P3Direct

Understanding Opportunity Zones

Wednesday March 6th, 2019 | P3C

SPEAKERS

JAY BROWN
ALVAREZ & MARSAL

JACK CALLAHAN
COHN REZNICK

CHRIS COMPTON
WINSTEAD

AGENDA

- Why invest in an Opportunity Zone fund?
- How did Opportunity Zones come to be?
- Steps in the Opportunity Zone process
- Opportunity Zone property
- “Substantial improvement”
- Some of the things to think about
- Questions?

WHY INVEST IN AN OPPORTUNITY ZONE FUND?

The short answer - If the investor meets the requirements (of which there are many):

- Defer federal income tax on current recognized capital gains
- Have a portion of that deferred gain forgiven
- Avoid federal income tax on appreciation in Opportunity Fund investment

HOW DID OPPORTUNITY ZONES COME TO BE?

- Creation of the Tax Cuts and Jobs Act of 2017.
- Goal is revitalization of economically depressed geographies.
- Attempt to implement lessons learned from prior efforts . . .

  - Requisite long term investment to maximize benefits.
  - Attempt principally to capture investor's gains from other successful investments.
  - Broad – but not unlimited categories of qualifying investments.
  - To fully benefit from the Opportunity Zone provisions, the taxpayer needs to make astute opportunity zone investments.

STEPS IN THE OPPORTUNITY ZONES PROCESS

- **Step 1: A <u>taxpayer</u> realizes and recognizes any <u>capital</u> <u>gain</u>.**
  - Shares of stock
  - Real estate
  - Partnership interest that result in capital gain
  - Other property

- **Step 2: The taxpayer invests the gain dollars in a "Qualified Opportunity Fund" (Fund)**
  - Timing: Investment within 180 days for realization/recognition event
  - Taxpayer cannot invest directly in property, even if it's in opportunity zone
  - The Fund can self-certify

AIAI

STEPS IN THE OPPORTUNITY ZONES PROCESS

- **Step 2: The taxpayer invests the gain dollars in a "Qualified Opportunity Fund" (continued).**
  - Fund must be "organized as a corporation or partnership"
  - Purpose of the entity must be to invest in opportunity zone property
  - Initial adjusted basis in the Fund is 0

- **Step 3: Fund makes equity investment in opportunity zone property**

STEPS IN THE OPPORTUNITY ZONES PROCESS

Step 4: Fund must hold 90% of its assets in opportunity zone property

- Twice annual testing
- Penalty for failure to comply
- Draft IRS Form 8996 is out

STEPS IN THE OPPORTUNITY ZONES PROCESS

- **Step 5: If the taxpayer holds its Fund interest for 5+ years, the taxpayer receives an increase in his/her adjusted basis of 10% of the deferred gain**

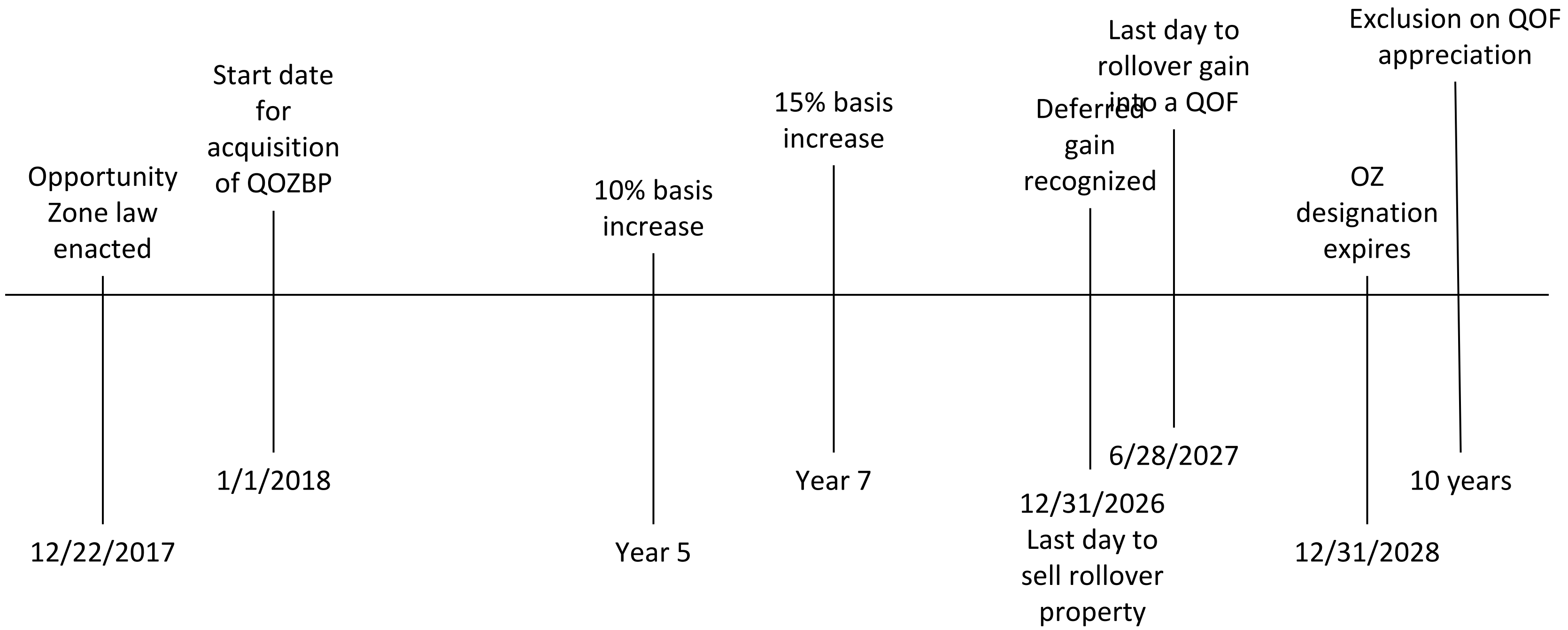
- **Step 6: If the taxpayer holds its Fund interest for 7+ years, the taxpayer receives an increase in his/her adjusted basis of 5% of the deferred gain**

AIAI

STEPS IN THE OPPORTUNITY ZONES PROCESS

- **Step 7: On 12/31/2026, there is a "deemed disposition," so that all the deferred gains related to the investment in the Fund ends and gain is recognized.**
  - The gain is the lesser of:
    - The original deferred gain, or
    - The FMV of the taxpayer's Fund investment
  - Reduced by the taxpayer's basis the Fund investment.

STEPS IN THE OPPORTUNITY ZONES PROCESS



STEPS IN THE OPPORTUNITY ZONES PROCESS

Investments made in 2019

- Eligible for all incentives

Investments made after 2019 but before 2022

- The rollover gain will be deferred and 10% may be excluded
- The tax exclusion on appreciation is available if the investment is held for 10 years

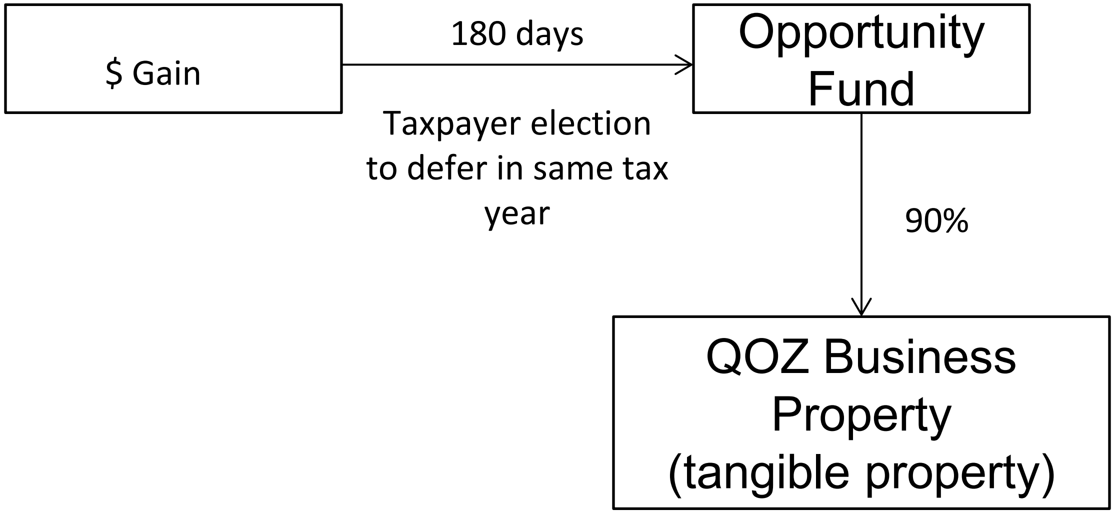
Investments made after 2021 and by June 28, 2027

- No step-up in basis on rollover gain
- Exclusion from tax on appreciation is available if the investment is held for 10 years

- **Category 1: Opportunity Zone Property**

- **Tangible property**
  - Real property
  - Land and improvements to real property
  - Equipment and other personal property

- **Tangible property needs to be in the opportunity zone during "substantially all" of the Fund's holding period.**


$ Gain
180 days
Opportunity Fund
Taxpayer election to defer in same tax year
90%
QOZ Business Property (tangible property)

OPPORTUNITY ZONE PROPERTY

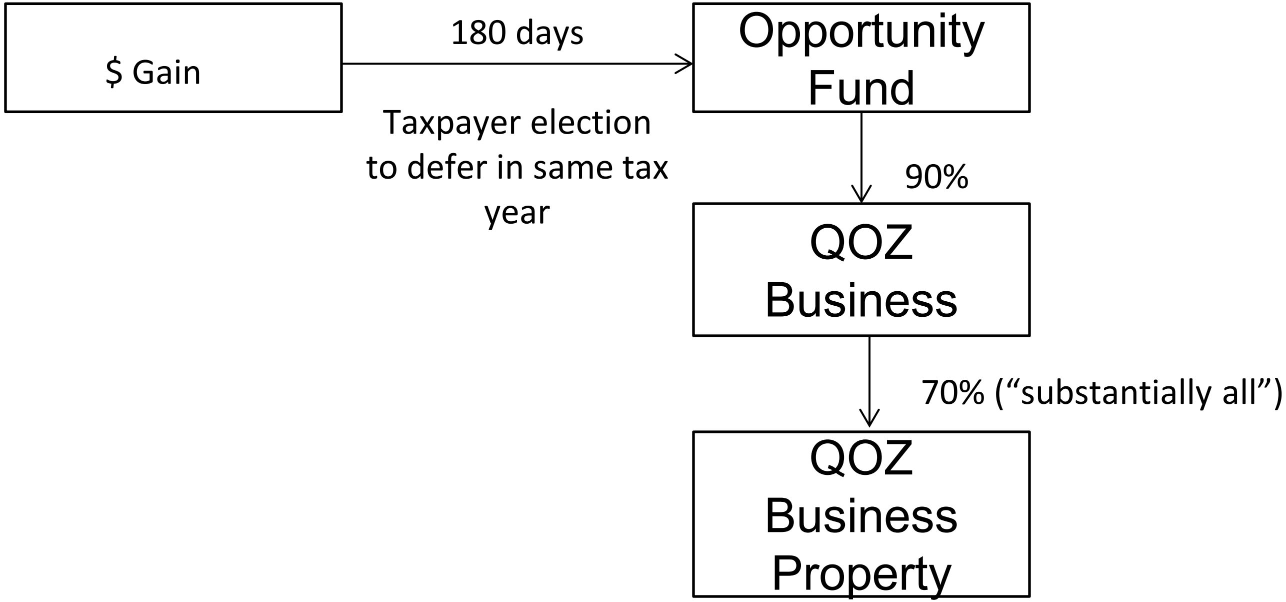
- **Category 2: Opportunity Zone Stock or Partnership Interests**
  - Fund is not limited to direct ownership of real estate
  - The stock or partnership interest can be an investment in a domestic operating business.
  - “Substantially all” of the business tangible property must be:
    - Acquired by purchase from unrelated third parties after 2017, and
    - Used in the opportunity zone during “substantially all” of the business’s holding period.
  - Among other things, at least 50% of the business’s gross income comes from the “active conduct” of the business.
  - A “substantial portion” of the intangible property of the entity is used in the active conduct of the trade or business.

Category 2: Opportunity Zone Stock or Partnership Interests

- The balance sheet cannot contain too much financial property, which would imply the business's focus is investment speculation, rather than economic development

  - Less than 5% of average aggregate unadjusted basis is "nonqualified financial property"
  - Cash should be deployed within 30 months

- By statute, certain businesses don't qualify (golf courses, country clubs, massage parlors, hot tub or sun tan facilities, race tracks, gambling, package liquor stores)


$ Gain
180 days
Taxpayer election to defer in same tax year
Opportunity Fund
90%
QOZ Business
70% ("substantially all")
QOZ Business Property

Direct	Indirect
90% of all assets must be QOZBP	70% ("substantially all") of tangible property must be QOZBP
No guidance on working capital safe harbor	Working capital safe harbor applies to unlimited amount of cash
No active conduct standard	50% of gross income from active conduct of trade or business
All IP counts toward 10% of non-QOZBP assets	Can own unlimited amount of IP (if substantial portion used in QOZB)
No prohibition on sin businesses	Prohibition on sin businesses
No specific reference to lease of property by a QOF	Property leased by a QOZB subject to QOZBP rules

“SUBSTANTIAL IMPROVEMENT”

- An Opportunity Zone Fund has a 30-month window to improve property
- Amount of improvements must exceed acquisition basis in the building
- When does 30-month period start? Still open
- How does this apply to operating businesses?
- Basis allocable to land excluded

THINGS TO THINK ABOUT

- **How should developers and sponsors think about the related party rules?**
  - Can/should the Fund purchase of assets owned by the developer?
  - Can the Fund pay the developer property management or asset management fees?
  - Use of ground leases to avoid related party purchase rules
- **Mixed fund investments**

THINGS TO THINK ABOUT – cont.

- **How does an investor think about opportunity fund investment versus a like-kind exchange?**

- **In a mixed fund, can the partnership make special allocations?**
  - Use for the developer's "promote?"

- **Does partnership-level nonrecourse borrowing solve all the problems?**
  - What is the tax result of a distribution of refinancing proceeds?

AIAI

STILL MORE – THINGS TO THINK ABOUT

- **Can a fund hold multiple properties?**
  - **How does the Fund structure an exit?**
- **State law conformity/nonconformity**
- **Does deferred gain mean roll-over investors start with an adjusted basis of $0?**
  - Investor's allocable share of annual tax loss?
  - Taxation of operating cash flow distributions?

AIAI
Association for the Improvement of American Infrastructure

QUESTIONS