Opportunity Zones:

Tax Benefits & Issues

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Opportunity Zones: Purpose

The Internal Revenue Code Sec. 1400Z-2 was written to encourage economic growth and investment in designated distressed communities (Qualified Opportunity Zones, "QOZ") by providing Federal income tax benefits to taxpayers who invest in businesses located within these zones (Reg-115420-18).

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QOZ – Locations and Map Tool

- Approximately 8,750 communities throughout all 50 States were designated as qualified Opportunity Zones (IR-2018-206, Oct. 19, 2018)

- For a list of all designated Qualified Opportunity Zones visit:
  - https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx (Access to interactive map)
  - IRS Notice 2018-48, 2018-28 Internal Revenue Bulletin 9

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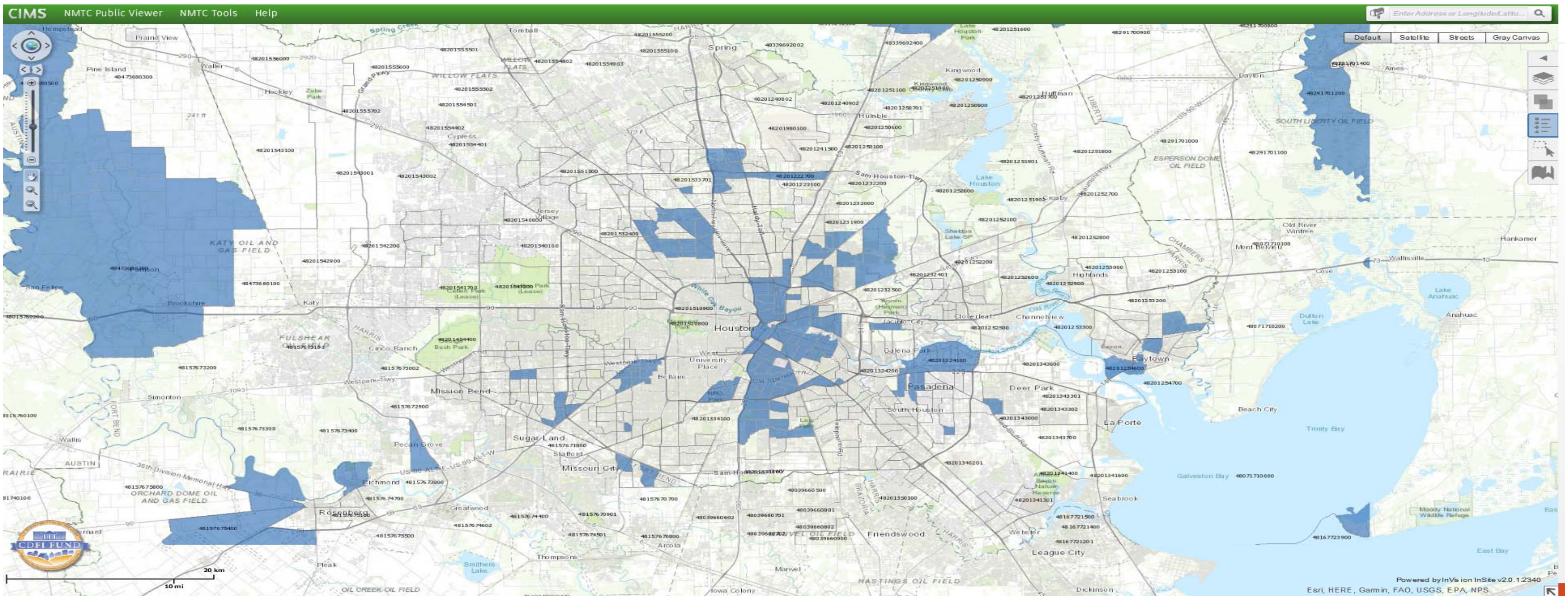
QOZ – Houston & Surrounding Area



(https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml)

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Qualified Opportunity Zones (QOZ) vs. IRC Sec. 1031

- Ability to Receive Cash – Reinvestment of Capital Gain Only (QOZ) vs. Total Proceeds (1031)
- Permanent Tax Exclusion (QOZ) vs. Temporary Deferral (1031)
- No Identification Date Requirement for Investment (QOZ)
- No Like-Kind Property Requirement (QOZ)
- Not Real Estate Specific (QOZ)

Sec. 1400Z-2 Opportunity Zones: Why?

- The "Why"
  - ➢ Potential 8 Year Deferral of Capital Gain
  - ➢ Permanent Exclusion of up to 15% of the Original Capital Gain
  - ➢ Permanent Exclusion of 100% of the Gain to be Recognized from the Qualified Investment

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Sec. 1400Z-2 Opportunity Zones: How?

- The Simplified "How"
  - Step 1: Qualified taxpayer incurs a capital gain
  - Step 2: Taxpayer elects deferral treatment (anticipated via Form 8949) and reinvests the gain into a Qualified Opportunity Fund (QOF)
  - Step 3: The QOF invests more than 90% of it's assets in Qualified Opportunity Zone property (QOZP) which is located within a Qualified Opportunity Zone (QOZ).

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The "How" Step 1 Additional Detail

- Qualified Taxpayer: Those that recognize capital gains for Federal income tax purposes.
  - Individuals
  - C Corporations (including RICs and REITs)
  - Partnerships
  - S Corporations
  - Decedents' Estates
  - Trusts
  - Certain other pass-through entities:
    - Common Trust Funds as described in Sec. 584
    - Qualified Settlement Funds
    - Disputed Ownership Funds
    - Other entities taxable under Sec. 1.468B

- As it relates to a partnership, the deferral election on capital gains can be made by the partnership or by the individual partners of a partnership

- If a taxpayer acquires an original interest in a QOF in connection with a gain-deferral election, if a later sale of the interest triggers an inclusion of the deferred gain, the taxpayer is eligible to make an additional deferral election so long as the gain was reinvested in a QOF (Reg-115420-18).

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The "How" Step 2 Additional Detail

- Qualified Opportunity Funds (QOFs):
  - can only be a Corporation or a Partnership entity;
  - self-certify as a QOF (Form 8996)
  - must invest in opportunity zones and meet annual reporting thresholds (discussed in Step 3 Additional Detail)

- Taxpayer has 180 days to reinvest the capital gain into a QOF.
  - A partner receiving a capital gain via Schedule K-1 has 180 days from the last day of the partnership's tax year; or
  - A partner can elect to start the 180-day clock as of the date the assets were sold by the partnership.

- The investment to an entity before it qualifies as a QOF (explained in Step 3 Additional Detail) will preclude the gain from being eligible for deferral and additional tax benefits.

- Investment in a QOF must be an equity interest (debt not allowed)

- Status as an eligible interest is not impaired by the taxpayer's use of the interest to collateralize a loan.

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The "How" Step 3 Additional Detail

- The QOF invests more than 90% of it's assets in Qualified Opportunity Zone property (QOZP) which is located within a Qualified Opportunity Zone (QOZ).

  - The QOF must perform semi-annual compliance checks (90% test - Form 8996).

  - Cash on hand is counted as QOZP as "working capital" so long as:
    1. The cash is for (designated in writing) the purchase, construction and/or substantial improvement in an opportunity zone; and
    2. The cash must be spent within 31 months.

The “How” Step 3 Additional Detail

- To meet the 90% test, the QOF invests in either a:
  1. Subsidiary Corporation or Partnership that operates a Qualified Opportunity Zone Business (QOZB); or
  2. Operates a QOZB directly by holding Qualified Opportunity Zone Business Property (QOZBP) directly.
- Although the QOF must maintain the 90%, a QOZB operated through a sub or partnership must only maintain 70% of its assets as QOZBP.
- If a QOF invests in a sub/partnership, the interest must have been acquired after 12/31/17.
- QOZBP is:
  1. Purchased post 12/31/17
  2. Original use of the property within a opportunity zone must begin with the business (can be used property but not used inside an QOZ)
  3. Existing real estate if substantially improved (improvements must double original cost basis of building – excludes land)

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Tax Benefits Explained

1. Potential 8 Year Deferral of Capital Gain
   - Tax on the initial capital gain is deferred until the EARLIER of:
     1. The date the interest in the QOF is sold; or
     2. December 31, 2026
   - Tax-basis in QOF investment = zero.

2. Permanent Exclusion of up to 15% of the Deferred Capital Gain
   - If the QOF investment is held for 5 years, the basis in QOF investment is stepped-up by 10% of the amount of the initially deferred gain.
   - If the QOF investment is held for 7 years, the basis in the QOF investment is stepped-up by an additional 5% of the amount of the initially deferred gain.
   - Remember, gain recognition on the deferred gain occurs on December 31, 2026 at the latest. Must be invested by 12/31/19 to enjoy maximum benefits. Timing is Everything!

3. Permanent Exclusion of 100% of the Gain to be Recognized from the Qualified Investment
   - If the QOF investment is held for 10 years, at the time of sale, the basis of the QOF investment receives the elective step-up to fair market value – no gain on sale.
   - The ability to receive the 100% step-up to FMV expires at Dec. 31, 2047

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Unfavorable Requirements

- Related Parties:
  - Gains arising from related party transactions are not eligible for deferral
  - Follows the related party definitions of IRC Sec. 267(b) & 707(b)(1)
  - However, 50% ownership was replaced with 20%
- Deferred Gain Retains Character (Short-Term vs. Long-Term)
- Depreciation Recapture - Portion of Gain Not Eligible for Deferral
- Outside cash investors in QOF are not eligible for tax benefits provided pursuant to these Proposed Regulations – Investment in QOF must be from the elected deferred capital gain to enjoy benefits

Potential Issues

- Basis & At-Risk Limitations
  - ➢ Zero Basis in First Five Years – Losses Limited
  - ➢ Would a refinance and 100% reinvestment of the cash proceeds in Qualified Opportunity Zone Property free-up/provide basis to deduct losses via Qualified Non-Recourse Debt allocations to partners?

- Refinance – Cash Out vs. Reinvestment
  - ➢ If property is refinanced, complete reinvestment of re-fi funds required (90% Rule)?
  - ➢ Do distributions cause previously deferred gain to be recognized? Additional Regulations will be issued.

- Nonrecaptured 1231 Losses? – The Proposed Regulations provide that in order to be eligible for deferral, the gain, if not for the elective deferral, would have otherwise been treated as capital gain for Federal income tax purposes.

- Tax due on 85% – No Cash

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Example

- **September 2018:**
  - Individual taxpayer sold capital gain property for $2MM and had an unadjusted basis of $1MM ($1MM Capital Gain)
- **December 31, 2018:**
  - Reinvested the $1MM into a QOF and put the other $1MM cash in your pocket
  - Elect gain deferral treatment and no taxable gain is reported on your 2018 tax return
  - Basis in the new investment is zero.
- **December 31, 2023**:
  - Taxpayer is able to permanently exclude 10% of the deferred gain
  - Basis in the investment becomes $100,000
- **December 31, 2025:**
  - Taxpayer is able to permanently exclude an additional 5% of the deferred gain
  - Basis in the investment becomes $150,000

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Example Contd.

- **December 31, 2026:**
  - ➢ Taxpayer is still holding his QOF investment
  - ➢ Taxpayer is required to pay tax on $850k of the deferred capital gain from 2018
  - ➢ Basis in Taxpayer's QOF investment is now $1MM
- **December 31, 2029:**
  - ➢ Taxpayer sells QOF investment for $6MM
  - ➢ Taxpayer elects to treat the basis = Fair Market Value
  - ➢ Taxpayer receives $6MM cash but pays ZERO income tax.

Questions?

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