on Capital Gain</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonus Depreciation</td>
</tr>
<tr>
<td>Value of Bonus Depreciation</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Permanent Exclusion of Taxes from QOF Gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Growth</td>
</tr>
<tr>
<td>Potential Taxes on Investment Growth</td>
</tr>
<tr>
<td>Present Value of Avoided Taxes</td>
</tr>
<tr>
<td>Present Value Tax Benefits</td>
</tr>
<tr>
<td>Additional Return Generated by Tax Benefits</td>
</tr>
</tbody>
</table>
Model #2 –10% Basis Increase

- This model makes the same assumptions as Model #1 except the QOF investment is made in 2020, so the 10% basis increase under Int. Rev. Code §1400Z-2(b)(2)(B)(iii) applies.
- Note that the earlier 2020 investment compared to the 2022 Model #1 investment also increases the “time value” of deferring the remaining capital gains.

### Present Value of QOF Tax Benefits

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanently Excluded Capital Gain</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Permanently Excluded Taxes on Capital Gain</td>
<td>$318,000</td>
</tr>
<tr>
<td>Deferral of Taxes on Remaining Capital Gain</td>
<td></td>
</tr>
<tr>
<td>Deferred Remaining Capital Gain</td>
<td>$9,000,000</td>
</tr>
<tr>
<td>Taxes on Deferred Capital Gain</td>
<td>$2,862,000</td>
</tr>
<tr>
<td>Present Value of Taxes</td>
<td>$2,135,668</td>
</tr>
<tr>
<td>Value of Deferring Taxes on Capital Gain</td>
<td>$726,332</td>
</tr>
</tbody>
</table>

### Depreciation

- Bonus Depreciation: $0
- Value of Bonus Depreciation: $0

### Permanent Exclusion of Taxes from QOF Gains

- Investment Growth: $0
- Potential Taxes on Investment Growth: $0
- Present Value of Avoided Taxes: $0
- Present Value Tax Benefits: $1,044,332
- Additional Return Generated by Tax Benefits: 10.44%

### Model Assumptions

<table>
<thead>
<tr>
<th>Assumption</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Gain Amount</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Federal Capital Gain Tax Rate</td>
<td>23.8%</td>
</tr>
<tr>
<td>Federal Ordinary Income Rate</td>
<td>37.0%</td>
</tr>
<tr>
<td>State Tax Rate</td>
<td>8.0%</td>
</tr>
<tr>
<td>WACC (Weighted Average Cost of Capital)</td>
<td>5.0%</td>
</tr>
<tr>
<td>Year Investment is Made Into QOF</td>
<td>2020</td>
</tr>
<tr>
<td>Year QOF Investment is Sold</td>
<td>2030</td>
</tr>
<tr>
<td>Investment Growth</td>
<td>0.0%</td>
</tr>
<tr>
<td>Portion Eligible for Bonus Depreciation</td>
<td>0.0%</td>
</tr>
</tbody>
</table>
Model #3 –12% Investment Growth

- This model makes the same assumptions as Model #2 except the QOF investment grows at an annual rate of 12%.
- While any return this high is obviously subject to market risks, 12% is a typical return projected by many real estate investments.
- The tax benefits spike under this model based on avoiding taxes from a capital gain that totals over $21 million.

<table>
<thead>
<tr>
<th>Present Value of QOF Tax Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanent Exclusion of Portion of Taxes on Capital Gain</td>
</tr>
<tr>
<td>Permanently Excluded Capital Gain</td>
</tr>
<tr>
<td>Permanently Excluded Taxes on Capital Gain</td>
</tr>
<tr>
<td>Deferral of Taxes on Remaining Capital Gain</td>
</tr>
<tr>
<td>Deferred Remaining Capital Gain</td>
</tr>
<tr>
<td>Taxes on Deferred Capital Gain</td>
</tr>
<tr>
<td>Present Value of Taxes</td>
</tr>
<tr>
<td>Value of Deferring Taxes on Capital Gain</td>
</tr>
<tr>
<td>Depreciation</td>
</tr>
<tr>
<td>Bonus Depreciation</td>
</tr>
<tr>
<td>Value of Bonus Depreciation</td>
</tr>
<tr>
<td>Permanent Exclusion of Taxes from QOF Gains</td>
</tr>
<tr>
<td>Investment Growth</td>
</tr>
<tr>
<td>Potential Taxes on Investment Growth</td>
</tr>
<tr>
<td>Present Value of Avoided Taxes</td>
</tr>
<tr>
<td>Present Value Tax Benefits</td>
</tr>
<tr>
<td>Additional Return Generated by Tax Benefits</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Model Assumptions</th>
</tr>
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<tbody>
<tr>
<td>Capital Gain Amount</td>
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<tr>
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</tr>
<tr>
<td>Federal Ordinary Income Rate</td>
</tr>
<tr>
<td>State Tax Rate</td>
</tr>
<tr>
<td>WACC (Weighted Average Cost of Capital)</td>
</tr>
<tr>
<td>Year Investment is Made Into QOF</td>
</tr>
<tr>
<td>Year QOF Investment is Sold</td>
</tr>
<tr>
<td>Investment Growth</td>
</tr>
<tr>
<td>Portion Eligible for Bonus Depreciation</td>
</tr>
</tbody>
</table>
Model #4 – Bonus Depreciation

- This model makes the same assumptions as Model #3 except the QOF investment produces $10 million of 100% bonus depreciation in the first year.
- The QOF initially has a zero basis under Int. Rev. Code §1400Z-2(b)(2)(B)(i), which generally prohibits utilization of bonus depreciation under Int. Rev. Code §704(d) (assuming the QOF is a tax partnership). However, the investor’s outside basis could be increased with sufficient QOF debt or the QOF could produce sufficient income to increase outside basis and allow the deduction.
- This model assumes the bonus depreciation deduction offsets ordinary income and that the deduction is not limited by restrictions (e.g., passive loss restrictions).

### Table: Model Assumptions

<table>
<thead>
<tr>
<th>Assumption</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Gain Amount</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Federal Capital Gain Tax Rate</td>
<td>23.8%</td>
</tr>
<tr>
<td>Federal Ordinary Income Rate</td>
<td>37.0%</td>
</tr>
<tr>
<td>State Tax Rate</td>
<td>8.0%</td>
</tr>
<tr>
<td>WACC (Weighted Average Cost of Capital)</td>
<td>5.0%</td>
</tr>
<tr>
<td>Year Investment is Made into QOF</td>
<td>2020</td>
</tr>
<tr>
<td>Year QOF Investment is Sold</td>
<td>2030</td>
</tr>
<tr>
<td>Investment Growth</td>
<td>12.0%</td>
</tr>
<tr>
<td>Portion Eligible for Bonus Depreciation</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

### Table: Present Value of QOF Tax Benefits

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanently Excluded Capital Gain</td>
<td>$1,000,000</td>
</tr>
<tr>
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<td>$318,000</td>
</tr>
<tr>
<td>Deferred Remaining Capital Gain</td>
<td>$9,000,000</td>
</tr>
<tr>
<td>Taxes on Deferred Capital Gain</td>
<td>$2,862,000</td>
</tr>
<tr>
<td>Present Value of Taxes</td>
<td>$2,135,668</td>
</tr>
<tr>
<td>Value of Deferring Taxes on Capital Gain</td>
<td>$726,332</td>
</tr>
<tr>
<td>Bonus Depreciation</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Value of Bonus Depreciation</td>
<td>$4,500,000</td>
</tr>
<tr>
<td>Present Value of Taxes from QOF Gains</td>
<td></td>
</tr>
<tr>
<td>Investment Growth</td>
<td>$21,058,482</td>
</tr>
<tr>
<td>Potential Taxes on Investment Growth</td>
<td>$6,696,597</td>
</tr>
<tr>
<td>Present Value of Avoided Taxes</td>
<td>$4,111,130</td>
</tr>
<tr>
<td>Present Value Tax Benefits</td>
<td>$9,655,461</td>
</tr>
<tr>
<td>Additional Return Generated by Tax Benefits</td>
<td>96.55%</td>
</tr>
</tbody>
</table>
Model #5 – Bonus Depreciation with 5% Investment Growth

- This model makes the same assumptions as Model #4 except the investment growth is only 5%.
- This allows the investor to reap significant tax benefits while investing in a QOF with substantially less risks than a QOF that produces 12% growth.

### Present Value of QOF Tax Benefits

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permanently Excluded Capital Gain</td>
<td>$1,000,000</td>
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<tr>
<td>Permanently Excluded Taxes on Capital Gain</td>
<td>$318,000</td>
</tr>
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<td>$9,000,000</td>
</tr>
<tr>
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<tr>
<td>Present Value of Taxes</td>
<td>$2,135,668</td>
</tr>
<tr>
<td>Value of Deferring Taxes on Capital Gain</td>
<td>$726,332</td>
</tr>
</tbody>
</table>

### Depreciation

- **Bonus Depreciation**: $10,000,000
- **Value of Bonus Depreciation**: $4,500,000

### Permanent Exclusion of Taxes from QOF Gains

- **Investment Growth**: $21,058,482
- **Potential Taxes on Investment Growth**: $6,696,597
- **Present Value of Avoided Taxes**: $1,227,756
- **Present Value Tax Benefits**: $6,772,087
- **Additional Return Generated by Tax Benefits**: 67.72%

### Model Assumptions

<table>
<thead>
<tr>
<th>Assumption</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Gain Amount</td>
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<tr>
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</tr>
<tr>
<td>Federal Ordinary Income Rate</td>
<td>37.0%</td>
</tr>
<tr>
<td>State Tax Rate</td>
<td>8.0%</td>
</tr>
<tr>
<td>WACC (Weighted Average Cost of Capital)</td>
<td>5.0%</td>
</tr>
<tr>
<td>Year Investment is Made Into QOF</td>
<td>2020</td>
</tr>
<tr>
<td>Year QOF Investment is Sold</td>
<td>2030</td>
</tr>
<tr>
<td>Investment Growth</td>
<td>5.0%</td>
</tr>
<tr>
<td>Portion Eligible for Bonus Depreciation</td>
<td>100.0%</td>
</tr>
</tbody>
</table>
Financial Models - Takeaways

- While the tax benefits of a QOF are substantial, the underlying investment still must produce gains and, more importantly, avoid losses. No amount of tax savings is worth it if a QOF loses its entire initial investment.

- Investors should consider several variables before investing in a QOF, including the risks of the underlying investment, the reasonableness of projected returns (which could also drive a large portion of projected tax benefits), whether depreciation deductions generated by the QOF can be utilized, when those deductions can be used and the character of the income it will offset.

- While commercial real estate investments appear to be the most common QOF investment on the market, there are many other types of investments that potentially qualify as QOFs and may be more suitable to many investors.
  - Operating businesses potentially qualify as a qualified opportunity zone business, although there could be a business reason to relocate an operating business in the future that would disqualify the QOF.
  - Industrial investments also potentially qualify as a qualified opportunity zone business that may produce lower returns but could mitigate much of the QOF investment risk.
Comparing Opportunity Zones to the New Markets Tax Credit

ABA Annual Meeting, Jan. 2020

Michelle Layser
Assistant Professor
Project Goal

Using theoretically based framework, compare Opportunity Zones to New Markets Tax Credit

- Identify ways the programmatic benefits differ
- Predict the impact of OZs on low-income communities
## Design Comparison

<table>
<thead>
<tr>
<th>Opportunity Zones</th>
<th>New Markets Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unlimited subsidized equity capital</td>
<td>Capped subsidy for debt financing</td>
</tr>
<tr>
<td>Self-certified opportunity funds</td>
<td>Agency-certified CDEs</td>
</tr>
<tr>
<td>No social-mission requirement</td>
<td>CDEs must have social mission</td>
</tr>
<tr>
<td>Tax break increases with profitability</td>
<td>Tax break does NOT increase with profitability</td>
</tr>
<tr>
<td>Funds choose investments</td>
<td>CDFI Fund chooses investments based on competitive application process</td>
</tr>
<tr>
<td>Tied to ownership (fewer opportunities for nonprofits)</td>
<td>Not tied to ownership (loans to nonprofits qualify)</td>
</tr>
</tbody>
</table>
Research Question

• What are likely to be the programmatic benefits of Opportunity Zones?
  – i.e., What types of projects are likely to be subsidized?
Programmatic Benefits

- Promote activities that reduce **place-based** inequities

<table>
<thead>
<tr>
<th>Programmatic Benefit</th>
<th>When the targeted community has spatial inequality due to . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jobs</td>
<td>Spatial Mismatch?</td>
</tr>
<tr>
<td>Housing</td>
<td>Disinvestment due to redlining / discrimination?</td>
</tr>
<tr>
<td>Community Infrastructure</td>
<td>Weak community infrastructure (e.g., few physical gathering</td>
</tr>
<tr>
<td>(gathering places; service</td>
<td>spaces; few local institutions to facilitate communication)</td>
</tr>
<tr>
<td>organizations; institutions that facilitate social interaction)</td>
<td></td>
</tr>
</tbody>
</table>
Method: Data Collection

• Collect project data about both the NMTC and OZs
  – Source: Project descriptions published online by private parties
  – For NMTC: Use Google/Google satellite to determine project type; plot location
Method: Coding and Analysis

- Use an analytical framework to categorize projects and generate meaningful comparisons
  - Code projects based on type of programmatic benefit
  - Perform spatial analytics and exploratory data analysis of different NMTC project types’ correlation with rent increases
  - Compare the mix of project types to predict whether OZs are likely to be more or less strongly correlated with rent increases
## Results: What types of projects are likely to be subsidized?

<table>
<thead>
<tr>
<th>Opportunity Zones</th>
<th>Compare to New Markets Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apartments/Condos – 26%</td>
<td>• Education – 21%</td>
</tr>
<tr>
<td></td>
<td>• Apartments/Condos – 12%</td>
</tr>
<tr>
<td>Luxury, market rate</td>
<td>• Medical Facilities – 11%</td>
</tr>
<tr>
<td>Office Space – 11%</td>
<td>• Homeless/Social Services – 10%</td>
</tr>
<tr>
<td>Tech startups (small?; high-skilled jobs)</td>
<td>• Retail/Restaurants – 9%</td>
</tr>
<tr>
<td>Retail/Restaurants – 6%</td>
<td>• Manufacturing/Wholesale – 8%</td>
</tr>
<tr>
<td>Unknown – 39%</td>
<td></td>
</tr>
</tbody>
</table>
Correlation with rent increase?

- Has been observed in some studies of place-based tax incentives
- Slight positive correlation in this study
  - Correlation is stronger when projects are more closely clustered
OZ projects will probably be more clustered than NMTC projects
Reporting requirements are needed!

- Who is investing and how much?
- Where are they investing?
- What are they investing in?
- Impact
  - What metrics?
Legislative Proposals

- House and Senate proposals would add OZ reporting requirements
  - H.R. 2593 (Kind)
  - S.1399 (Booker)
  - S.2787 – Opportunity Zone Reporting and Reform Act (Wyden)
Questions?
mlayser@illinois.edu
Can Opportunity Zone Investments Fund Small Businesses?

EDWARD W. DE BARBIERI
ALBANY LAW SCHOOL
(d) QUALIFIED OPPORTUNITY FUND For purposes of this section—

(1) IN GENERAL The term “qualified opportunity fund” means any investment vehicle which is organized ... for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property ...
What is Qualified Opportunity Zone Property?

(i) qualified opportunity zone stock,

(ii) qualified opportunity zone partnership interest, or

(iii) qualified opportunity zone business property. (MOST INVESTOR ATTENTION)
- Community goals and priorities - Is there a mechanism in place to hold the project sponsor accountable to commitments such as a community benefits agreement? (MIGHT INCLUDE PRIORITIES AROUND SMALL BUSINESS DEVELOPMENT)
- Accessible, high-quality jobs - Does the project sponsor or principal have a history of providing jobs for populations facing employment barriers?
- Community wealth-building - Will the project/business directly expand or incubate new entrepreneurs—for example, via a business incubator or accelerator? Will the project/business facilitate shared employee or tenant ownership?
Who plans economic development?

Outsourcing economic development policy to select group of private individuals who by accident of the economy have capital gains
To what extent do we want to limit gov't oversight? Role of the public?
Why grant tax exemption for place-based economic development purposes?

- Precedent for place-based tax incentives (state enterprise zones, NMTC, post-disaster incentives, EB-5)

- Without a "public purpose," inconsistent with other types of tax exemption, such as charitable and educational and religious (highly regulated) (courts outsource to legislatures meaning of public purpose)