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Opportunity Zones and Their Potential in Economic Development and Disaster Recovery

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OUR AGENDA

- The ABCs of OZ
- *What* is the Opportunity Zone incentive
- *Who* can benefit from the Opportunity Zone incentive
- *How* does the Opportunity Zone incentive work
- *How* the Opportunity Zone incentive can contribute to economic development and disaster recovery
- *What* you can do to encourage and facilitate use of the Opportunity Zone incentive – and make your communities competitive for OZ dollars

WHY YOU NEED TO KNOW ABOUT OZ

- Significant tax benefits for investors with capital gains
  - Defer tax until 2026 on capital gains invested in Opportunity Funds
  - 10% increase in basis if investment held 5 years
  - Additional 5% increase in basis if investment held 7 years
  - Capital gain on investments held at least 10 years completely free from federal income tax (state treatments vary)
- Can decrease cost of capital for entrepreneurs and developers
- Incentivizes investment in areas that might otherwise be overlooked, including disaster areas
- Applies to investments in active trades and businesses, real estate, many types of project financing, and more
- A mechanism for impact investing

THE POLICY

- The Opportunity Zone ("OZ") incentive was enacted as part of the tax reform bill in December 2017
- Goal is to spur long-term investment, economic growth and job creation in low income communities
- A descendent of Empowerment/Enterprise Zones, and New Markets Tax Credit; can be combined with other incentives
- 8766 Opportunity Zones across every state, the possessions and the District of Columbia
- NOT a DIY project; upfront planning important to avoid mistakes that could inadvertently disqualify investments

QUALIFYING ACTIVITIES AND BUSINESSES

- Must be a “trade or business”
  - Depending on structure, must be “active”
- Real estate (residential, commercial)
- Manufacturing
- Distribution/warehouse
- Grocery, retail & hospitality
- Medical clinics, day care facilities
- Energy generation, storage, transmission
- Farming
- Transportation and infrastructure
- Research
- Start-ups & incubators

OZ AND DISASTER RECOVERY

- If the Opportunity Zone is a disaster area, OZ can be used to rebuild existing businesses and properties AND to capitalize new businesses and developments
- Generally there is no way for OZ to be used in a disaster area if the area is not a designated Opportunity Zone
  - Some wiggle room if the disaster area abuts an OZ and most of the OZ business or property is in the Opportunity Zone
- Legislation has been introduced in the House and the Senate to create new Opportunity Zones in certain disaster areas
  - H.R. 1851, Disaster Recovery and Opportunity Act of 2019; Meadows (R-NC), Dunn (R-FL)
  - S. 1000, Disaster Opportunity Zones Act; Rubio & Scott (R-FL)

THE PLAYERS

- Investors with capital gains, including businesses, family offices, and impact investors
- Developers, entrepreneurs, farmers, innovators, businesses, universities and other public sector entities who partner with private investors
  - Even tax-exempts should understand the OZ incentive, especially the market impact
- Urban and rural economic development authorities
- Fund sponsors and managers
- Communities, local government and business leaders, faith community in Opportunity Zones
- "People *with* money, people who *need* money, and people who can *manage* money"

THE MECHANICS

CAPITAL GAINS	Individuals and businesses invest unrecognized capital gains in Opportunity Funds	Tax on capital gains deferred as late as 12/31/2026
OPPORTUNITY FUNDS	Opportunity Funds hold at least 90% of assets into Opportunity Zone Property	10% increase in basis after investment held 5 years; 15% total increase in basis if held 7 years
OPPORTUNITY ZONE PROPERTY	Opportunity Zone property is stock, partnership interest or Opportunity Zone business property	Gains on OF investments held at least 10 years are tax free

ANATOMY OF AN OPPORTUNITY FUND

EXAMPLE OF A BASIC OZ MODEL

QUALIFIED OPPORTUNITY ZONE INCENTIVE TIMELINE EXAMPLE

On or before April 27, 2019
Taxpayer contributes the $1M of capital gain to a QOF

QOF makes a timely investment of the $1M in Qualified Opportunity Zone Property

On or before April 27, 2026 (7 years) Taxpayer's basis in investment in QOF increases by another 5% of investment ($50k)

April 27, 2029 (10 years)
Taxpayer sells its investment for $3M and elects to increase its basis to the FMV. No additional tax is owed on the $2M of appreciation.

Oct. 30, 2018
Taxpayer enters into a sale that generates $1M of capital gain

On April 27, 2024 (5 years)
Taxpayer's basis in investment in QOF increases by 10% of investment ($100k)

December 31, 2026
$850k of the $1M of initial capital gains are taxed and the basis in QOF investment increases to $1M

NOTE: For this example, the Taxpayer's initial basis is $0 in the QOF investment and that the Taxpayer's basis in its QOF interest is not adjusted for any reason other than as a result of the steps shown above. Please note that a Taxpayer's basis in its QOF interest may be increased or decreased for other reasons under generally applicable rules of U.S. federal income tax law.

TAX ANALYSIS

- How the 5, 7 and 10 year tax benefits work if $500,000 of capital gains are invested in an OZ Fund

No investment in OZ

- $500,000 capital gains
  * 23.8% (20% capital gains + 3.8% NIIT)
  $119,000 tax owed year 1

5 year investment in OZ Fund

$500,000 capital gains tax deferred
* 90% (10% of gain excluded)
$450,000 of deferred gain recognized
* 23.8%
$107,100 tax owed year 5

(Any increase in value of OZ Fund interest subject to 23.8% tax rate)

7 year investment in OZ Fund

$500,000 capital gains tax deferred
* 85% (15% of gain excluded)
$425,000 of deferred gain recognized
* 23.8%
$101,150 tax owed year 7

(Any increase in value of OZ Fund interest subject to 23.8% tax rate)

10 year investment in OZ Fund

-December 31, 2026:
85% of deferred gain recognized.
$101,150 of tax owed, basis increases to $500,000.

-Disposition of Interest:
Basis stepped up to fair market value of investment at time of sale or exchange; disposition is federal income tax free.

BASIC OZ FUND STRUCTURE

*OZ Fund and/or OZ Partnership may be taxed as a corporation.

POTENTIAL EXIT ISSUES WITH THIS STRUCTURE

*OZ Fund and/or OZ Partnership may be taxed as a corporation.

EXISTING BUSINESSES – SQUARE PEG IN A ROUND HOLE?

- Expand *within* an Opportunity Zone
- Expand *into* an Opportunity Zone
- Expand *beyond* an Opportunity Zone
- Policy is to accommodate existing businesses

- Dilute ownership interest (20% related party rule)
- Lease
- 70% “good” property/30% “bad” property
- Create new business entity in OZ

EXPAND EXISTING BUSINESS INTO AN OZ

1) An Existing Business can invest in new business operations located in an OZ.

2) Care must be taken to minimize the extent to which New Business acquires property from Existing Business, which will not be qualifying OZ property.

3) Business operations must be monitored to ensure compliance with regulations.

4) New Business can act as part of the business operations of Existing Business, including manufacturing products and selling them to Existing Business.

5) After 10 years, Existing Business can take ownership of New Business by purchasing the interests in OZ Fund from Third Party Investor or allowing Third Party Investor to withdraw for consideration.

* OZ Fund and Lower-tier vehicle may be taxed as a corporation

THE DEFINITIONS

- Qualified Opportunity Fund (QOF):
  - Any investment vehicle organized as a corporation or partnership (which can include LLCs) for the purpose of investing in Qualified Opportunity Zone Property
  - Funds can be a mix of capital gains and non-capital gains (but only capital gains share qualifies for special tax treatment)
  - Funds self-certify annually to Treasury whether they meet requirements to comply with the OZ program (Form 8996)

THE DEFINITIONS

- Qualified Opportunity Zone Property (QOZP):
  1. OZ stock in an OZ business
  2. OZ partnership interest (capital or profits) in an OZ business (includes LLCs)
  3. OZ business property (QOZBP)
     - Tangible property used in a trade or business of the QOF
     - Acquired by purchase or lease after 12/31/2017
     - Original use in the OZ begins with the QOF or substantially improved property (improvements at least double basis). Land not considered.
     - Substantially all the use is in an OZ (70% threshold)

THE DEFINITIONS

- Qualified Opportunity Zone Business (QOZB):
  - Substantially all the tangible property owned or leased is OZ business property. 70% threshold applies
  - At least 50% of gross income derived from *active* trade/business. 3 safe harbors & facts & circumstances.
  - Substantial amount of any intangible property is used in the *active* trade or business (40% threshold)
  - Limits on financial property (deter passive investment)
    - 31 month safe harbor for working capital
    - May maintain assets in cash or equivalents
  - No “sin” businesses

DIRECT INVESTMENT OR EQUITY INTEREST?

- Three primary reasons why equity interest may be preferable
  - 70% “substantial” test for tangible assets
  - 31-month safe harbor for working capital
  - Additional buffer for cash-on-hand

OTHER TERMS AND CONDITIONS

- Must invest in QOF within 180 days after recognizing capital gain (day 1 is date of transaction)
  - For pass-through gain, 180 days can begin on last day of entity's taxable year
  - For 1231 net gains, 180 days begins on last day of taxable year
- Stock/partnership interest and tangible property must be acquired post 12/31/2017
- Related party rules apply (20% threshold)
- Can invest until 2026 (but may not qualify for all the benefits by waiting) and hold until 2047
- Failure of QOF to meet 90% test may result in penalties
  - Can disregard new investments within prior 6 months
  - 1 year to reinvest gains

OTHER TERMS AND CONDITIONS

- Investors can invest in a QOF located anywhere
- QOF can invest in QOZBP located anywhere
- May “twin” with New Markets Tax Credit and other federal, state, and local incentives
- States vary in conforming with Federal rules

FIRST ROUND OF PROPOSED REGULATIONS

- Substantial improvements do NOT include land costs
  - More projects will qualify
- "Substantially all" threshold for tangible property held by a QOZB is 70% (compared to 90% for direct investment in tangible property by a QOF)
  - Some property could be outside the OZ or acquired prior to 12/31/17
- For QOZB, 31 month safe harbor for working capital if used for acquisition, construction, or substantial improvement of tangible property (now extended to business start-ups)
  - Must have a written plan
  - More liberal treatment of "dead" cash will help avoid penalties

FIRST ROUND OF PROPOSED REGULATIONS

- LLCs OK (except single member)
- Only capital gains qualify for OZ benefits
- Pass-throughs can invest in QOF
- 180 day investment period extended in some cases – more time for investors
- Can hold investments until 2047 – fosters long-term commitment
- An “eligible entity” can delay QOF status
- QOF use Form 8996 to self-certify
- Investors use Form 8949 to elect OZ treatment
- Investors file Form 8997 to track investment activity Y/Y

SECOND ROUND OF REGULATIONS

- "Original use" means first depreciated or "reboot" after 5 years
- Leases qualify as an acquisition. Normal related party, original use and substantial improvement tests don't apply, but special rules do
- Vacant land: Original use and substantial improvement tests don't apply, but must be used in an active trade or business. No land banking.
- Aggregation: Parcels cannot be aggregated for purposes of the substantial improvement test
- Property straddling QOZ and non-QOZ may count toward meeting some QOZB tests if value in QOZ exceeds value outside QOZ

SECOND ROUND OF REGULATIONS, cont.

- 50% test: Does not require that 50% of sales arise within the QOZ. Facts & circumstances and 3 safe harbors:
  - 50% of compensation paid
  - 50% of hours worked
  - Combination of management/control and tangible property to earn 50% of revenue
- Working capital safe harbor extended to development of operating businesses

SECOND ROUND OF REGULATIONS, cont.

- Substantially all thresholds:
  - At least 90% of the time the QOF holds property, at least 70% of the use of the property must be in the QOZ
  - A QOZB must be a QOZB at least 90% of the time the QOF holds an equity interest in the business
  - 40% of intangibles must be used in the QOZB
- These round out other thresholds established in statute and first round regulations:
  - At least 70% of QOZB tangible property must be qualified OZ business property (first regs)
  - At least 50% of gross receipts must be from active conduct of business in the OZ (statute)
  - Less than 5% of basis in QOZB assets may be nonqualified financial property (statute)

SECOND ROUND OF REGULATIONS, cont.

- 1231 gains not determinable until 12/31; 180 day period begins then
- 10-year QOF investors can elect to exclude capital gains on sales by the QOF of QOZP (tangible property, equity interest).
- Deemed sale rules apply if distributions within first two years
- Taxpayer can qualify for OZ incentive by purchasing QOF interest from third party
- Carried interest does not qualify for OZ benefits
- Property may be contributed to a QOF, not just cash (up to amount of qualified capital gains)

SECOND ROUND OF REGULATIONS, cont.

- Default rule (with exceptions): transfers in ownership/changes in structure trigger recognition of deferred capital gain
  - Transfers upon death or to grantor trust don't trigger recognition
  - Gifts and charitable contributions do trigger recognition
  - Changes in partnership structure may trigger recognition
  - Greater than 25% change in S corporation ownership triggers recognition
  - *Can* contribute partnership QOF interests to another partnership without triggering gain
    - *But* taxable distributions from a partnership QOF generally accelerate gain recognition, dilute benefit of OZ investment

SECOND ROUND OF REGULATIONS, cont.

- QOFs have one year to reinvest sale proceeds back into tangible property or a QOZB without triggering the 90% penalty
- Investments into QOFs within the previous 6 months do not have to be included in the 90% test
- Inventory in transit counts toward 90% test
- “Know it when you see it” – general anti-abuse rule (GAAR)

TREASURY STILL CONSIDERING

- Reporting on impact of OZ investments to communities
- “Substantially all” definitions
- Original use definitions
- Treatment of land
- “Substantial improvement” definitions
- Treatment of inventory
- Leased property rules and valuations
- Whether straddled property rules can be applied more broadly
- 50% test
- Trade or business definitions

TREASURY STILL CONSIDERING, cont.

- Whether 1397C (50% income, 40% intangibles, <5% NQFP) should be extended to QOF
- Treatment of 1231 gains
- Whether to extend 12 month reinvestment rule to QOZBs
- Burdens to reset QOF holding period if capital gains reinvested
- Amount of deferral with contributed property – basis v. FMV
- Inclusion events
- Timing of basis adjustments
- Inside/outside basis and potential for abuse
- Accounting for mixed funds

TREASURY STILL CONSIDERING, cont.

- Ownership changes in S corporations
- Disparate results from sale of property
  - Sale of QOF interest in tangible property or QOZB
  - Sale by QOF of QOZBP
  - Sale by QOZB of property
- Whether to extend 10 year exclusion election to QOZBs
- Treatment of boot in an exclusion event
- Treatment of certain corporate distributions
- Treatment of QOF stock as not stock for consolidated rules
- GAAR
- Burden on small business
- FINAL REGS BY YEAR-END!

GENTRIFICATION CONCERNS

- Statute and current regulations don’t require impact accountability
- Congress working on legislation
- Treasury planning to revise Form 8996 to require limited QOF reporting
- Some localities imposing their own information reporting
- Voluntary standards to demonstrate impact investment

MYTHS AND MISPERCEPTIONS (the answer is “NO!”)

- OZ is just a big giveaway for the rich (NYT).
- The OZ rules are so onerous that they are not worth the candle.
- The OZ rules are not yet defined enough for projects and businesses to proceed.
- Treasury has to approve an Opportunity Fund.
- You can invest directly and not through an Opportunity Fund.
- There’s wiggle room in the 180 day investment period.

MYTHS AND MISPERCEPTIONS (the answer is “NO!”)

- Non-capital gains can qualify for OZ benefits.
- You can manipulate the rules to hold land for speculation.
- A building always has to be entirely in an OZ.
- Leased property won’t work.
- ALL types of businesses qualify.
- QOZBs can own QOZBs.
- Lots can be aggregated to meet the substantial improvement test.
- OZ is a DIY project.

OTHER PENDING QUESTIONS ABOUT OZ

- Legislative proposals
  - Technical Corrections
  - Disaster OZ
  - Customs duties relief
  - Lead remediation
  - Minority businesses
  - Infrastructure OZ
  - Accountability and milestones
    - Concerns about gentrification
    - Affordable and workforce housing
    - Number of jobs created
    - Quality of life

AFTER REGS, HERE COMES THE IRS

- OZ guidance doesn't end with final regulations
- IRS will need to develop procedures and processes to administer and enforce OZ
  - Will the IRS have a dedicated OZ audit or oversight program?
  - What could trigger an IRS determination that a fund is not a qualifying fund?
    - What constitutes "reasonable cause" for a QOF failing to meet the 90% test?
    - How long will the QOF have to come into compliance?
    - What will be the penalty process?
    - Will the IRS contact partners directly?
  - What information reporting will the IRS require?
  - What substantiation will the IRS require, e.g., to establish "substantially all" thresholds are met?
  - What information will the IRS require in a written plan?
  - Will the IRS have a system to track reporting in 2026 and ultimate disposition of QOF investments?

QUESTIONS? PLEASE CONTACT:

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