Opportunity Zones

A New Tax Incentive for Investments in Low-Income Communities

Brian O'Connor (Moderator)
Partner | Venable LLP | bjoconnor@Venable.com

Walter Calvert
Partner | Venable LLP | wrcalvert@Venable.com

Chris Feiss
Founder | Oasis Fund | caf@83npartners.com

Elizabeth Stieff
Associate | Venable LLP | EFSteiff@Venable.com

Doug Trueheart
Principal | E.Cohen | dtrueheart@ecohen.com

VENABLE LLP

E.Cohen
TAX | ASSURANCE | CONSULTING

Overview

- Investor Perspective
- Sponsor Perspective
- Q&A

Investor Perspective

Benefits and Communities

Qualified Opportunity Zone Program

- Internal Revenue Code Sections 1400z-1 and 1400z-2
- Incentives for long-term, private sector investments in low-income communities (LIC)

Qualified Opportunity Zones (QOZ)

- Internal Revenue Code Section 1400z-1
- 8,761 tracts designated as QOZs
- All 50 states, District of Columbia, and 5 U.S. territories

Qualified Opportunity Funds (QOF)

- Internal Revenue Code Section 1400z-2 provides investors with various incentives to invest in QOZs
- Investor must reinvest "eligible gain" into a QOF and make an election
- Election made on Form 8949

Tax Incentives

1. Deferral of recognition of “eligible gain” on original investment
2. Partial exclusion of “eligible gain” on original investment
3. Exclusion of appreciation gain in QOF

Eligible Gain

Eligible Gain is gain from a sale or exchange that:

- Is treated as capital gain for Federal income tax purposes
- Would be recognized for Federal income tax purposes before January 1, 2027
- Does not arise from a sale or exchange with a related party
  - 20% direct or indirect relationship before or after the sale or exchange

Eligible Gain (continued)

- Includes NET 1231 gains (gain from sale of depreciable property used in a trade or business)
- Does not include depreciation recapture taxed as ordinary income

Eligible Taxpayers

- Any taxpayer that realizes eligible gain, including individuals, C corporations (including RICs and REITs), partnerships, S corporations, trusts, and estates
- Partnerships and S corporations my elect to:
  - Reinvest the gain at the entity level, or
  - Pass the gain through to their owners who are free to make their own decision on reinvestment

Note

- Only reinvested eligible gain qualifies for incentives
- Some or all of the eligible gain may be reinvested
- Eligible gain may be reinvested in multiple QOFs
- No tracing rules

Timing of Reinvestment

- General rule: Reinvestment of eligible gain into an equity investment in QOF must be within 180 days of sale or exchange giving rise to eligible gain
- For pass-through eligible gain from a partnership or S corporation, the 180-day period begins on the last day of the pass-through entity's taxable year
- For <u>NET</u> section 1231 eligible gain, the 180-day period begins on the last day of the investor's taxable year

Tax Incentive 1: Deferral of Recognition of Eligible Gain of Original Investment

- Defer gain on investor's original investment until the end of 2026, unless investor disposes of the interest before.
- If the investor disposes of its interest before the end of 2026, the gain deferral ends and the investor must recognize the deferred gain on the original investment plus any gain on the QOF investment for the tax year of the disposition.
- Taxpayers should plan for liquidity to pay tax on deferred gain

Tax Incentive 2: Partial Exclusion of Eligible Gain on Original Investment

- A small portion of the gain on the original investment may be excluded from income, if the investment is held for specific holding periods.
- If the investor holds the QOF investment for at least seven years, the investor's basis is increased in total by 15% of original investment gain.
  - To qualify for the full 15% basis increase, the investor must make its gain rollover investment into a QOF before the end of 2019.
- If the investor holds the Fund investment for at least five years, the investor's basis is increased by 10% of original investment gain.
  - To qualify for 10% basis increase, the investor must make its gain rollover investment into a QOF before the end of 2021 (assumes not eligible for 15%).

Tax Incentive 3: Exclusion on Appreciation Gain in QOF

- Exclusion from taxable income and gain realized for an investor's investment in the QOF itself if the investor holds the investment for at least 10 years.
  - Provides the greatest tax benefit for an investment in an LIC in which significant appreciation in value can be anticipated.
- Proposed Regulations allow this benefit to be realized until December 31, 2047 (past the 12/31/28 QOZ designation expiration).
- Permits an investor in a QOF that makes an investment as late as June 2027 to hold the investment in the QOF for the entire 10-year holding period plus another 10 years.
- Examples:
  - Good investments would be a newly constructed commercial office or retail project in an up-and-coming LIC.
  - Bad investments would be charter schools because of the small likelihood of substantial appreciation in value.

Tax Benefit Example

	No Basis Adj.		10% Basis Adj.		15% Basis Adj.		Post 2026 QOF Sale 15% Basis Adj.		10 Year Holding Period 15% Basis Adj.	
Year QOF Interest Sold	2022		2024		2025		2027		2029	
Original Investment Value @ Rollover	10,000,000	[A]	10,000,000	[C]	10,000,000	[F]	10,000,000	[I]	10,000,000	[L]
Appreciation of QOF Interest	5,000,000		5,000,000		5,000,000		5,000,000		5,000,000	
Value @ QOF Sale Date	15,000,000		15,000,000		15,000,000		15,000,000		15,000,000	
Original Investment Basis	4,000,000		4,000,000	[D]	4,000,000	[G]	4,000,000	[J]	4,000,000	[M]
Basis Adjustment	0		600,000	([C]-[D])x10%	900,000	([F]-[G])x15%	900,000	([I]-[J])x15%	900,000	([L]-[M])x15%
Adjusted Basis	4,000,000	[B]	4,600,000	[E]	4,900,000	[H]	4,900,000	[K]	4,900,000	[N]
Original Investment Gain	6,000,000	[A]-[B]	5,400,000	[C]-[E]	5,100,000	[F]-[H]	5,100,000	[I]-[K]	5,100,000	[L]-[N]
QOF Appreciation Gain	5,000,000		5,000,000		5,000,000		5,000,000		-	
Total Gain	11,000,000		10,400,000		10,100,000		10,100,000		5,100,000	
							1,020,000	recognized in 2026		
							1,000,000	recognized in 2027		
Total Tax (assuming 20%)	2,200,000		2,080,000		2,020,000		2,020,000		1,020,000	recognized in 2026

VENABLE LLP

E Cohen
TAX | ASSURANCE | CONSULTING

Inclusion and Non-Inclusion Events (new)

- Inclusion Events cause early recognition of deferred gain
- Non-Inclusion Events do not cause early recognition of deferred gain
- Examples of Inclusion Events
  - Gifts of QOF interest
  - Distribution from QOF to investor in excess of basis
  - Sale or other taxable disposition of QOF interest
- Examples of Non-Inclusion Events
  - Transfer of QOF interest to a grantor trust
  - Transfer by reason of death by owner of QOF interest
  - Transfer of QOF interest to a partnership
  - Corporate QOF tax-free mergers and spin-offs

Sponsor Perspective

Structure and Eligible Businesses

Opportunity Zone Program Overview – What: The Qualified Opportunity Fund

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

What: Qualified Opportunity Zone Fund

- Formed under state law to be a tax law corporation or partnership
- Has a purpose of investing in "qualified opportunity zone property" ("Zone Property") (other than another QOF)
  - Include statement of purpose in the entity's organic documents
- Holds at least 90% of its assets in Zone Property
- Self-certifies with the IRS with filing of first tax return

Forming a Fund

- An entity that is recognized as a corporation or partnership for federal income tax purposes
  - Form as a state law corporation
    - C Corporation or
    - S Corporation for federal income tax purposes
  - Form as a state law partnership or LLC
    - Typically a limited partnership or limited liability company
    - Needs to be a "partnership" for federal income tax purposes
      - Needs at least two partners/members to be a "partnership"
- Can be newly formed or an existing entity

VENABLE LLP

E Cohen
TAX | ASSURANCE | CONSULTING

How: Certifying the Fund with the IRS

- Taxpayers self-certify that they are a QOF.
- No approval or action by the IRS is required.
- Use IRS Form 8966 both for:
  - Initial self-certification and
  - For annual reporting of compliance with the 90% asset test, which would be attached to the taxpayer's income tax return for relevant years.

VENABLE LLP

E Cohen
TAX | ASSURANCE | CONSULTING

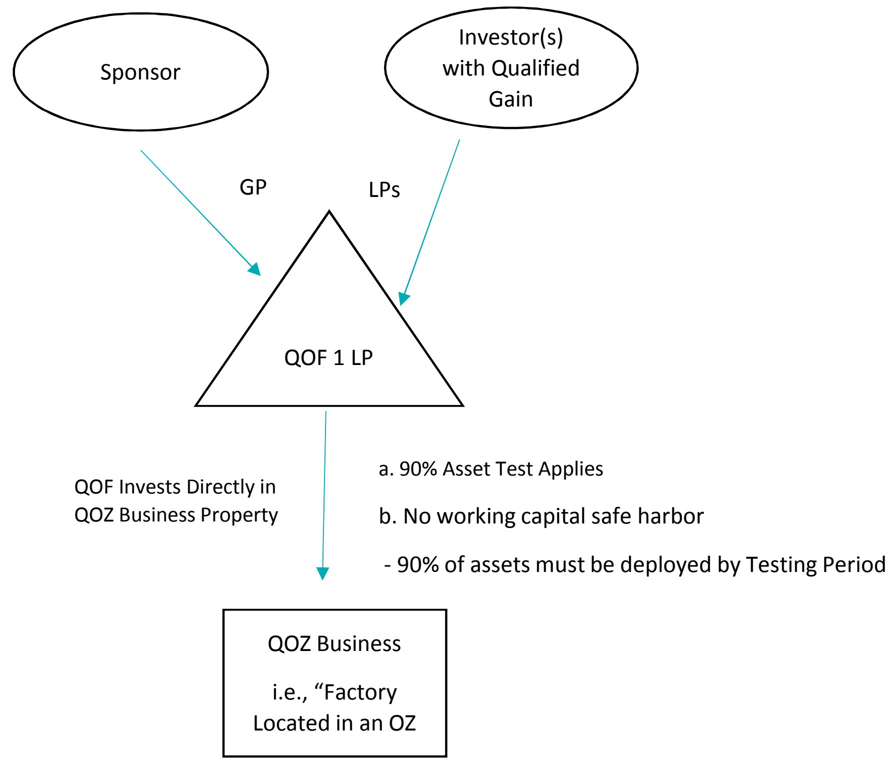
How: Funding the Fund

- Investor's gains from a prior investment are reinvested in the Fund in the form of an equity interest (not debt)
- Non-pro rata distributions ("special allocations") are allowed
- Other funding permitted, but
  - Don't get the Opportunity Zone Fund benefits
  - Require separate accounting

Qualified Opportunity Fund Structure

The Single-Tier Fund

- QOF directly owns QOZ Business Property.
- The 90% test applies (90% of the assets of QOZ Business must be Zone Property).
- No working capital safe harbor, so QOF could not hold more than 10% of its assets as cash.
- All IP counts toward the 10% of assets that can be non-Zone Property.

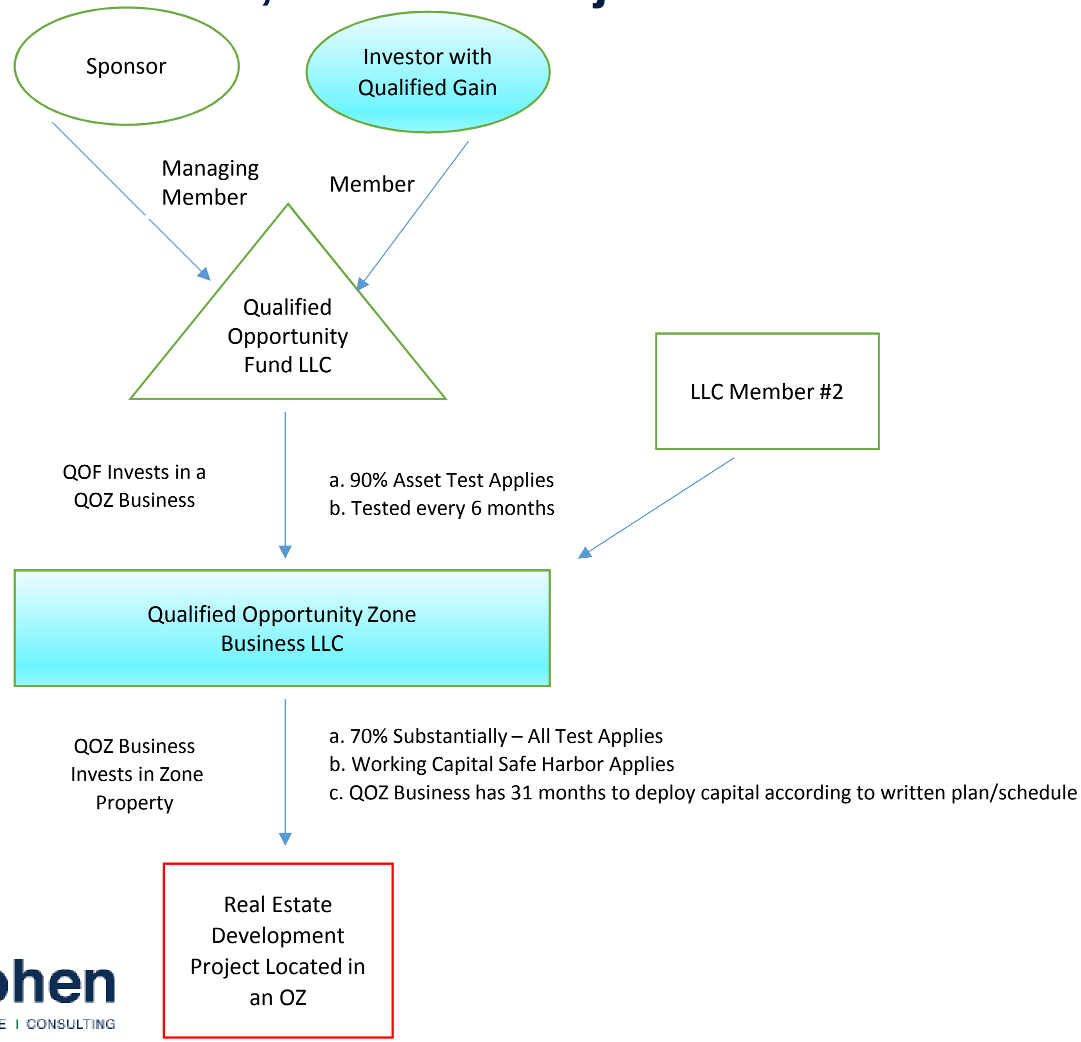


The QOF has invested 90% of its assets directly in Qualified Opportunity Zone Business Property.

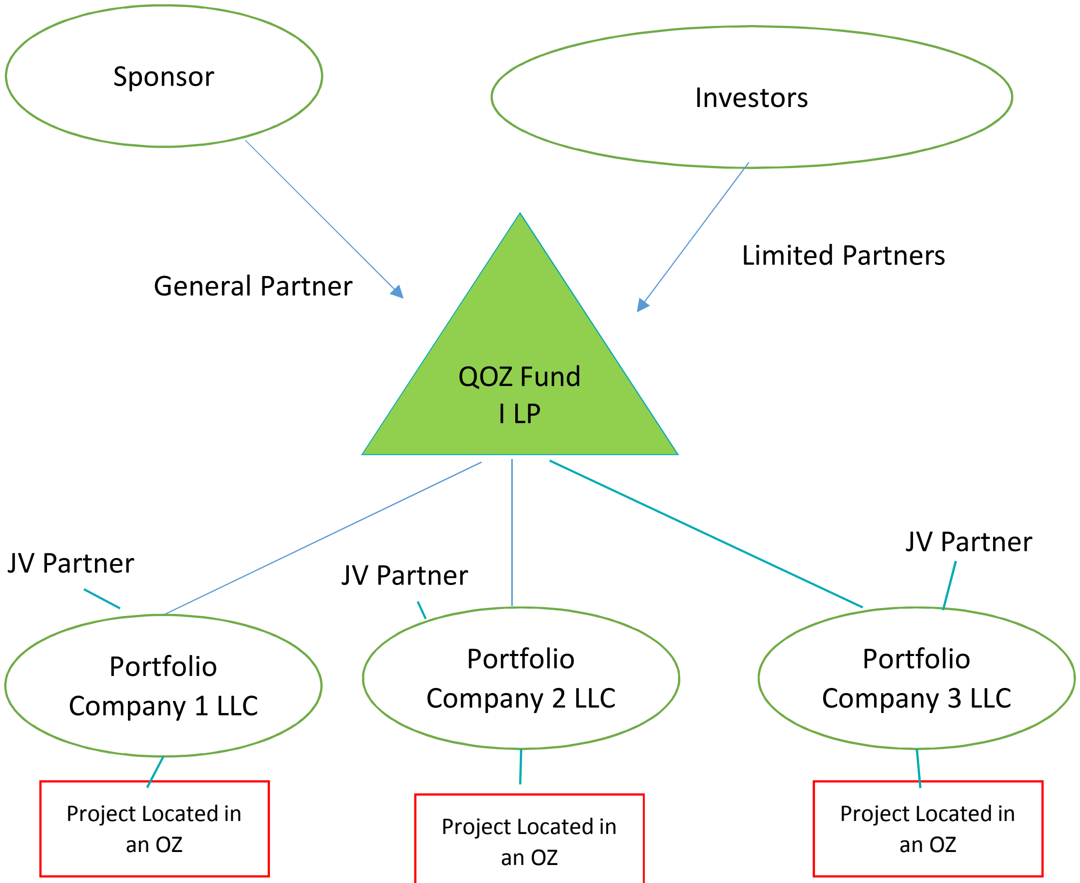
VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

The Two-Tier Fund – Limited Investors, Limited Projects



Two-Tier Fund – Multi-Investor, Multi-Project



- QOF indirectly owns multiple qualifying projects, each as a separate partnership/LLC with the developer and other key employees receiving equity.
- Thus, it intends to satisfy the 90% test by holding "QOZ Partnership Interests" (Type 2).
- Working capital safe harbor applies.
- 50% gross income test applies.
- Can own an unlimited amount of IP as long as used in the active conduct of the trade or business.

90% Test:
1. QOZ Stock
2. QOZ Partnership Interest; or
3. QOZ Business Property

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

What: A Qualified Opportunity Fund
The 90% Test

- Holds at least 90% of its assets in Qualified Opportunity Zone Property
- Qualified Opportunity Zone Property is:
  - Qualified opportunity zone (QOZ) stock
  - QOZ partnership interest, or
  - QOZ business property

  ** If a QOF invests at least 90% of its assets in QOZ stock or QOZ partnership interest, then it meets the 90% test.

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

What: A Qualified Opportunity Fund
The 90% Asset Test

- To determine whether QOF has met the 90% standard:
  - Average of the percentage of Zone Property held in the QOF as measured on the testing period dates
  - Tested twice per year
    - On the last day of the first 6-month period of the QOF's tax year
    - On the last day of QOF's tax year
- Form 8996 used for annual reporting of compliance with the 90% Asset Test

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

What: A Qualified Opportunity Fund
Testing Period Considerations

- QOF shall identify on Form 8996 :
  - The taxable year in which an entity becomes a QOF and
  - The 1st month in that year to be treated as a QOF
- Example in the regulations:
  - Entity formed in February, chooses April as its 1st month as a QOF, so testing dates are end of September and end of December.
- Note that the last day of the taxable year is always a testing date.

What: A Qualified Opportunity Fund
Results of QOF's Failure to Comply

- If a QOF fails to meet the 90% requirement, the QOF has to pay a penalty for each month it fails to meet the requirement.
- Six-month grace period for new contributions before testing begins (new)
- If the QOF is a partnership, the penalty is taken pro rata based on the distributive share of each partner of the partnership.
- Possible Narrow Escape Route
  - No penalty will be imposed if the QOF shows that the failure is due to reasonable cause.
  - What is reasonable cause?

Qualified Opportunity Zone Property

VENABLE LLP

E Cohen
TAX | ASSURANCE | CONSULTING

Qualified Opportunity Zone Property

- **Recap** – Definition:
  - A QOF has a purpose of investing in "qualified opportunity zone property" ("**Zone Property**") (other than another QOF).
  - At least 90% of a QOF's assets must be Zone Property.
- Qualified Opportunity Zone Property is:
  1. Qualified opportunity zone (QOZ) stock
  2. QOZ partnership interest, or
  3. QOZ business property

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

Qualified Opportunity Zone Stock

- Any stock of a U.S. corporation, if:
  - Stock was purchased by QOF after 12/31/17 solely in exchange for cash.
  - Stock was issued by a qualified opportunity zone business (**QOZ Business**) or a corporation organized for such purpose and the corporation remains a QOZ Business during substantially all of the QOF's holding period.

Qualified Opportunity Zone Partnership Interest

- Any capital or profits interest in a domestic partnership, if:
  - Interest was purchased by QOF after 12/31/17 solely in exchange for cash.
  - At the time interest was purchased, interest was issued by a QOZ Business or a partnership organized for such purpose and the partnership remains a QOZ Business during substantially all of the QOF's holding period.

What Is a Qualified Opportunity Zone Business?

- A QOZ Business is a trade or business that:
  - Owns or leases substantially all (i.e., 70% or more) of its tangible property in Zone Property.
  - Generates at least 50% of its total gross income from active business.
  - Uses a substantial portion of its intangible property in the active conduct of the business.
  - Maintains less than 5% of the average of the aggregate unadjusted basis of its property as nonqualified financial property (i.e., debt, stock, partnership interests, annuities, derivative financial instruments such as options, other than working capital held as cash or short-term debt instruments).
  - Is not an ineligible business.

VENABLE LLP

E Cohen
TAX | ASSURANCE | CONSULTING

Ineligible Businesses

- The following businesses do not qualify as QOZ Businesses, even if located in an OZ:
  - Golf courses
  - Country clubs
  - Massage parlors
  - Hot tub facilities
  - Suntan facilities
  - Racetrack or other gambling facility
  - Liquor stores

Qualified Opportunity Zone Business Property

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

Qualified Opportunity Zone Business Property

- 3rd Type of Zone Property is QOZ Business Property
  - Tangible property that is used in a QOZ trade or business of the QOF, if:
  - Such property was **purchased by** QOF ***from an unrelated party after 12/31/17***.
  - The "**original use**" of such property in the OZ commences with the QOF or the QOF "**substantially improves**" the property.
  - During substantially all of the QOF's holding period, substantially all of the use of such property was in an OZ.

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

What Is Meant by "Substantially Improve" the QOZ Business Property?

- QOZ Business Property is deemed "substantially improved" by the QOF only if:
  - During any 30-month period beginning after the date the property is acquired, improvements exceed the adjusted basis of the property when acquired ("*Doubling Down*").
- The basis of the land may be deducted.
- Example: QOF acquires property for $100,000 ($25,000 attributable to land and $75,000 to the building) then is required to invest an additional $75,000 in the property for it to qualify as "Zone Property."

"*Excluding the basis of land from the amount that needs to be doubled for a building to be substantially improved facilitates repurposing of vacant buildings on QOZs*"

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

Working Capital Safe Harbor

- **Recap**: For a QOZ Business – Nonqualified financial property is limited to less than 5% of the average of the aggregate unadjusted bases of property held by the QOZ Business.
  - Therefore, a QOZ Business cannot hold more than 5% of its assets in nonqualified financial property. Reasonable amounts of working capital (i.e., 5%) are excluded from nonqualified financial property.
  - However, the regulations provide a "Working Capital Safe Harbor" for QOF investments in QOZ Businesses that acquire, construct or rehab tangible Zone Property, which includes both real property and other tangible property used in a QOZ Business.

Working Capital Safe Harbor Requirements

- Working capital is deemed "reasonable" if the QOZ Business:
  1. Has a written plan that identifies the cash as property held for acquisition, construction, or substantial improvement of tangible property in the OZ;
  2. Has a written schedule that the cash will be used for the QOZ Business within 31 months of acquisition; and
  3. Actually uses the working capital in accordance with the plan and written schedule.
     - Exception for government-related delays (new)
     - Safe harbor available for both capital projects and "start-up" operating costs (new)
     - Serial capital contributions may have separate plans (new)

Start-ups and Other Operating Businesses as Qualified Operating Zone Businesses (new)

- Working capital safe harbor is available
- 50% gross income test safe harbor:
  - At least 50% employees and independent contracts in Zone by hours, or
  - At least 50% employees and independent contractors in Zone by payroll, or
  - Business's management or operational functions in Zone are necessary to generate at least 50% of its gross income.

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

Leasing to the Fund

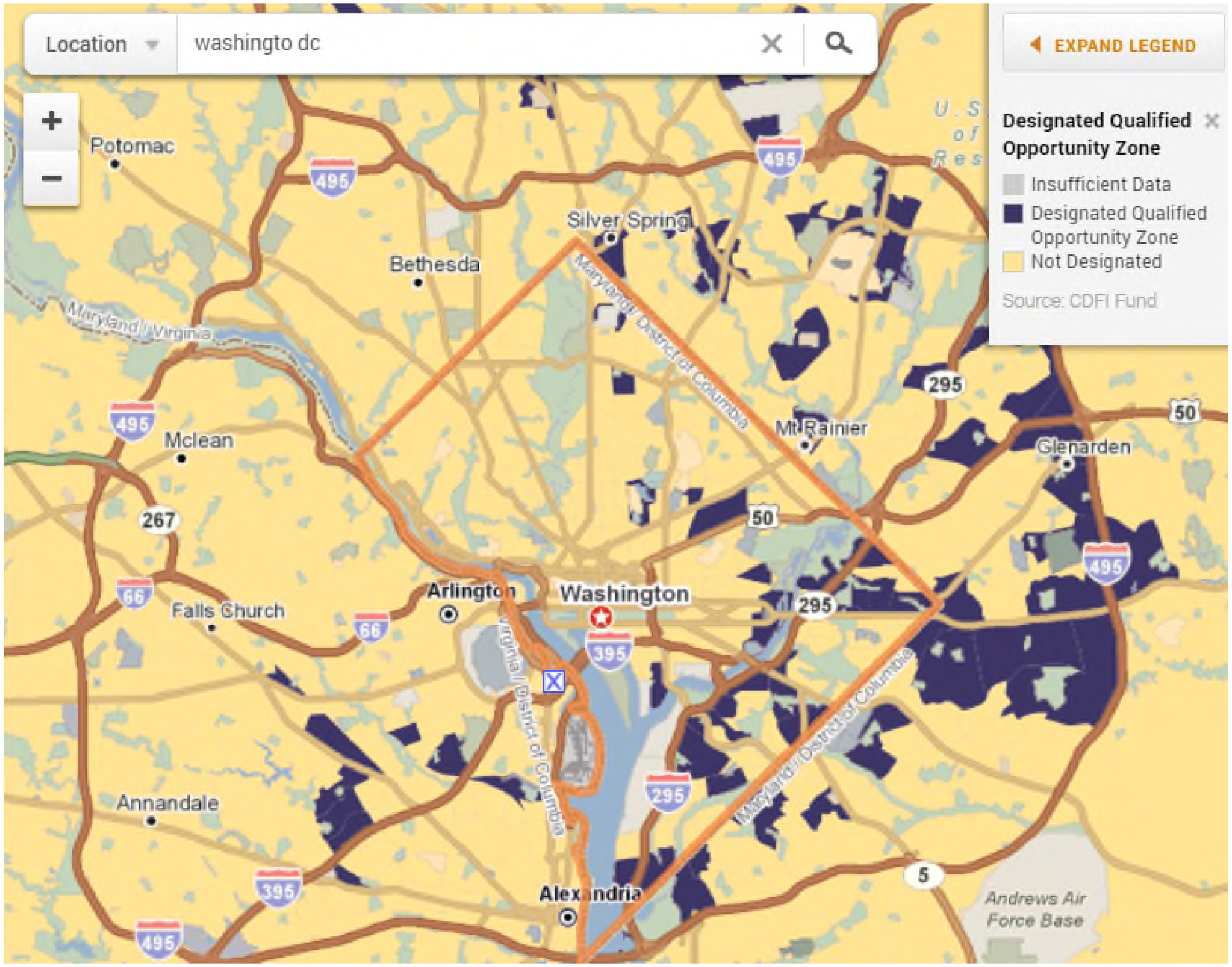
- More favorable rules than for purchased real property to qualify as QO2BF if three requirements are satisfied:
  - Leased after 2017
  - Market-rate lease terms
  - Substantially all use in the Zone
- Related party leases qualify if:
  - Lessee cannot prepay for more than 12 months of use
  - For tangible personal property, tenant must spend amount in Zone equal to lease value

Leasing to a Fund (cont)

- Valuation
  - As reported for financial reporting purposes, or
  - Present value of lease payments
- No original use or substantial improvement requirements
- Anti-Abuse Rule: No plan, intention, or expectation of purchase by lessee for an amount other than FMV at time of purchase

Where: Low-Income Communities

- All QOZs have been nominated, certified, and designated.
- Various mapping tools are available to identify QOZs:
  - https://www.novoco.com/resource-centers/opportunity-zone-resource-center/guidance/novogradac-opportunity-zones-mapping-tool
  - https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml
  - https://www.cohnreznick.com/nmtc-map
  - https://go.bakertilly.com/contactbtc0618



VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

Exiting the QOF Investment After Ten Years

- Investor sells its interest in the QOF
  - Investor's basis in the QOF steps up to FMV prior to sale
  - All gain is excluded
- QOF sells its assets (new)
  - Partnership QOF
    - Investor gets to exclude flow-through gain from capital assets
    - All other gain <u>is</u> taxable
  - Corporate QOF
    - Zero tax rate on capital gain
    - Other gain <u>is</u> taxed
  - No reliance until proposed regulations are finalized
- Lower tier QOZB sells its assets
  - <u>No</u> exclusion

Comparison with Section 1031 Rollovers

	1031 Exchange	Qualified Opportunity Zone
Capital Source	Real property	Capital gains
Required Reinvestment	Entire net proceeds	Amount of gain
Reinvestment Limitations	Real estate only – whether within or without an OZ	Any trade or business located in an OZ
Reinvestment Timing	180-days	180 days, but note the special rule for partnerships
Deferral Period	Indefinite	Until December 31, 2026
Is any deferred gain eligible for reduction?	No	Yes, up to 15%.
Is future growth exempt from taxation?	No	Yes, if the rollover investment is held for 10 years

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

Questions?

Brian O'Connor
Partner, Venable LLP
+1 410.244.7863
bjoconnor@Venable.com

Walter Calvert
Partner, Venable LLP
+1 410.244.7726
wrcalvert@Venable.com

Doug Trueheart
Principal, E. Cohen
+1 301.917.6236
dtrueheart@ecohen.com

Elizabeth Fialkowski Stieff
Associate, Venable
+1 410.528.4643
efstieff@Venable.com

VENABLE LLP

E. Cohen
TAX | ASSURANCE | CONSULTING

VENABLE LLP

E Cohen
TAX | ASSURANCE | CONSULTING