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OPPORTUNITY ZONES: MORE THAN A PRIMER

Presented to: Redbrick LMD Interested Potential Investors

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AGENDA

- Why invest in an Opportunity Zone?
- Where are the Qualified Opportunity Zones?
- How did Opportunity Zones come to be?
- Steps in the Opportunity Zone investment process.
- Qualified Opportunity Zone Business Property.
- “Substantial improvement.”
- Some of the things to think about.
- Questions and (hopefully) answers.

WHY INVEST IN AN OPPORTUNITY ZONE FUND?

- The short answer . . . If the investor meets the requirements (of which there are many), the investor can:
- Defer federal income tax on recognized capital gains,
- Have a portion of that deferred gain forgiven, and
- Avoid federal income tax on gain from the disposition Opportunity Zone investment.

WHERE ARE THE QUALIFIED OPPORTUNITY ZONES?

- *Notice 2018-48*, 2018-18 IRB 9. 8,700+ Opportunity Zones.
- Listed by State, county and census tract.
- Interactive map: Treasury’s Community Development Financial Institutions Fund website.
- https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml
- Some of the locations may pleasantly surprise folks . . . Combination of timing and gentrification.

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HOW DID OPPORTUNITY ZONES COME TO BE?

- Creation of the <u>*Tax Cuts and Jobs Act of 2017*</u>.
- 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.
- <u>To fully benefit from the Opportunity Zone provisions, the taxpayer needs to make astute investments</u>.

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STEPS IN THE OZ PROCESS

- A taxpayer realizes and recognizes a capital gain. So, sale or exchange of . . .
  - Shares of stock.
  - Real estate.
  - Partnership interest that results in capital gain.
  - Other property.
- The taxpayer invests the “gain dollars” in a “Qualified Opportunity Fund,” or “QOF.”
  - Timing: Investment within 180 days from realization/recognition event.
  - Special – and beneficial – timing rules for gains through partnerships.

STEPS IN THE OZ PROCESS

- The taxpayer invests the gain dollars in a QOF (continued).
  - Only “gain dollars” need to be invested; free return of adjusted basis.
  - Taxpayer cannot invest directly in property, even if in Opportunity Zone.
  - Process generally is very “user friendly” – The fund self-certifies.
  - The QOF can be a corporation, S corporation, partnership or state law LLC.

- Final Regulations treat “§1231 gains” as capital gains.
  - Requirement to net §1231 gains dropped in final regulations.
  - Creates opportunity for §1231 gain deferral and current use of ordinary losses.

STEPS IN THE OZ PROCESS

- Typical structure.
  - The QOF invests in a lower tier partnership, a “qualified opportunity zone business” (“QOZB”); then
  - The QOZB owns the real estate or “qualified opportunity zone business property” (“QOZBP”).

- Semi-annual testing: 90% of the QOF’s assets must be “good” assets.”
  - Penalty for failure to comply.
  - If a QOZB has at least 70% “good assets,” the QOZB fully qualifies as a good asset for the QOF 90% asset test. (“All or nothing” test . . .)

STEPS IN THE OZ PROCESS

- Since the investor invests pretax dollars, the investor has no basis for the "gain dollars" contributed.
- If the taxpayer holds his/her QOF interest for 5+ years, the taxpayer receives an increase in his/her adjusted basis of 10% of the deferred gain.
- Practical deadline: Fund a QOF with capital gain dollars no later than 12/31/21 for the basis boost.
- The basis bump shouldn't drive decision-making. At a 20% capital gains rate, the basis bump is worth 2 points on the tax rate.

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STEPS IN THE OZ PROCESS

- 12/31/26 toll charge for QOF investing.
- There is a taxable "deemed disposition." All the deferred generally gains are recognized.
- The gain is the lesser of: The original deferred gain; or the FMV of the taxpayer's QOF interest.
- Reduced by the taxpayer's basis in his/her QOF investment.
  - Gain is subject to capital gains rates then in effect.
- Taxpayer bears the risk of future tax law rate changes.

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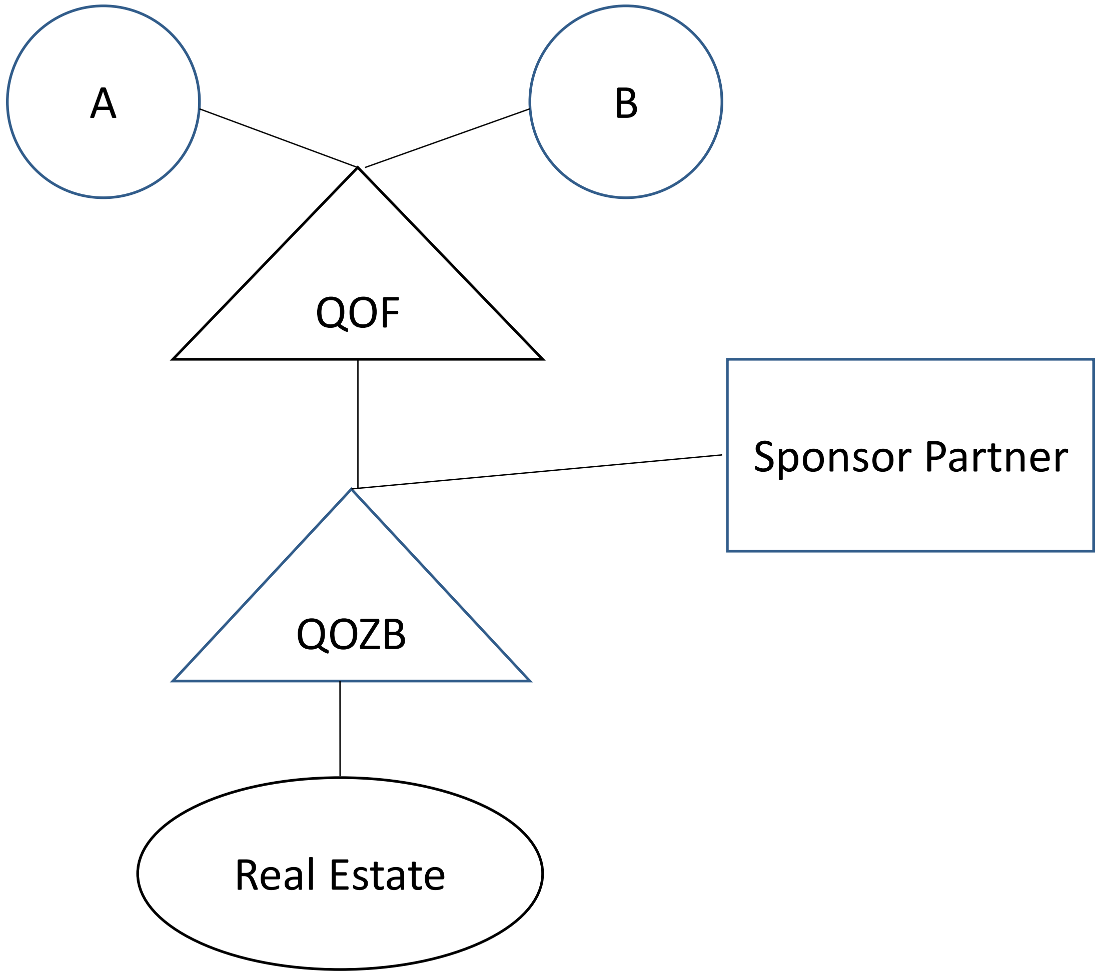
STEPS IN THE OZ PROCESS

- Putting the "deemed disposition" rule in context . . .
  - The deferred gain is the building block for the tax on the deemed disposition.
  - So, protecting the cash on sale attributable to the adjusted basis from the originating transaction is paramount.
  - The basis adjustment essentially is free . . .
  - Taxpayer has interest-free use of the adjusted basis dollars until, say, April 15, 2027.
  - What is the value of free use of that cash on a discounted present value?
- If the taxpayer holds the QOF investment for 10+ years, the taxpayer is <u>permanently</u> exempt from capital gains from the sale of his/her QOF interest.

TYPICAL REAL ESTATE QOZB STRUCTURE



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OTHER OPPORTUNITY ZONE RULES

- Property must be acquired in a taxable transaction after 2017 from an unrelated third party.
  - Related party rules are VERY broad. General rule is more than 20% common ownership between buyer and seller creates related party relationship.
  - Partnership capital contributions do not satisfy this requirement/

- The balance sheet cannot contain too much financial property.
  - Less than 5% of average aggregate unadjusted basis is “nonqualified financial property.”
  - Cash generally is “nonqualified financial property.”
  - There is an important exception for a working capital plan that shows the timely expenditure of this NQFP.

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OTHER OPPORTUNITY ZONE RULES

- “Sin businesses” are bad.
- 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).
- The taint applies to leasing to these “sin” businesses if more than 5% of net rentable area or gross income.

OTHER OPPORTUNITY ZONE RULES

- Contributing “gain dollars” don’t give an investor “outside” basis. . .
- The OZ rules do not change other aspects of real estate partnership investing. Allocations of taxable income are subject to tax.
- Outside basis increases for non-capital gain dollar contributions and allocations of income.
- Outside basis decreases for allocations of loss and cash distributions. Distributions of operating cash flow can be taxed unless the investor has outside basis.
- Consider distributions of refinancing proceeds outside “disguised sale” window to create basis and provide cash for 2016 tax liability.

SUBSTANTIAL IMPROVEMENT AND ORIGINAL USE

- A QOZB may either construct property for “original use” or “substantially improve” existing property.
- A QOZB generally has a 30-month window to improve property.
- Amount of improvements must exceed acquisition basis in the property.
- When does 30-month period start?
- Must land be “substantially improved”? Does the basis allocable to land count?
  - *Rev. Rul. 2018-29*: Basis allocable to land is excluded.

SUBSTANTIAL IMPROVEMENT AND ORIGINAL USE

- The QOF can qualify if “original use” of the property commences with the QOF.
- “Original use” means time at which property is placed in service.
- Vacant or unused property generally qualifies if it has been vacant or unused for either:
  - An uninterrupted period of at least one calendar year prior to OZ designation and purchase; or
  - An uninterrupted 3 calendar year period beginning after OZ designation and prior to purchase.

SOME OF THE THINGS TO THINK ABOUT

- Does this make sense for a given investor or gain?
  - Incremental benefit.
  - Comparative after-tax returns.
- State law conformity/nonconformity.
- Who is the taxpayer?
  - S corporations and/or their shareholders?
  - Partnerships or their partners?
- Mixed fund investments.
- How does a like-kind exchange compare?

TAX LAW CHANGES? WHAT CHANGES?

- House Ways & Means passes *Build Back Better Act*.
  - Individual income tax rates increased to statutory maximum of 39.6%.
  - Capital gains tax increased to 25% + 3.8% Medicare tax.
  - Capital gains tax rate increase effective after 9/13/21.
- Next steps in the legislative process and possible timing.
- Refinements to the existing Opportunity Zone regime.