OPPORTUNITY ZONE EXPO

Moderator and Panelists

Roy Carrasquillo | Carrasquillo Law Group P.C.

Joseph "Jay" Darby | Sullivan & Worcester

Debbie A. Klis | Polsinelli, PC

Amy Tranckino | Sheppard Mullin

Moderated by: Adam Yormack of Escalante Yormack Law, PLLC

Getting in the Zone – Opportunity Zone

- How to get your gains involved in Opportunity Zones
- Identifying, gathering and acting
- What you need to know about Opportunity Zones
- Best strategies and growth potential
- Understanding potential of Opportunity Zones (Benefits)
- What is eligible capital?
- What is a Qualified Business? Former Partnerships? Stocks, Real Estate, etc.
- What is a Qualified Zone?
- What is a Qualified Fund?
- Timing, Understanding 180 Days
- Responsibilities as an Investor

Introduction to Qualified Opportunity Zone

- The 2017 Tax Cuts and Jobs Act

- New Sections 1400Z-1 and 1400Z-2

- Tax benefits encourage investment in “Qualified Opportunity Zones” through “Qualified Opportunity Funds”

Qualified Opportunity Funds – Tax Incentives

- Deferral of eligible gain
- Possible reduction of the amount of eligible gain realized
- Possible permanent exclusion of gain on appreciation

What are Qualified Opportunity Zones?

- Geographic zones throughout the United States designated by the IRS

- Notice 2018-48 lists census tracts designated as Qualified Opportunity Zones

What Do You Need to Know about OZ?

- There is a great deal of uncertainty
- Government Shutdown delays hearings and future guidance
- Taxpayers must sell interest in QOF to enjoy tax benefits
  - More traditional private equity exit strategy of selling assets does not work under current rules
- Only “eligible gain” qualifies for tax benefits

What Else Do You Need to Know?

- Additional capital contributions may be problematic
- Gain recognition 12/31/2026 even if no sale of interest
- Treatment of debt financed distributions unclear
- Related party issues

What is a Qualified Fund?

A Qualified Opportunity Fund (QOF) is an entity classified as a corporation or partnership structured with the following QOF basics:

	Timing	Assets	Testing	Types
QOF	**180 days** from date of capital gain event to reinvest into a QOF **Capital gain realized by flow-through entity** (partnership or S corp), owners have **additional 180 day window** beginning on last day of entity's taxable year	Fund must hold at least **90% of assets in QOZB Property** Can hold qualified property directly, but generally more favorable for Fund to own a ***QOZB***, which is a lower-tier partnership or corporation	**Twice per year**	Fund must be **domestic corporation or partnership** (cannot be a disregarded entity) No limit on the # of QOFs that can be created **QOZB Property must be purchased by Fund in 2018 or later for cash.**

How the Tax Benefits Work? … Example #1

- Example 1. Investment in Fund Held for 10 Years & Sold in 2028

Opportunity Zone Investment Held for at Least 10 Years			Ordinary Investment		Difference	
Deferred Gain (taxed in 2026)	$100.00		Gain (taxed in 2018)	$100.00		
Basis Step-Up	$15.00		Basis Step-Up	$0.00		
Taxable Gain	$85.00		Taxable Gain	$100.00		
Tax (at 23.8%)	$20.23		Tax (at 23.8%)	$23.80	$3.57	
Gain on Disposition of Investment in Fund	$100.00		Gain on Investment	$100.00		
Basis Step-Up	$100.00		Basis Step-Up	$0.00		
Taxable Gain on Disposition of Investment in Fund	$0.00		Taxable Gain	$100.00		
Tax (at 23.8%)	$0.00		Tax (at 23.8%)	$23.80	$23.80	
					$27.37	**TOTAL**

Assume an investment in an Opportunity Fund for 10 years, and assume the investment in the Opportunity Fund doubles (i.e., enjoys 100% appreciation) over the 10-year period, a taxpayer in this hypothetical situation would save $27.37 in tax, and would also enjoy the benefit of deferral of tax on the gain that is invested in the Opportunity Fund until 2026.

How the Tax Benefits Work? Example #2

❖ Example 2. Investment in Fund is Held for 7 Years and Sold in 2025

Opportunity Zone Investment Held for at Least 7 Years			Ordinary Investment		Difference
Deferred Capital Gain (taxed in 2025)	$100.00		Capital Gain (taxed in 2018)	$100.00	
Basis Step-Up	$15.00		Basis Step-Up	$0.00	
Taxable Capital Gain	$85.00		Taxable Capital Gain	$100.00	
Tax (at 23.8%)	$20.23		Tax (at 23.8%)	$23.80	**$3.57**

As a result of holding an investment in an Opportunity Fund for 7 years, a taxpayer in this hypothetical situation would save $3.57 in tax, and would also enjoy the benefit of deferral of tax on the gain that is invested in the Opportunity Fund until 2025.

How the Tax Benefits Work? Example 3

❖Example 3. Investment in Fund is Held for 5 Years and Sold in 2023

Opportunity Zone Investment Held for at Least 5 Years			Ordinary Investment		Difference
Deferred Capital Gain (taxed in 2023)	$100.00		Capital Gain (taxed in 2018)	$100.00	
Basis Step-Up	$10.00		Basis Step-Up	$0.00	
Taxable Capital Gain	$90.00		Taxable Capital Gain	$100.00	
Tax (at 23.8%)	$21.42		Tax (at 23.8%)	$23.80	**$2.38**

As a result of holding an investment in an Opportunity Fund for 5 years, a taxpayer in this hypothetical situation would save $2.38 in tax, and would also enjoy the benefit of deferral of tax on the gain that is invested in the Opportunity Fund until 2023.

Qualified Opportunity Zone Property

- The next important concept is the types of property in which a Qualified Opportunity Fund can invest. The eligible investment property is defined as "Qualified Opportunity Zone Property." This, in turn, is broken down into three specific sub-categories:

  - ✓ *Qualified Opportunity Zone Stock* (meaning equity (i.e., stock) in an eligible corporation),
  - ✓ *Qualified Opportunity Zone Partnership Interest* (meaning equity (*i.e.*, a partnership interest) in a partnership), and
  - ✓ *Qualified Opportunity Zone Business Property* (meaning a direct investment by the Fund in applicable property used in a trade or business in the applicable zone).

Qualified Opportunity Zone Property

- <u>Qualified Opportunity Zone Stock</u> means a domestic corporation, that satisfies three criteria:

  ✓ The stock must be acquired after December 31, 2017, at its original issue price from the corporation, solely in exchange for cash.

  ✓ At the time the stock is issued, the corporation must be a Qualified Opportunity Zone Business (or, in the case of a new corporation, must be organized for the purpose of being a Qualified Opportunity Zone Business).

  ✓ During substantially all of the Opportunity Fund's holding period in such stock, the corporation must maintain its status as a Qualified Opportunity Zone Business.

Qualified Opportunity Zone Property

- A Qualified Opportunity Zone Partnership Interest closely mirrors the requirements of a Qualified Opportunity Zone Corporation, except that it is a business operated through a partnership. In particular, it must be a domestic partnership, and must meet the same three requirements as set forth above for a corporation, namely:

  ✓ The partnership interest must be acquired after December 31, 2017, at its original issue price from the partnership, solely in exchange for cash.

  ✓ At the time the partnership interest is issued, the partnership must be a Qualified Opportunity Zone Business (or, in the case of a new partnership, must be organized for the purpose of being a Qualified Opportunity Zone Business).

  ✓ During substantially all of the Qualified Opportunity Fund's holding period in such partnership interest, the partnership must maintain its status as a Qualified Opportunity Zone Business.

Qualified Opportunity Zone Property

- The third category of eligible investment property, <u>Qualified Opportunity Zone Business Property,</u> is different from the first two, and involves a direct investment in property owned directly by the OZ Fund.

- “Qualified Opportunity Zone Business Property” means tangible property used in a trade or business of the OZ Fund.

- Note, first of all, that this assumes the OZ Fund is engaged in a trade or business, and uses the tangible property in that business.

Qualified Opportunity Zone Property

- Such property must then meet the following three additional requirements:

  - ✓ The property must be acquired by the Fund by purchase from an unrelated party (as defined in Code Section 179(d)(2), but modified by Code Section 1400Z-2(e)(2) to a 20% relationship test) after December 31, 2017.

  - ✓ The original use of the property in the Qualified Opportunity Zone must commence with the Qualified Opportunity Fund or the Qualified Opportunity Fund must substantially improve the property.

  - ✓ During substantially all of the Qualified Opportunity Fund's holding period for such property, substantially all of the use of such property must be in the Qualified Opportunity Zone.

Qualified Opportunity Zone Property

- Under the second requirement, above, one of the alternatives choices is to substantially improve the property. "Substantial improvement" is defined as follows:

- "For purposes of subparagraph (A)(ii), property shall be treated as substantially improved by the Qualified Opportunity Fund only if, during any 30–month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the Qualified Opportunity Fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30–month period in the hands of the Qualified Opportunity Fund."

Qualified Opportunity Zone Property

- This requirement specifies that, in order to be "substantial," the capitalized expenditures over *any* 30-month period following the acquisition date of the property must exceed the "adjusted tax basis" of the taxpayer in the property at the beginning of the 30-month period (i.e., the acquisition purchase price).

- Note that this requirement approximately maps to or corresponds to the requirement, under the Historic Rehabilitation Tax Credit, in order for a building rehabilitation project to qualify as "substantially rehabilitated."

Qualified Opportunity Zone Property

- The foregoing rules provide a very notable dichotomy between OZ Funds that seek to operate their own businesses directly, versus OZ Funds that seek to invest in one or more eligible corporations or partnerships that qualify as a "Qualified Opportunity Zone Business" (an "OZ Business").

  - ✓ For example, the direct investment by an OZ Fund requires that 90% of the funds must be invested in tangible property, while indirect investments (through an OZ Business) have no minimum stated requirement (though Proposed Regs. provide a 70% minimum in OZB).
  - ✓ Thus, can't have too much cash on-hand when semi-annual test occurs
  - ✓ A direct OZ Fund investment does not have an "active" business requirement, meaning that NNN leasing activities that may not rise to the level of a "business" activity is more likely than not to qualify
  - ✓ An OZ Business must derive at least 50% of gross income from an "active" business.
  - ✓ There is an extensive and highly intricate list of further differences.

Qualified Opportunity Zone Business

- The term "Qualified Opportunity Zone Business" means a trade or business

  - ✓ in which substantially all of the tangible property owned or leased by the taxpayer is Qualified Opportunity Zone Business Property

    - ▪ (determined by substituting "Qualified Opportunity Zone Business" for Qualified Opportunity Fund" in each place it appears in paragraph (2)(D));

  - ✓ which satisfies the requirements of paragraph (2), (4), (8) of Code Section 1397C(b); and

  - ✓ which is not described in Code Section 144(c)(6)(B).

Qualified Opportunity Zone Business

- Basically, a Qualified Opportunity Zone Business must purchase tangible property that is used in the applicable trade or business, and that is

  ✓ such property acquired by purchase from an unrelated party after December 31, 2017,

  ✓ the original use of such property commences with the business, or the business substantially improves the property (under the substantial improvement standards described above), which suggests property can be used though a tax bill of “fixes to TCJA would require new property only, and

  ✓ during substantially all of the period that the business holds such property, substantially all the use of the property is in the Qualified Opportunity Zone.

Qualified Opportunity Zone Business

- The applicable requirements imported from Code §1397C(b), paragraphs (2), (4) and (8) are, respectively, the following:

  - ✓ (2) at least 50% of the gross income of such entity is derived from the active conduct of such business,

  - ✓ (4) a substantial portion of the intangible property of such entity is used in the active conduct of such business, and

  - ✓ (8) less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to Non-Qualified Financial Property.

Qualified Opportunity Zone Business

- The term "Non-Qualified Financial Property" means
  - ✓ debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property as specified in regulations;
  - ✓ such term does not include –
    - o reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or
    - o accounts receivable of the businesses as described in Code §1221(a)(4).
- Proposed Regulations provide that "working capital" can be held by a QOZ Business for up to 31 months so long as there is a written plan to spend the money and the taxpayer acts on the plan.

Qualified Opportunity Zone Business

- Code §144(c)(6)(B) defines which businesses "are not eligible to be considered within the scope of an eligible business"

- These are generally "sin" businesses and are comprised of the following:

  - ✓ "No portion of the proceeds may be used to provide (including the provision of land for) any 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."

Qualified Opportunity Zone Business

- The single biggest area of uncertainty is in the definition of an OZ Business that provides –
  - ✓ "substantially all of the tangible property owned or leased by the taxpayer is [required to be] Qualified Opportunity Zone Business Property (determined by substituting "Qualified Opportunity Zone Business" for Qualified Opportunity Fund" in each place it appears).
- An obvious preference of many businesses is to lease the real property it occupies and use its capital for business assets and operations.
- The definition of Qualified OZ Business Property in IRC 179(d)(2) requires that it is "purchased," which is defined as "any acquisition" of property if "not acquired from a related party …"

Qualified Opportunity Zone Business

- For leases, assuming not QOZBP, the asset might still satisfy 70/30 Test
- The Proposed Regulations provide that “substantially all” for this purpose means 70% or more of all tangible property.
- Treasury was intentional in treating direct and indirect investments by Qualified Opportunity Zone Funds differently on certain issues
- Indeed, there are many situations where there is a substantive difference in the way the legislation is written between a direct OZ Fund investment in Qualified Opportunity Zone Business Property versus an indirect investment through an OZ Business.

Understanding 180-Day Reinvestment Rule

- *Basic Rule -*
  - The 180-day reinvestment period for a QOZ begins the day the capital gains “would be recognized” for U.S. federal income tax purposes but for Section 1400Z-2 (*i.e.*, date of the sale or exchange)

- *Round Two Rule -*
  - If the investor defers tax by investing the capital gains in a QOF and later disposes of its entire interest in the QOF, the taxpayer may further defer that gain by investing in another QOF within 180 days of the date of disposition

Understanding 180-Day Reinvestment Rule (cont.)

- *Additional Time for Partners.* For Partners in a Partnership, the 180-days begin at the <u>end</u> of the Partnership's taxable year <u>not</u> on the date of the sale or exchange:
  - However, Partners may elect for 180-day period to begin at the same time as for the Partnership, but only if the partner knows

    (i) when the Partnership recognized the gain, <u>and</u>

    (ii) that the Partnership will not elect to deference under Section 1400Z-2
  - Unless a Partner makes an election to begin the 180-day period on the date of the sale or exchange, these rules grant the Partner with meaningful additional time to invest their eligible gains

Example of a Qualified Opportunity Fund

- $20 million sale results in $6 million of gain
- Only the $6 million of gain needs to be invested to obtain full QOZ benefits and is eligible for such benefits
- If calendar-year partnership sells a capital asset on February 1, 2019, the partnership has 180 days, until July 31, 2019 to reinvest
- Partners have additional window between January 1, 2020 and June 29, 2020 to invest in QOF
- The money invested in the QOF need not be the same money generated in the sale that generated the capital gains (*i.e.*, no tracing of funds occurs)
- A flow-through entity that sells an asset that generates the gain can differ from the entity that reinvests the capital gain proceeds in a QOF unlike a 1031 like-kind exchange

Responsibilities as an Investor

- Investors can invest 100% of the proceeds of a sale into the QOF (only the capital gain portion of the sale, or a fractional portion can qualify for benefits)

  - ✓ Example - an asset sold for $20 million with a basis of $5 million
  - ✓ $15 mil would be eligible to receive the tax benefits of a QOF investment

- Most QOFs will have minimum investment of $100k-$1 mil with no maximum

- Other cash placed in a QOF will not yield tax-free gain if held for 10 years

- Investors who realized capital gains as early as January 2018 may still qualify for QOZ investment if it was a pass-through entity (*i.e., a partnership,* LLC, or an S corporation) if invested by January 1, 2019 & June 29, 2019 in a QOF

Responsibilities as an Investor Continued

- An investor may make a QOF investment as late as June 2027 to receive a 10-year step-up in basis treatment
- A taxpayer elects deferral of capital gains in a QOF investment on Form 8949 and files with its *tax* return.
- *Investment* in the *QOF* must be an equity interest, not a debt interest.
- Investors who realized capital gains as early as January 2018 may still qualify for QOZ investment if it was a pass-through entity (*i.e., a partnership,* LLC, or an S corporation) if invested by January 1, 2019 & June 29, 2019 in a QOF

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