Opportunity Zone Program

Tax Cuts and Jobs Act

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Overview

- History of Opportunity Zone Program
- Opportunity Zones – Qualification and Designation
- Tax Benefits of the Opportunity Zone Program
- Opportunity Funds – What are the rules, how do you qualify?
- Opportunity Zone Businesses and Opportunity Zone Business Property – What are these?
- Possible Types of Investments

History – Investment in Opportunity Act

- Drafted in 2016/Introduced February 2017
- Bipartisan Legislation
  - Rep. Tiberi (R)
  - Rep. Kind (D)
  - Sen. Scott (R)
  - Sen. Booker (D)
- Goal to encourage private capital investment in economically distressed areas.

Opportunity Zone Program

- Opportunity Zone Program
  - The Investment in Opportunity Act was included in the Tax Cuts and Jobs Act.
- December 22, 2017
- New York Times and USA Today

The New York Times

Tucked Into the Tax Bill, a Plan to Help Distressed America

USA TODAY

Sen. Tim Scott: New Tax Law Will Spur Opportunity in Distressed Communities

Tim Scott

The Investing in Opportunity Act gives investors incentive to put their sidelined capital gains into struggling areas in every zip code.

Poverty has long been one of the most challenging social crises of our time. Despite good-intentioned efforts to generate positive change, currently 52 million Americans continue to face the dire circumstances of a lack of jobs, education, and the confidence that things will get better.

I will be at the White House on Wednesday with President Trump, administration officials and community leaders to discuss the Investing in Opportunity Act. The IIOA, which was included in last year's tax reform package, seeks to direct trillions in capital gains to distressed communities in every state.

How do Taxpayers Benefit?

Taxpayers can defer *and potentially reduce* taxation on capital gains

by making timely investments in

Opportunity Funds

which invest in

Opportunity Zone Property

Source: Novogradac & Company LLP

3 Tax Incentive Benefits

1. Temporary Deferral of Eligible Gain
   - *Applies to any capital gain from the sale or exchange of any property to an unrelated person*
   - *$6 trillion of potential eligible capital*

2. Partial reduction of Deferred Gain
   - *Income Tax is still paid on a large portion of the Deferred Gain*

3. Forgiveness of Additional Gain
   - *Applies to the Appreciation in the Investment*

Eligible Gains

- Eligible Gains
  - Capital Gains
    - Long-term
    - Short-term
  - Section 1231 Gains
  - Section 1250 Unrecaptured Gain
- Not Eligible
  - Depreciation recapture (Ordinary Income)
  - Inventory
- Tax Attributes are Retained

Temporary Deferral of Gain

- Applies to any Eligible Taxpayer
- Sale or Exchange of Property to an Unrelated Person
- On or before December 31, 2026
- Election is made by the Taxpayer
- Deferred Gain: The Aggregate Amount Invested That Does Not Exceed the Amount of Gain Generated
  - In an Opportunity Fund (O-Fund) as an Eligible Interest
  - Within 180 days of the sale/exchange

Eligible Taxpayers

- Individuals
- C Corporations
- RICs
- REITs
- S Corporations
- Partnerships (LLCs and LPs)
- Trusts and Estates

180-Day Period

- Must invest in an Eligible Interest in an Opportunity Fund within 180 days from the Sale or Exchange of the Property
- Multiple Elections are Possible within a Single Gain:
  - Invest in different funds
  - Must use same 180-day period
- Special rule for Pass-through Entities

Eligible Interest

- Must be Equity
  - Preferred Stock
  - Partnership Interest with Special Allocations
- No Debt Instruments
- May acquire Eligible Interest with debt proceeds
  - Must be equity owner for tax purposes
- 752(a) Deemed Contribution

Pass-Through Entities (Special Rule)

- Taxpayers can be the partnership and/or the partners when a partnership generates an Eligible Gain
- Investment Period
  - – Normal 180 Days Rule for Partnerships
  - – Special Rule for Partners
    - Commence on the last day of Partnership's Taxable Period
    - Election to use Partnership's Taxable Period
- Example

Deferred Gain: When & How Much

When: Includable in taxable income for the taxable year which includes the earlier of:

- **Investor's sale of its interest in the O-Fund; or**
- **December 31, 2026**

How Much: Subject to income tax is based on the lesser of:

- **Amount of the Deferred Gain**

or

- **The fair market value of investment in the O-Fund**

Less

The Taxpayer's basis in the O-Fund

Ability to Invest Previously Deferred Gain in new O-Fund

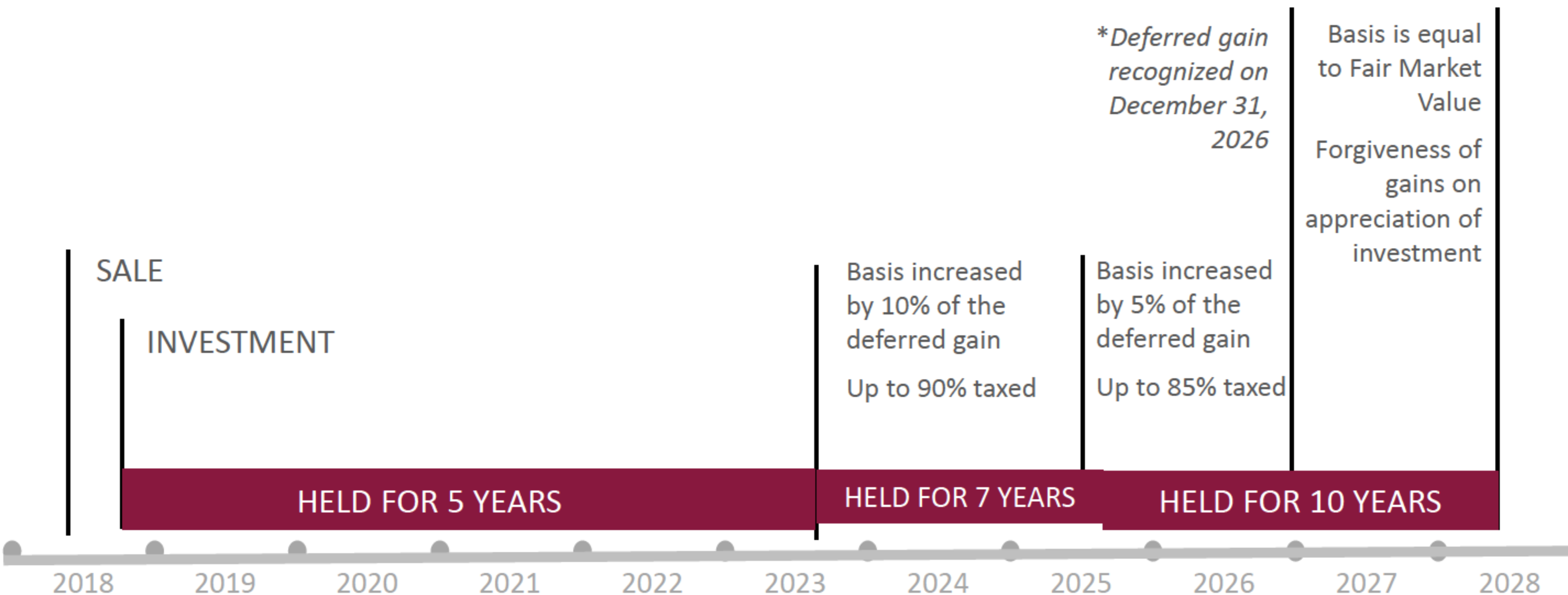
Partial Reduction of Deferred Gain (Tax Basis)

- **Taxpayer has an Initial Basis in the O-Fund of Zero**
- **Hold for 5 Years**
  - Investor's tax basis in the O-Fund is increased by 10% of the amount of the Deferred Gain
- **Hold for 7 Years**
  - Investor's tax basis in the O-Fund is increased by an additional 5% of the amount of the Deferred Gain

Full Forgiveness

- Where Investor holds its interest in the O-Fund for at least 10 years:
  - Elections to step-up the Tax Basis to FMV of Investor's interest in the O-Fund on the date of the sale or exchange
    - *Significant benefit but must hold long term*
  - The result is no gain on the appreciation above Investor's original investment in the O-Fund.
    - *Perhaps no income tax on depreciation recapture?*
  - **Sale or Exchange must be on or before December 31, 2047 in order to make the election**
- Phantom income issue arising on December 31, 2026

Deferral, Partial Reduction, and Forgiveness of Additional Gains



Source: Novogradac & Company LLP

Example*

- Investor sells stock for $30M ($20M of long term capital gain) on July 1, 2018
- Investor invests $20M in an interest in an O-Fund on November 1, 2018.
  - Does not need to invest the entire $30M
- December 31, 2026:
  - Investor's tax basis in the O-Fund was increased by $3M (15% of $20M)
    - $2M on November 1, 2023, and $1M on November 1, 2025.
  - Investor has to pay tax on $17M long-term capital gain
- November 2, 2028:
  - Investment in the O-Fund has appreciated from $20M to $60M ($40M in potential gain)
  - If the investment in the O-Fund is sold, then there is no taxable gain on the $40M of appreciation.

* Results/outcomes may vary

What is an Opportunity Zone (O-Zone)

- Population census tract that is a low-income community (LIC)
  - Approximately 75,000 total census tracts in the U.S.
  - 37% of the census tracts in the United States are LICs
- What is a LIC
  - Same definition for NMTCs
    - Based upon poverty rate (20%) or median family income (80%)
- Timely nominated by each Governor
- 25% of the LICs were eligible for nomination
  - Approximately 8,700 census tracts
  - 5% of the tracts to be nominated can be contiguous tracts

What is an Opportunity Fund (O-Fund)

- Intermediary Between Investors and the Investments in the Opportunity Zone

- Statutory Requirements:

  Organized as a Corporation or Partnership (LLC can be an O-Fund)

  An **investment vehicle** organized for the purpose of investing in **Opportunity Zone Property**.

  90% Requirement

- Certification Process

- Penalty imposed for Noncompliance

Opportunity Fund Certification

- Self-Certification using Form 8996
  - Attached to the taxpayer's federal income tax return for the taxable year, taking into account extensions.
- Identify the "first taxable year" and "first month" entity wants to be an O-Fund
- Investments made before the first month not eligible
- Where less than 6 months remaining in taxable year from first month then 90% Requirement is measured on last day of year

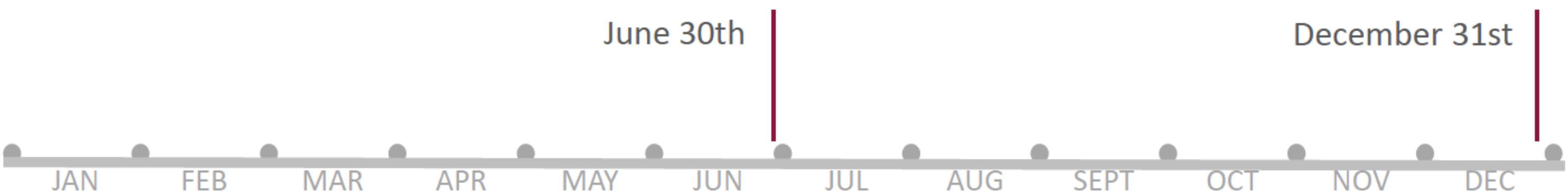
Opportunity Fund – 90% Requirement

Must hold at least 90% of assets in Opportunity Zone Property, determined by the average of the percentage of Opportunity Zone Property held on:

The last day of the first six month period of the fund's taxable year

And

The last day of the fund's taxable year



Source: Novogradac & Company LLP

Measuring the 90% Requirement

- If an O-Fund has an "applicable financial statement" (AFS), then the value of assets are as reported on the AFS:
  - Financial statements prepared for SEC or other federal agency (not the IRS)
  - Certified audited financial statement prepared in accordance with US GAAP
- If no AFS, then value is cost of the asset

Penalty for Noncompliance with the 90% Requirement

Failure to meet the 90% Requirement:

Monthly penalty for failing to meet the 90% Requirement

% Shortfall
x Underpayment Rate*
Penalty

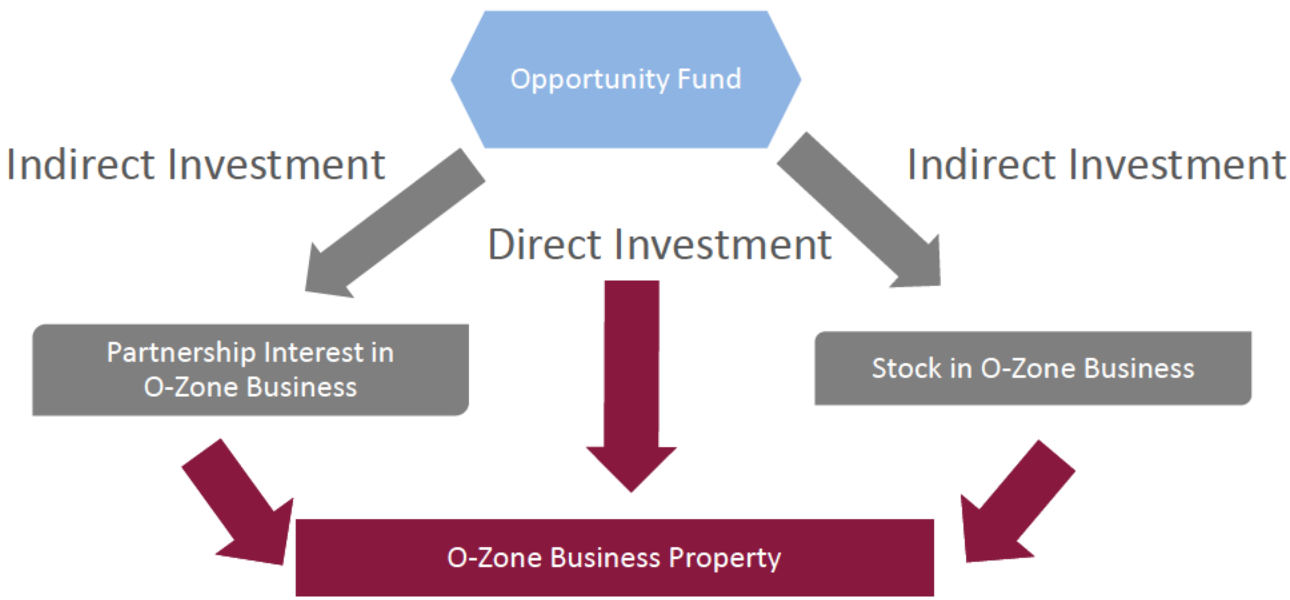
No penalty if it is shown failure is due to **reasonable cause**

*Federal short-term rate plus 3%) – **Currently 5% Annually**

Source: Novogradac & Company LLP

Opportunity Zone Property

- Broad Definition - However, no debt.
- Investments that constitute O-Zone Property are:
  - Indirect Approach: Equity investment in an Opportunity Zone Business (an O-Zone Business).
  - Direct Approach: Direct purchase of Opportunity Zone Business Property (O-Zone Business Property).



Source: Novogradac & Company LLP

Indirect Investment

- **Original Issuance:** Stock or a partnership interest in a **qualifying entity after December 31, 2017**, in exchange for cash.
  - Could be issued through an underwriter

- **Qualifying entity:** Domestic Corporation or Partnership (including LLCs)

- **Opportunity Zone Business (an O-Zone Business): At time of issuance** or is **organized for the purpose** of being an O-Zone Business (for newly formed entities).
  - No guidance here

- **Must remain an O-Zone Business:** For **substantially all** of the O-Fund's holding period.

Opportunity Zone Businesses

*A trade or business in which **substantially all** of the **tangible property** owned or leased by the taxpayer is **O-Zone Business Property** and:

At least 50% of income derived from active conduct of trade or business

Substantial portion of intangible property used in active conduct of business

< 5 percent unadjusted basis of property is nonqualified financial property (cash, cash equivalents, long term loans)

Source: Novogradac & Company LLP

Opportunity Zone Businesses - Regulations

- Tangible Property Test
  - "Substantially All" **is 70%**
  - Tangible Property that is Leased or Owned
  - Must be Opportunity Zone Business Property
- Intangible Property Test
  - "Substantial Portion"
  - Must be Used in Active Conduct of a Trade or Business **in the Opportunity Zone**
- Gross Income Test
  - 50% of the Income
  - Must be Derived from the Active Conduct of a Trade or Business **in the Opportunity Zone**

Opportunity Zone Businesses - Regulations

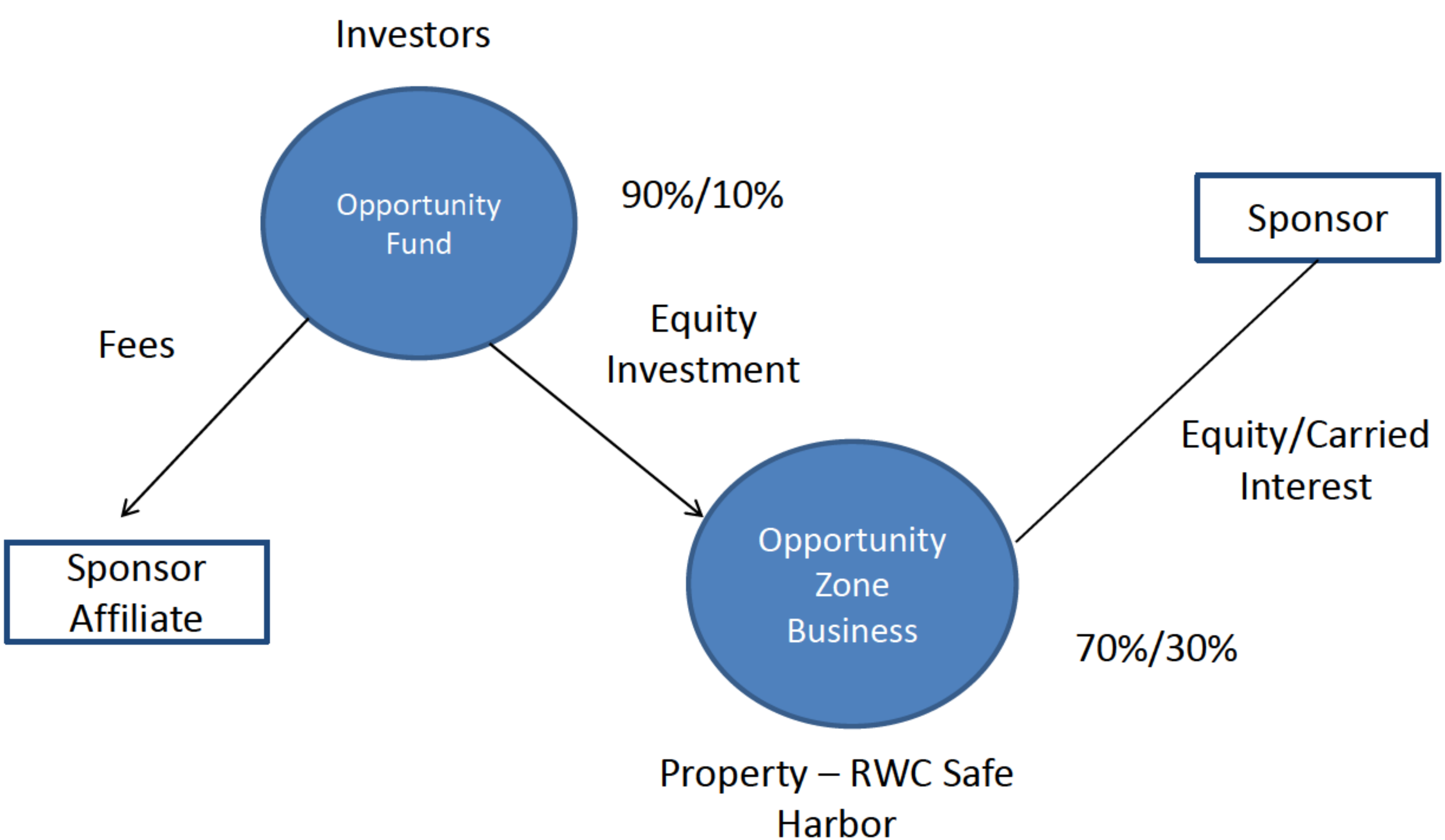
- Non-Qualified Financial Property
  - Less 5% of average of its assets can be cash or “cash type” assets
    - Does not include Accounts/Notes Receivable
    - Exception to NQFP for **reasonable amounts of working capital** (RWC) in cash, cash equivalents, or short term debt instruments (Working Capital Assets)
- **RWC– Safe Harbor-** Working Capital Assets are treated as RWC (Written Plan):
    - **Amounts designated in writing** for acquisition, construction, and/or substantial improvement of tangible property in an Opportunity Zone;
    - **Written schedule** consistent with ordinary start-up of a business for expending the Working Capital Assets within 31 months of receipt; and
    - Working Capital Assets are **actually used** in a manner that is **substantially consistent** with the previous provisions.

Excluded Businesses

Can’t be a “Sin Business”

- Golf Course
- Country Club
- Massage Parlor
- Hot Tub Facility
- Suntan Facility
- Racetrack (or other gambling facilities)
- Any store the principal business of which is the sale of alcoholic beverages for consumption off premises

Indirect Approach Structure



Direct v. Indirect Approach

	Direct	Indirect
% Invested in Opportunity Zone Business Property	90%	70% of Tangible Property Must be Opportunity Zone Business Property
% of Cash that can be held on measurement dates	10%	Less than 5% + RWC
% of Assets that can be intangible property	10%	Unlimited. But, a "substantial portion" must be used in the business
% of Property that must be tangible property	90%	No minimum
Ineligible businesses	No Prohibitions	"Sin Businesses" are prohibited

O-Zone Business Property

- **Key Definition (Especially for Real Estate)**
  - **Used in both the Direct and Indirect Approach**
- **Requirements:**

(1) **Tangible property** used in a **trade or business;**

(2) Acquired by **purchase from an unrelated party** (more than 20% standard) after **December 31, 2017;**

(3) **Original use in the Opportunity Zone** must commence with the O-Zone Business (or O-Fund); and

(4) During **substantially all** of the holding period, **substantially all of** the use is **in an Opportunity Zone**

Alternative to the Original Use Requirement

- The O-Zone Business (or the O-Fund) **substantially improves** the property
  - Can you be an original user of real estate?
  - Special Rule for Buildings/Revenue Ruling 2018-29

- What does it mean to "substantially improve"?:

*(1) Over a **30-Month** Period*

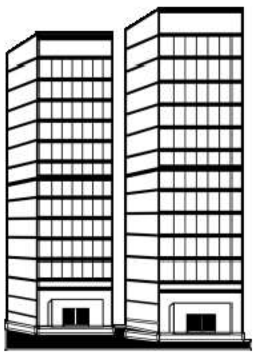
- *Statute: "During **any 30-month period** beginning after the date of acquisition"*
- *With respect to such tangible property*

*(2) **Additions to basis** that **exceed** the adjusted basis of such property*

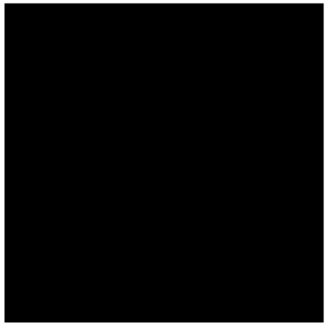
Special Rule – Acquisition of a Building

- Acquiring a Building an Underlying Land
  - Substantial improvement requirement met by improving the building
  - Revenue Ruling 2018-29
    - 60/40 (Land/Building)
    - Re-purposing of the building
    - Adding to the basis of the building (125%)
    - Cannot have original use with respect to land
  - What does this mean for vacant land?

Possible Investments in Opportunity Zones

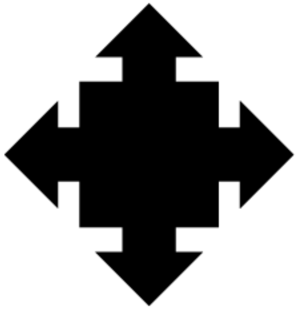


Real Estate Development and Significant Rehabilitations in Opportunity Zones



Opening New Businesses in Opportunity Zones

Acquiring an Existing Business and Relocating it (with Expansion) in an Opportunity Zone



Large Expansions of Businesses already within Opportunity Zones

Source: Novogradac & Company LLP

Opportunity Zones – Status

- Guidance is needed to address many important issues:
  - *Grace periods for Opportunity Fund and Opportunity Zone Business to make investments*
  - *Refinancing distributions*
  - *Interim gains issue (Reinvestment)*
    - *Avoiding the Penalty while holding cash*
    - *Not having an allocation of taxable gain to Investors*
    - *How long would the O-Fund have for reinvestment*
  - *Vacant Land – Substantial Improvement?*
  - *Multi-Asset Funds – Exit Mechanics*
  - *Meaning of the term "active" (to determine implication on triple net leases)*
  - *Residential Rental Property – Is it a problem for an O-Zone Business*
  - *Meaning of the other "substantially all" and "substantial portion"*
- Second tranche will be released in late 2018/early 2019