

Qualified Opportunity Zones – The Land of OZ?

2020 Presentation





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Agenda

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 Creation and Policy

 Current Guidance & Resources

 Tax Benefits

 OZ Geography



2. OZ Rules

Investor

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3. Structure Options

- Single Investor vs Multi Investor
- One Tier vs Two Tier
- Single Asset vs Multi Asset



4. Observations

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 Tax Observations



1. Background



Creation and Policy



Current Guidance & Resources



Tax Benefits



OZ Geography



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Background Creation and Policy

- Qualified Opportunity Zones Legislation
 - Created by the 2017 Tax Cuts and Jobs Act
- Policy
 - Designed to incentivize taxpayers to invest into economically distressed communities designated as OZs through investment vehicles called Qualified Opportunity Fund (“QOF”).

Background

Current Guidance & Resources

- IRS OZ FAQ website (general information)
- IRS Notice 2018-48 (list of designated OZs)
- Form 8996 and Instructions (QOF self-certification and annual reporting)
- Form 8949 and Instructions (taxpayers make capital gain deferral elections)
- Revenue Ruling 2018-29 (guidance on treatment of OZ land)
- **Final Regulations (Issued December 31, 2019, Effective March 20, 2020)**



Background Tax Benefits



Deferral

Deferral: Upon investment of capital gain into a QOF, gain is deferred from inclusion in taxpayer's income until the earlier of December 31, 2026, or an "inclusion event."



Tax Reduction

Tax Reduction: When deferral period ends,

- if QOF investment held for 5+ years, deferred gain is reduced by 10%;
- if QOF investment held for 7+ years, deferred gain is reduced by 15%.



Exclusion

Exclusion: If QOF investment is held for 10+ years, taxpayer is exempt from paying tax on gain realized on sale of QOF investment (or in some cases the sale of QOF's assets).



Background

Comparison of Tax Benefits

- Capital gain from sale of real estate
 - §1400Z-2 – Qualified Opportunity Zone
 - §1231 – Like Kind Exchange
- Capital gain from sale of business
 - §1400Z-2 – Qualified Opportunity Zone
 - §1202 – Qualified Small Business Stock
 - §1045 – Rollover Gain into Qualified Small Business Stock
- Other capital gain
 - §1400Z-2 – Qualified Opportunity Zone

Background

OZ Geography

- Census tracts in every State that are “low-income communities” (determined based on the income of residents) were eligible for QOZ nomination and designation.
- QOZs were nominated by the applicable State governor and then designated by the Secretary of Treasury
- The number of QOZs was generally limited to 25% of the total number of low-income communities in the State (100% for Puerto Rico)
- Low Income does not necessarily equal disadvantaged; e.g. college campuses

Background

OZ Geography

- The nomination and designation process has ended and there is no process to designate additional zones
- The designations expire at the end of 2028. But the important things are :
 - Investments can only be made with respect to a sale or exchange before January 1, 2027
 - The expiration of the designation will not affect the availability of the tax exclusion benefit for existing investments
 - The regulations allow for taxpayers to make the election for the tax exclusion benefit up until December 31, 2047

<https://charlottenc.gov/ED/Development/Pages/OpportunityZones.aspx>

2. OZ Rules

Investor

QOF

QOZ Property



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The OZ Participants

Typical Private Equity

Investor

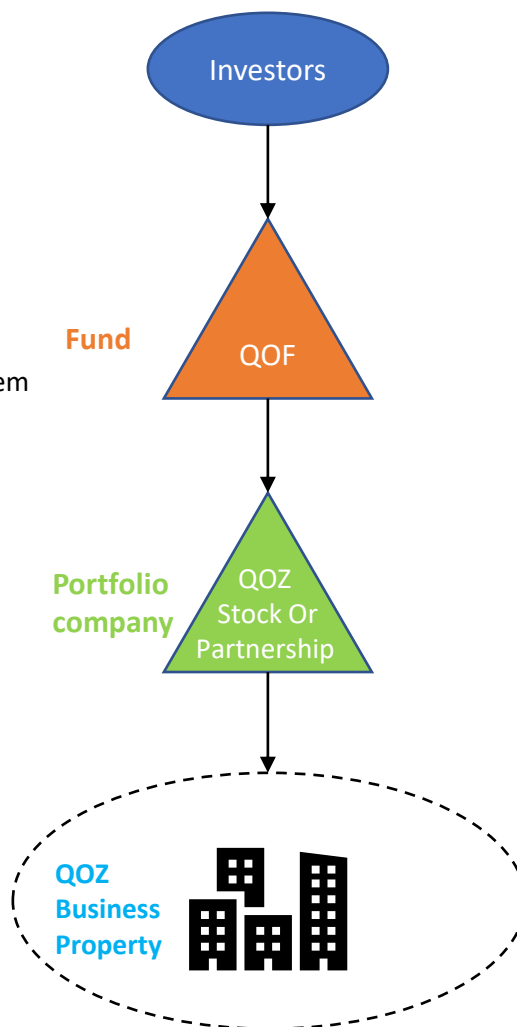
- Taxpayer with invests in fund
- Preferred return, plus X% of gain on exit

Fund

- Raises funds and sets up structure
- Finds suitable investments and manages them
- Return – 2%/20%

Portfolio Company

- Growth business



Opportunity Zone Private Equity

Investor

- Must invest capital gains to obtain tax benefits
- Receives tax benefits in addition to return on investment

Qualified Opportunity Fund “QOF”

- QOF must satisfy various requirements
- Carried interest does not receive OZ benefits

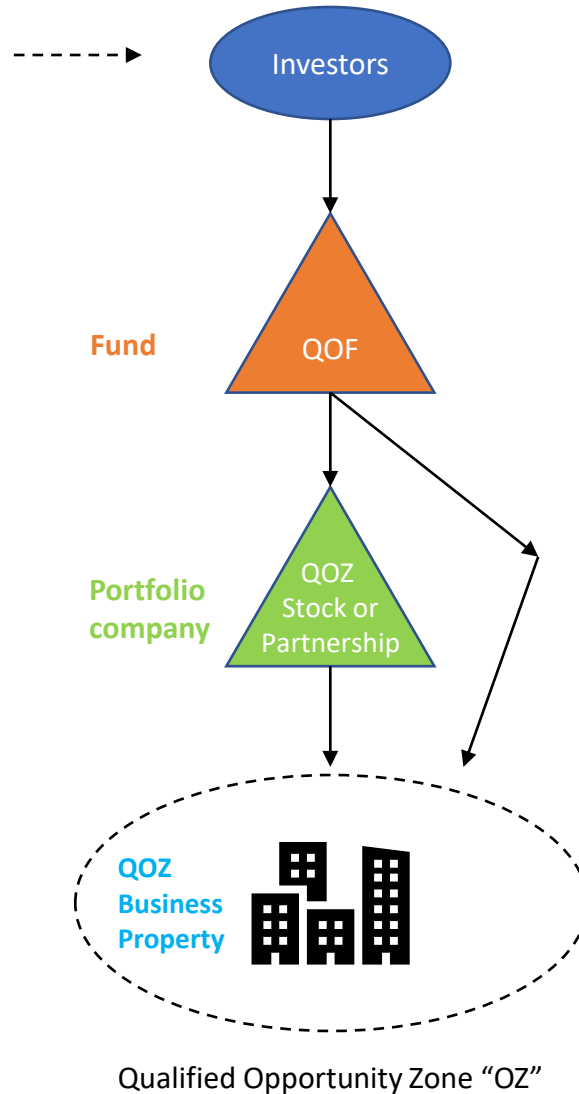
Qualified Opportunity Zone Property

- Business and assets owned by QOF must satisfy various requirements or pay an interest charge.
- No OZ benefits

Investor Overview

Investor Requirements

- Capital gain from sale to unrelated party
- Investor has 180 days to invest into a QOF
- File election with tax return



Investor

Deferral of Eligible Gain

- Eligible gain
 - Most types of capital gain eligible, including gross 1231 gain
 - Can be short-term or long-term capital gain
 - Only capital gain amount eligible, not gross proceeds
 - Arise from sale or exchange with unrelated person
 - Gain must be recognized before 12/31/2026
 - Not from straddle

Investor

180 Day Period

- To be eligible for OZ tax benefits, investor must invest capital gains in a QOF within a 180-day period.
 - 180-day period generally begins on day gain would be recognized
 - Pass-through entities, if they do not elect to defer – 180 days for owner begins on last day of pass-through entity tax year, or by election: (i) date entity realized gain or (ii) due date of pass-through return (w/o extension)
 - Installment Sale – When (i) installment payment received or (ii) on last day of each shareholder's tax year with gain
 - RICs and REITs – When (i) capital gain dividend paid or (ii) on last day of shareholders tax year

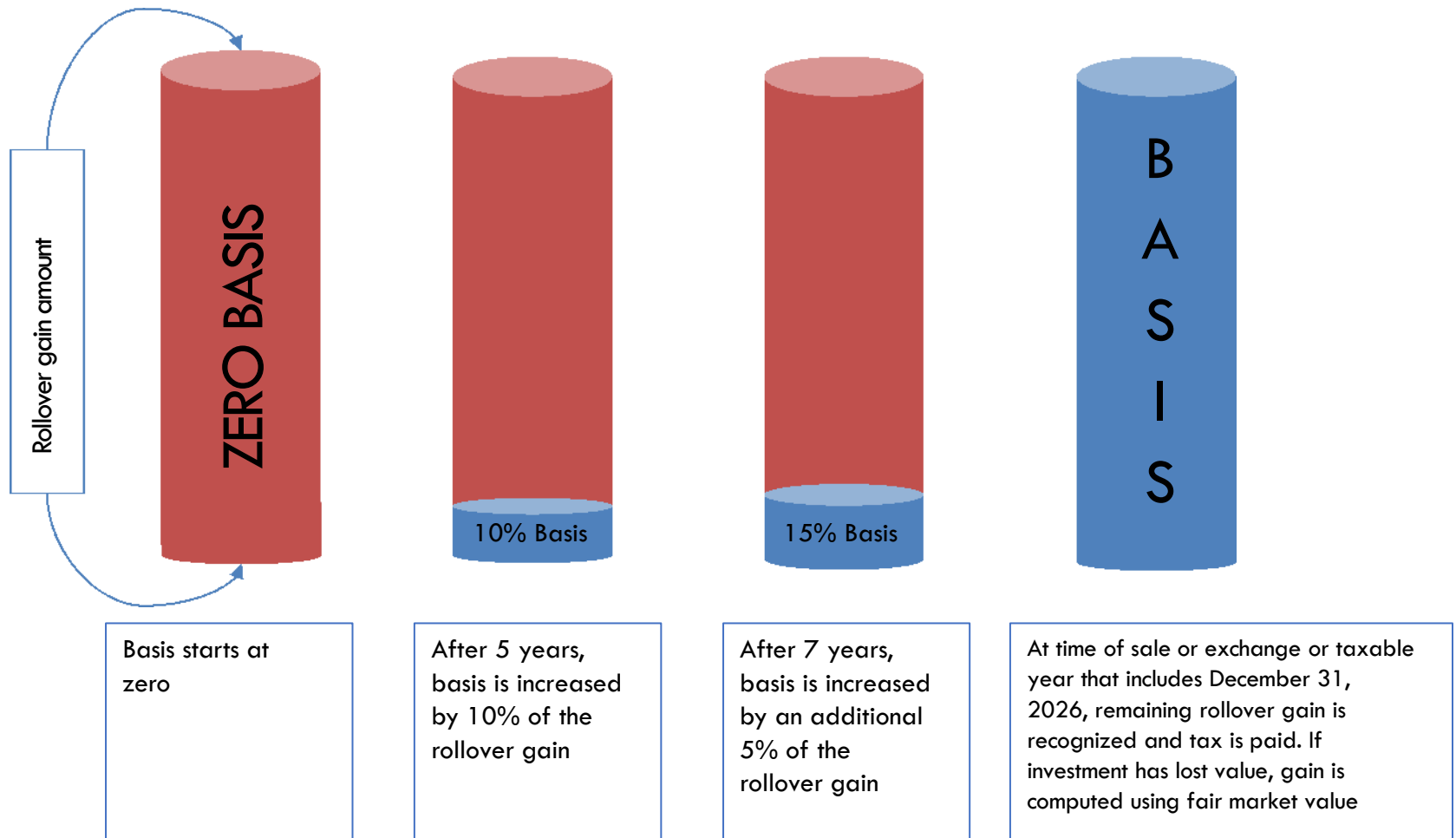
Investor Election and Reporting

- Must make election to defer gain on Form 8949
 - See IRS website for making election for 1231 gains
- Rules for partnerships –
 - If partnership elects to defer capital gain, it must notify partners
 - If partnership does not elect, partners may elect but must notify partnership
- Annual Reporting – Taxpayer must report annually on Form 8997 as to whether gains remain deferred.
- Exclusion Election – Election filed with tax return for year of sale

Investor Mixed-Funds Investment

- If a taxpayer invests capital gain and other amounts into a QOF, the taxpayer would be considered as holding two separate investments. Tax benefits are available only related to the capital gain portion.
- If property with a fair market value in excess of basis is contributed to a QOF, the amount in excess of basis is treated as a separate investment.
- Carried interest creates separate investment that does not provide tax benefits
- Some QOFs prohibit “other investments” as accounting / record keeping more complicated

Investor Basis Adjustments



Investor

End of Capital Gain Deferral

- Investor in QOF must pay tax on deferred gain on the earlier of:
 - December 31, 2026
 - An “inclusion event”.
- Regulations list several inclusion events – Be careful!
 - Transfer of QOF (sale, gift, divorce, death, etc...)
 - Termination or liquidation of QOF or QOF owner
 - Example: election or termination of S election
 - Distributions in excess of basis
- Inclusion events end deferral and opportunity to make exclusion election.
 - Exception for distributions in excess of basis

Investor

Exclusion of Gain – Sale of QOF

- If sell QOF after 10 years, taxpayer may elect to increase basis in QOF to fair market (and thereby exclude gain on sale).
 - Election is filed with timely filed tax return
- The regulations allow for taxpayers to make this election until December 31, 2047



Investor

Exclusion of Gain – Sale of Property by QOF

- When a QOF partnership or S corporation is held for at least 10 years, the taxpayer may elect to exclude all gains and losses (except related to inventory sold in the ordinary course of business) from income related to the sale of its QOZ Property which is allocable to the qualifying investment .
- If election is made, and cash not distributed within 90 days, there is deemed to be a distribution and recontribution in exchange for new non-qualifying investment.
- Any other gains realized by the QOF from the sale of a QOF asset would be subject to tax under the regular rules of taxation.



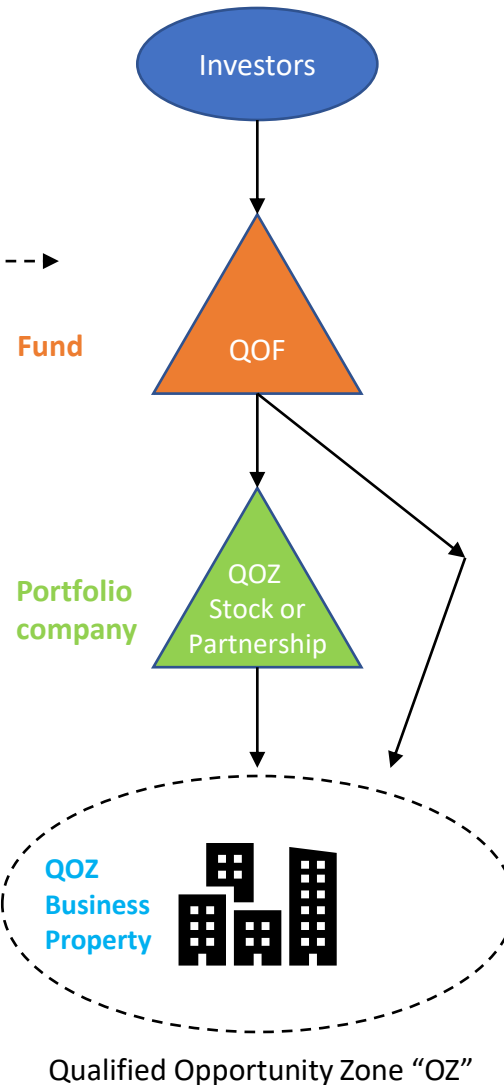
QOF Overview

Qualified Opportunity Fund “QOF” Requirements

- A partnership or corporation formed for purpose of investing in QOZ Property
- Elects to be treated as QOF
- QOF must invest 90% of assets in QOZ Property, which includes: QOZ Stock, QOZ Partnership, or QOZ Business Property

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Fund



QOF

General Requirements

- A QOF must either be a corporation (including a RIC or a REIT) or a partnership
- There is no application or approval process to become a QOF. Instead, an entity simply elects QOF status.
- QOFs must file Form 8996 with their annual income tax return, certifying QOF status.
- QOFs must hold at least 90% of their assets in Qualified Opportunity Zone Property (QOZ Property).
 - Test is measured by the average taken at 6 months and EOY
- A pre-existing entity may elect to be a QOF
 - Only asset acquired after 2017 count toward 90% test

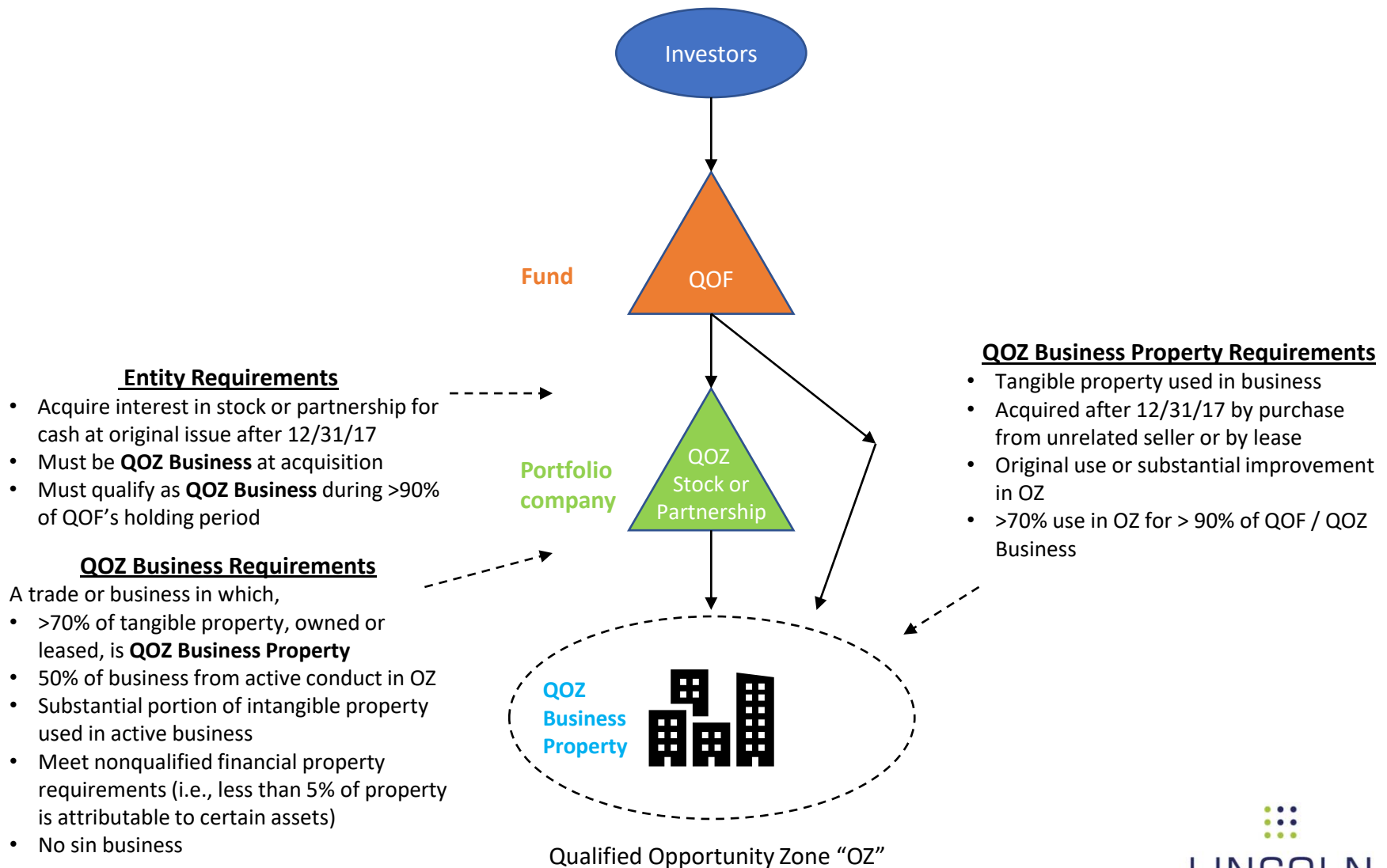
QOF

90% Requirement

- There are penalties for failure to comply with 90% requirement
 - Penalty equals the shortfall times (short term rate + underpayment rate)
 - Taxpayer can show reasonable cause
- Special rules that help in complying with 90% requirement
 - New capital investments in the QOF (i.e., contributions received in the prior six months) will not be included in the semi-annual testing
 - Proceeds from sales of the QOF's underlying QOZ property will not result in penalties if reinvested in new QOZ property within a year
 - The new investments and sales proceeds (noted above) must be kept as cash, cash equivalents or debt instruments with a term of 18 months or less
 - Safe harbor for QOF to determine compliance for QOZ Stock or QOZ Partnership - one six-month cure period provided
 - Tangible property of a QOZ business that ceases to be QOZ Business Property can continue be treated as QOZ Business Property for 5 years



QOZ Property Overview



QOZ Property

Types of QOZ Property

- QOZ Property
 1. Qualified Opportunity Zone Stock (**QOZ Stock**) or Qualified Opportunity Zone Partnership Interest (**QOZ Partnership**)
 - Entity requirements,
 - QOZ Business requirements, and
 - QOZ Business Property requirements.
 2. Qualified Opportunity Zone Business Property (**QOZ Business Property**)
 - QOZ Business Property requirements.

QOZ Property

QOZ Stock / Partnership: Entity Requirements

- The entity must be a corporation or partnership (cannot be a single member LLC) formed in the US or a US territory.
- The entity interest must be acquired from the entity, solely for cash, after December 31, 2017
- The entity must be a QOZ Business at the time of acquisition ; or, if the entity is new, it must be organized for the purpose of being a QOZ Business.
- The entity must qualify as a QOZ business during substantially all (90%) of the holding period of the entity interest
- For QOZ stock, cannot exceed redemption limits



QOZ Property

QOZ Stock / Partnership: QOZ Business Requirements

- A trade or business, as defined by IRC §162.
- 70% of all tangible property is **QOZ Business Property**;
- 50% of gross income is derived from active conduct of trade or business in the QOZ;
 - Measurement of 50%: (1) service hours, (2) service revenue, (3) tangible property and business functions, & (4) facts and circumstances
 - Active Conduct:
 - Ownership and leasing of real property can qualify
 - Speculation of land does not qualify

QOZ Property

QOZ Stock / Partnership: QOZ Business Requirements

- 40% of intangible property is used in the active conduct of a trade or business.
- Less than 5% of the property is attributable to nonqualified financial property
 - Includes stock, debt, partnership interest, other similar
 - Excludes reasonable amounts of working capital held in cash or short-term debt (i.e., 18 months)
 - 31 month safe harbor for working capital. Can be extended.
- Does not operate or lease more than de minimis amount of property to sin business (e.g., massage, alcohol, other)

QOZ Property

QOZ Business Property Requirements

- Tangible property must be used in trade or business
- Tangible property acquired by purchase (from unrelated party) or lease after 12/31/2017
 - There is no plan for seller to reacquire for other than FMV
 - Special rules for property manufactured or produced
- During 90% of the holding period or lease term of the tangible property, at least 70% of the use is in a QOZ.
There are safe harbors for:
 - Tangible property used in rendering service inside and outside a QOZ,
 - Tangible property owned by leasing business with offices in a QOZ, and
 - Inventory in transit.



QOZ Property

QOZ Business Property Requirements

- For purchased tangible property, it must satisfy one of the following:
 - The original use of the tangible property in the QOZ commences with QOF or QOZ Business (the “**Original Use Requirement**”), or
 - The QOF or QOZ Business substantially improves the tangible property (the “**Substantial Improvement Requirement**”).
- For leased tangible property:
 - The lease is arm’s length
 - There is no plan that lessee purchase for other than FMV
 - If the lessor and lessee are related (i) no prepayment of rent > 12 months, and (ii) if **the original use** of leased personal property in the QOZ does not commence with the lessee, lessee must purchase tangible property equal in value to leased property



QOZ Property

QOZ Business Property: Original Use Requirement

- QOF must be first to use property in the QOZ. Original use commences when property is placed in service in the QOZ.
 - **Existing Structures** – Generally cannot qualify for original use.
 - **Vacant Land and Building** – Can meet the original use requirement if certain requirements met.
 - **Used Property** – Used tangible property satisfies original use requirement if not previously used or placed in service in that QOZ.



QOZ Property

QOZ Business Property: Substantial Improvement Requirement

- For tangible property previously used in a QOZ, QOF must, within 30 months, invest an amount greater than unadjusted basis in tangible property (excluding land basis).
 - For buildings located on land in QOZ, must substantially improve the building, but not the land
 - Not required to substantially improve unimproved land, but it will not be considered QOZ Business Property if acquired without intent to improve by more than insubstantial amount.
 - Two or more buildings in a single QOZ or in continuous QOZs may be aggregated for purposes of substantial improvement test, if certain requirements met



Summary of Requirements

Investor Requirements

- Capital gain from sale to unrelated party
- Investor has 180 days to invest into a QOF
- File election with tax return

Qualified Opportunity Fund “QOF” Requirements

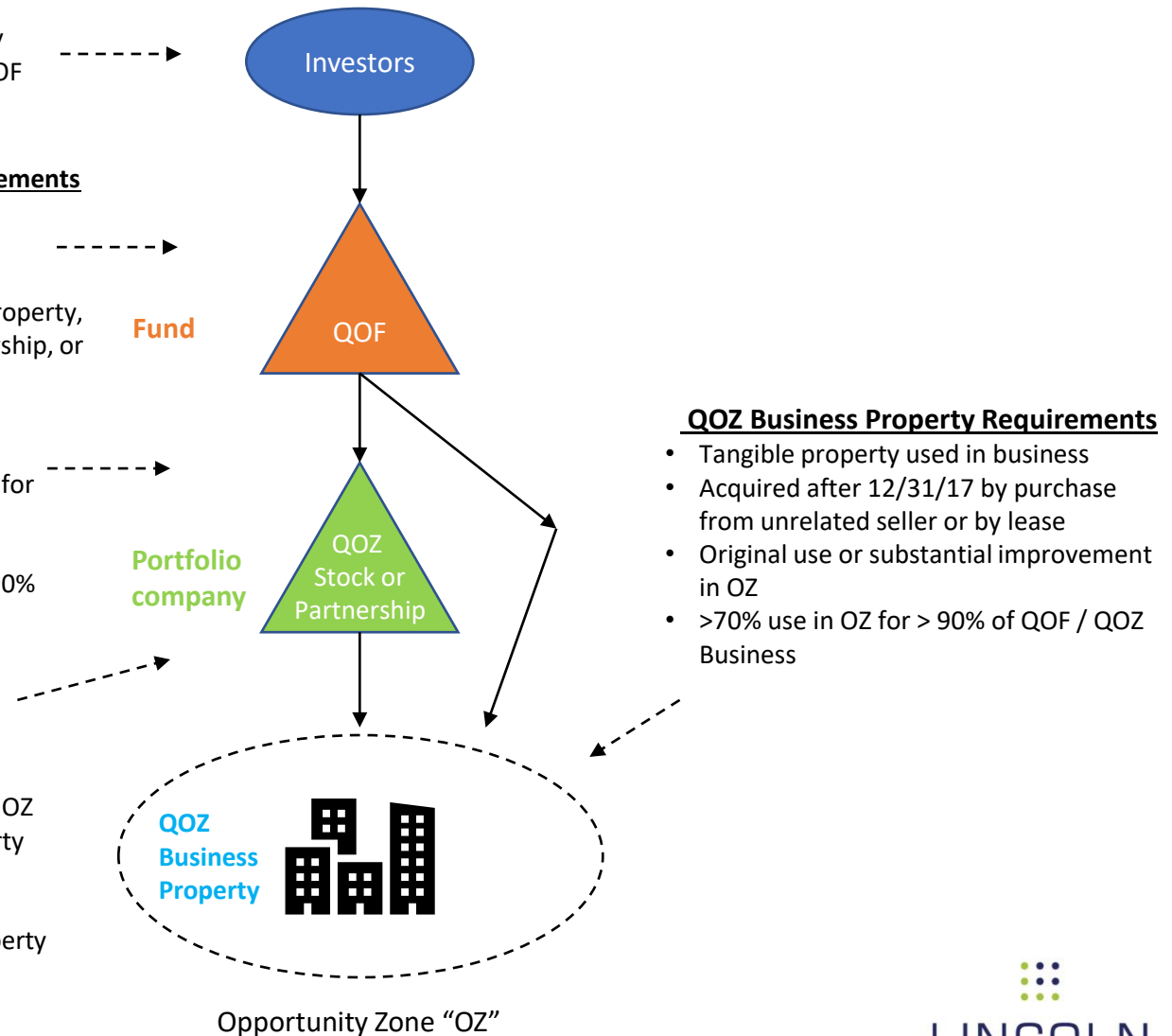
- A partnership or corporation formed for purpose of investing in QOZ Property
- Elects to be treated as a QOF
- QOF must invest 90% of assets in QOZ Property, which includes: QOZ Stock, QOZ Partnership, or QOZ Business Property

Entity Requirements

- Acquire interest in stock or partnership for cash at original issue after 12/31/17
- Must be **QOZ Business** at acquisition
- Must qualify as **QOZ Business** during >90% of QOF’s holding period

QOZ Business Requirements

- A trade or business in which,
- >70% of tangible property, owned or leased, is QOZ Business Property
 - 50% of business from active conduct in OZ
 - Substantial portion of intangible property used in active business
 - Meet nonqualified financial property requirements (i.e., less than 5% of property is attributable to certain assets)
 - No sin business



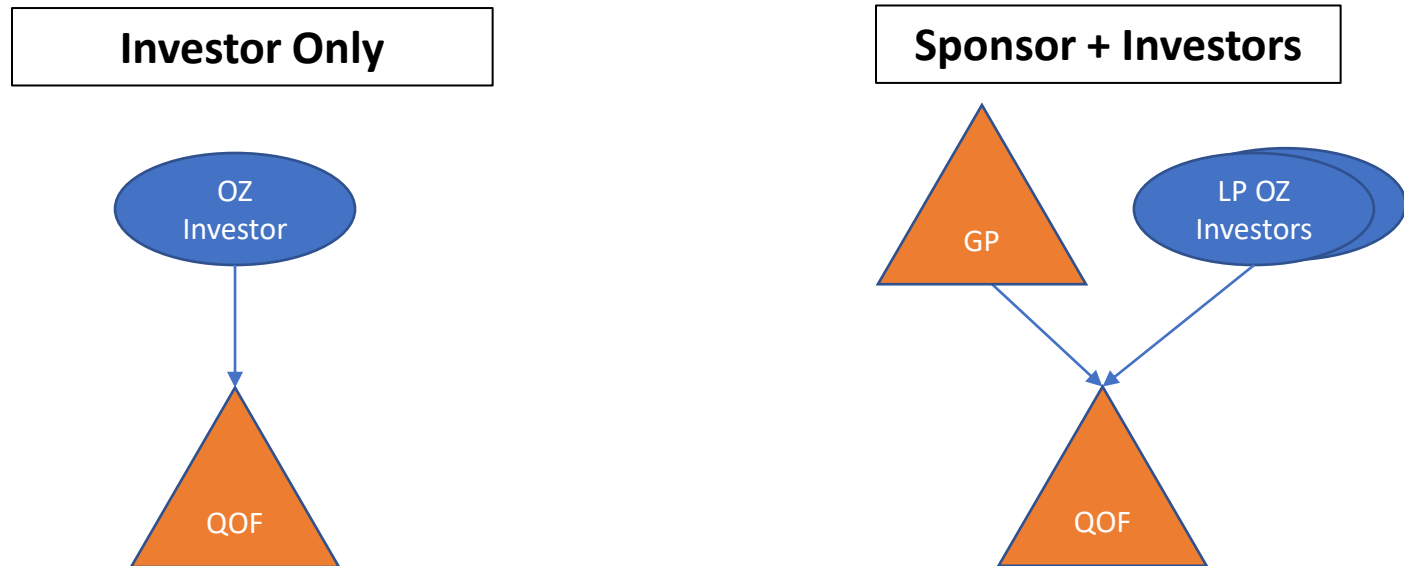
3. Structure Options

- Single Investor vs Multi Investor
- One Tier vs Two Tier
- Single Asset vs Multi Asset



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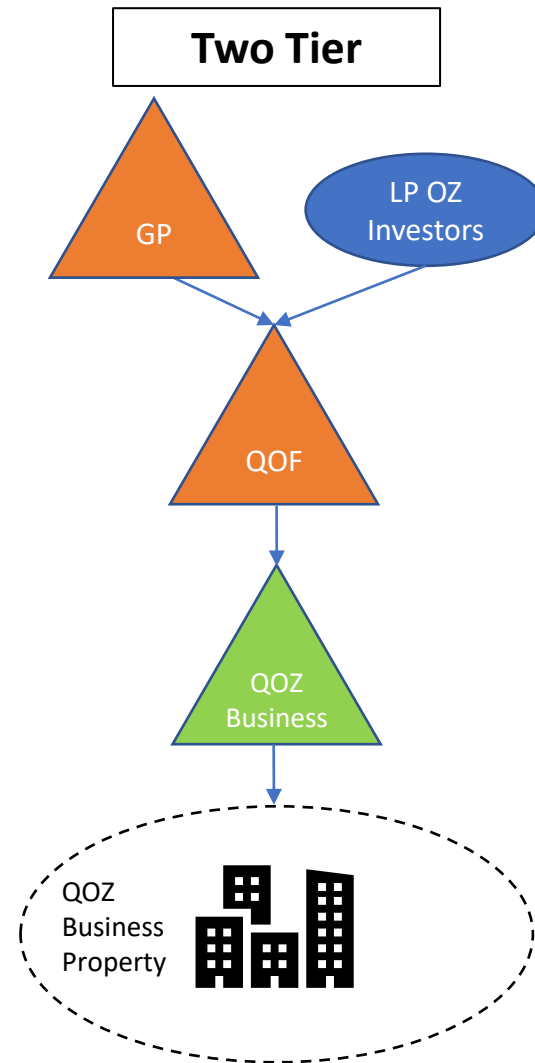
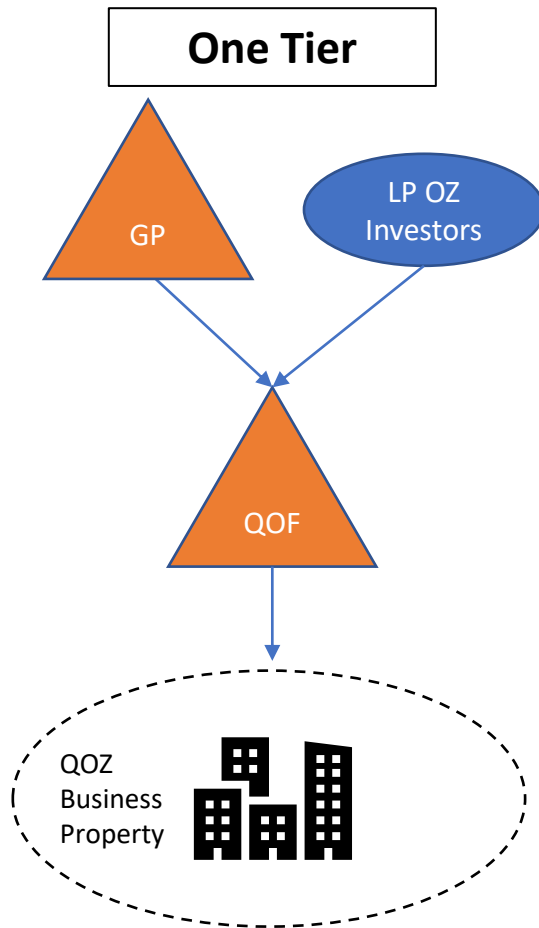
Single Investor vs Multi Investor



Single Investor vs Multi Investor

- Observations – Single Investor
 - Generally friends & family best terms for investors
 - Typically smaller transactions - \$5-10MM of equity
 - Frequently “local” – often in markets that are not yet the focus of larger scale investors
 - QOF and QOZ Business can borrow money

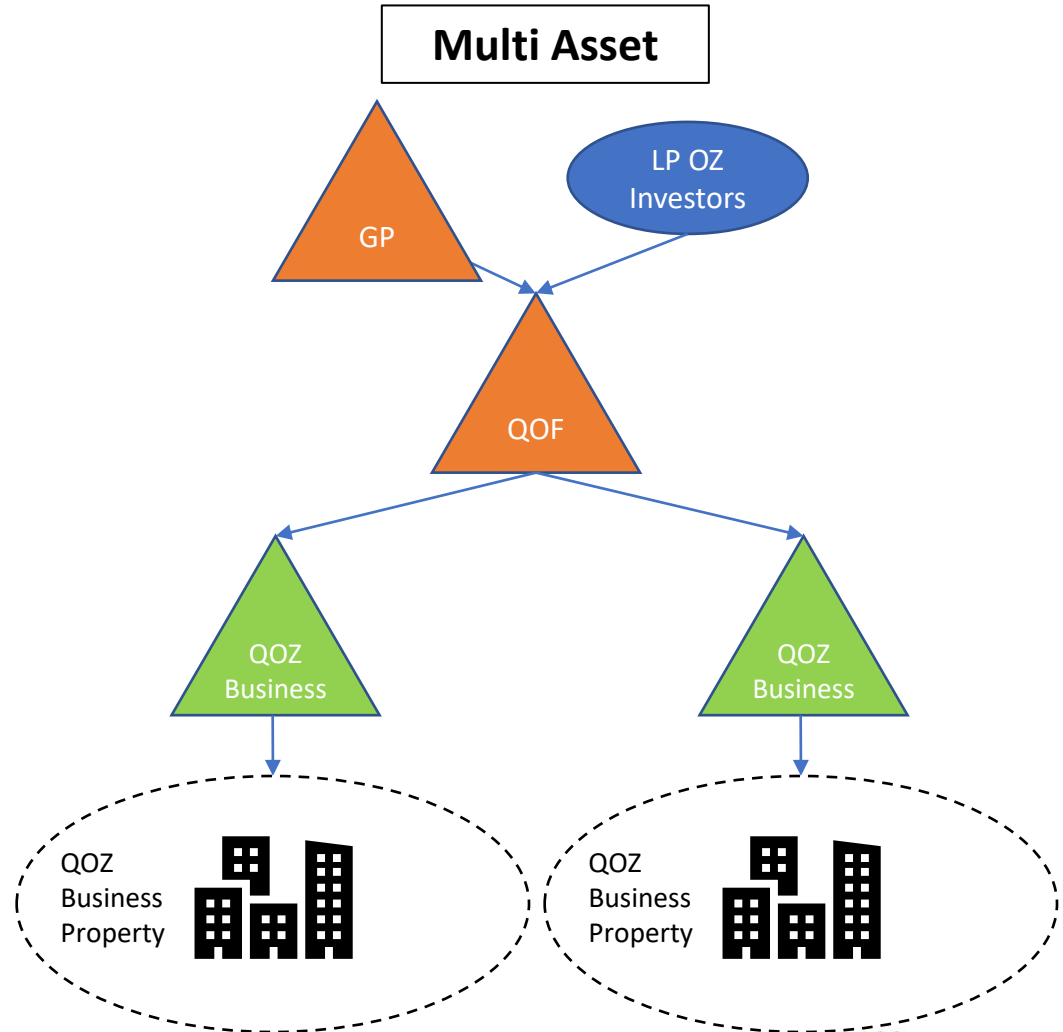
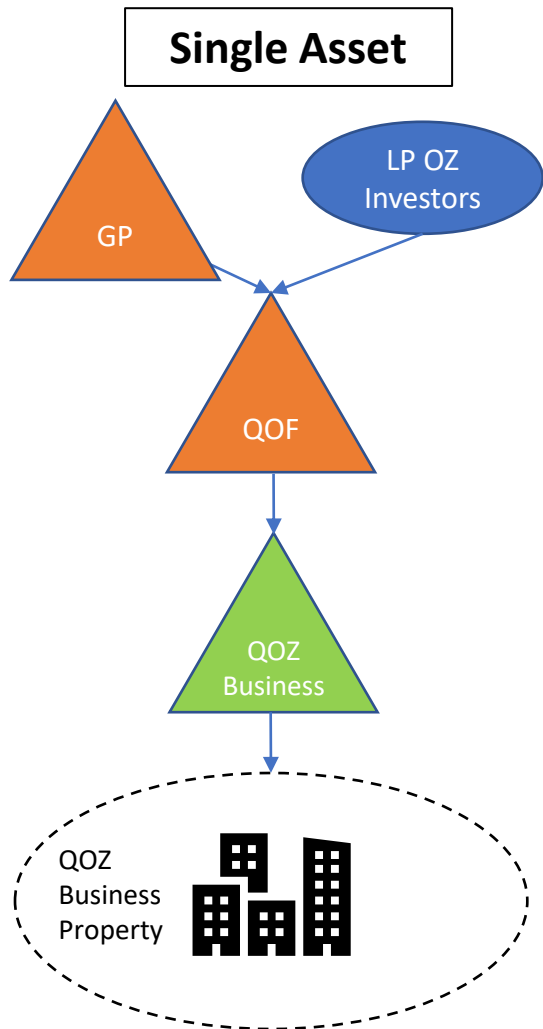
One Tier vs Two Tier



One Tier vs Two Tier

- Observations -Two Tier
 - Additional requirements to comply with definition of QOZ Property.
 - Entity requirements
 - QOZ Business requirements
 - But, only 70% of tangible property needs to meet QOZ Business Property requirements.
- Observations - One Tier
 - No limit on type of businesses; but, 90% of assets must be tangible property that meets QOZ Business Property requirements

Single Asset vs Multi Asset



Single Asset vs Multi Asset

- Observations – Single Asset
 - Favorable deal terms
 - Real estate professional or developer has identified a specific site
 - Exit in 10 years may be easier
- Observation – Multi Asset
 - Least favorable terms
 - Typically pools of 5-10 assets or more

4. Observations



Market
Observations



Tax
Observations



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Market Observations

- Commercial Real Estate
- Development and Renovation in Opportunity Zones
- Opening New Business in Opportunity Zones
- Expansion of Existing Businesses into Opportunity Zones
- Large Expansions of Businesses already within Opportunity Zones

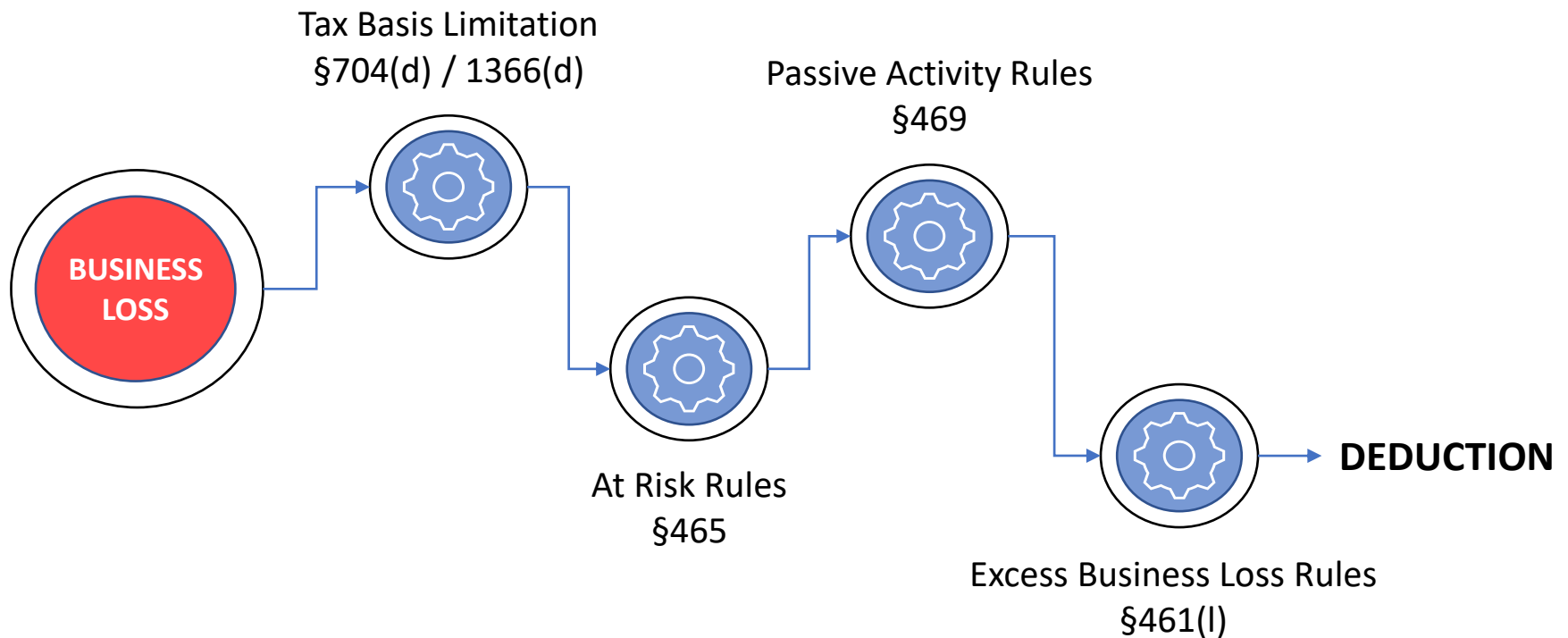
Market Observations

- Real Estate
 - Real estate development popular
 - Buying and leasing improved real estate possible; but, would need to substantially improve building.
 - Repairs do not qualify
- Other Businesses
 - Opportunity greater for new businesses than pre-existing businesses
 - Manufacturing
 - Services (e.g., Internet Co)
 - Rules regarding leased property allows service businesses to qualify

Tax Observations

- When is real estate considered “used in a trade or business”?
 - QOF is using real estate for its operating business
 - QOF is investor in real estate
 - QOF is dealer in real estate
- Related party issues
 - Anti-abuse rules
 - Leases have advantages
- Distributions from QOF
 - Less than basis
 - In excess of basis
- Can be combined with other tax benefits:
 - Low-income housing tax credit
 - Rehabilitation tax credit
 - Like-kind exchange
 - Renewable electricity production tax credit
 - New Markets tax credit
- How can individuals make use of losses?

Loss Limitation Rules: Individuals



Transactional Series Presentations

1. UNDERSTANDING THE TAX SECTIONS (BOILERPLATE) OF OPERATING AGREEMENTS
2. OPPORTUNITY ZONES – THE LAND OF OZ?
3. TOP SIDE PLANNING FOR PRIVATE EQUITY
4. U.S. INBOUND & OUTBOUND INTERNATIONAL TAXATION

THANK YOU!

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