Opportunity Zones 101

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Frost Brown Todd LLC
ATTORNEYS

The Opportunity Zone Tax Incentive

» December 22, 2017 – Tax Cuts and Jobs Act
» October 19, 2018 - 1st Round Proposed Regulations; Rev. Rul. 2018-29
» April 17, 2019 - 2nd Round Proposed Regulations
» December 17, 2019 – Final Regulations – Effective March 13, 2020
  - In the interim, rely on final regs OR 2nd Round – consistently applied
» COVID Relief:
  - IRS Notice 2020-23
  - IRS Notice 2020-39
» Other guidance:
  - IRS Form 8996, *Qualified Opportunity Fund* (and instructions)
  - IRS Form 8949 Instructions
  - IRS FAQs

Investor Incentives – Temporary Tax Deferral

- Temporary Tax Deferral
  - **TEMPORARY** - Capital gains from the sale of assets (to an unrelated party) can be deferred until December 31, 2026 or the sale of the new investment, whichever is earlier.
  - Taxpayer uses Form 8949 to elect to defer gain – filed with federal income tax return in the year gain would have been realized.
- Capital gain that an investor intends to defer must be capital gain that the investor recognized **no later than December 31, 2026**, the final date for the deferral of gain. No investor can make a qualifying investment in a QOF utilizing capital gain recognized after December 31, 2026.

Investor Incentives – 180-Day Rule

- **180-day Investment Period – Pass-Through Entity**
  - With respect to an owner's allocable share of a pass-through entity's eligible gains will generally begin on the last day of the pass-through entity's taxable year in which the eligible gain is realized.
  - In the alternative, the Final Regulations provide an elective rule that permits the owner of the pass-through entity to elect a start date for its 180-day investment period that begins either (1) the same day as the pass-through entity's 180-day period (i.e., 180 days from the date gain is generated); or (2) on the due date for the pass-through entity's tax return, without extensions, for the taxable year in which the partnership realized the eligible gain.

Investor Incentives – COVID-19 RELIEF

- **IRS Notice 2020-39**.
  - IRS Notice 2020-39 provides certain relief related to the calculation of time-sensitive deadlines under the OZ Program giving investors and existing projects additional time to address issues and delays related to the COVID-19 pandemic.
  - Notice 2020-39 provides that if the 180-Day period to make a qualifying investment into a QOF (depending on how the investor elected to calculate that 180-Day period) would have ended on or after April 1, 2020, and before December 31, 2020, then such taxpayers are **automatically provided an extension until December 31, 2020**.
  - The relief provided under Notice 2020-39 could potentially permit qualifying gains realized in 2019 to still be timely invested in a QOF until December 31, 2020.

Investor Incentives – Basis Step-up

- Basis Step-up
  - After a 5-year hold Taxpayer excludes 10% of the original capital gain.
  - After a 7-year hold Taxpayer excludes an additional 5% - 15% total – no longer available to Investors – had to invest in QOF by December 31, 2019.

Investor Incentives – Permanent Exclusion

- Permanent Appreciation Exclusion
  - After a 10-year hold, investors may permanently exclude any capital gains tax on post-acquisition gains.
  - Claimed as a basis step-up.
- **<u>An investor is only entitled to elect permanent exclusion of any appreciation on an investment in a QOF that was held for 10 years or more if the investor's original investment in the QOF was capital gain eligible for deferral and a deferral election was made</u>.**

What is a Qualified Opportunity Fund (QOF)?

- A QOF is any investment vehicle organized as either a partnership (including an LLC treated as a partnership for tax purposes) or corporation that was formed for the purpose of investing in qualified opportunity zone property (“QOZ Property”).
  - Can include existing entity that satisfies QOF requirements.
- At least 90 percent of the QOF’s assets must consist of QOZ Property. (90% test – semi-annual test)
- QOF self-certifies with IRS filing Form 8996. QOF not required to seek pre-approval or related action to operate as a Fund – eliminates delay and complexity often associated with other tax credits and incentives.
- QOF investor – Form 8997

QOF – 90% Investment Test

- To protect a QOF that might receive new investments shortly before a 90% Investment Test date, a QOF can choose to evaluate the 90% Investment Test without considering any investments that the QOF received in the 6-month period prior to a semi-annual test date.
- Under this optional election, a QOF may choose to determine compliance with the 90% Investment Test by excluding certain recently received property from both the numerator (total QOZ Property that the QOF holds) and denominator (total assets of the QOF) of the fraction-based test.
- To be eligible for exclusion, the property must meet each of the following criteria: (1) the amount of contributed property was received by the QOF (partnership or corporation) solely in exchange for an equity interest (partnership interest or stock) in the QOF; (2) the contribution occurred not more than six months before the date of the semi-annual 90% Investment Test from which the amount of property is excluded; and (3) between the date of that contribution and the date of the underlying asset test, the amount of property was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less.

QOF – 90% Investment Test – COVID-19 RELIEF

- **<u>COVID-19 Relief – 90% Investment Test – IRS Notice 2020-39</u>**.
  - Under Notice 2020-39, for any QOF with a semi-annual test date – either (i) the last day of the QOF's first six-month period of the taxable year, or (ii) the last day of the taxable year – that falls within **<u>the period beginning on April 1, 2020, and ending on December 31, 2020</u>**, any failure by that QOF to satisfy the 90% Investment Test for that taxable year of the QOF is (a) due to reasonable cause under Code section 1400Z-2(f)(3); and (b) disregarded for purposes of determining whether the QOF or any otherwise qualifying investments in that QOF satisfy the requirements of Code section 1400Z-2 and the OZ Regulations for any taxable year of the QOF.
  - As a result, if the QOF fails the 90% Investment Test for the tax year due to failing to meet the standard at one or more of its semi-annual test dates occurring during the relief period under Notice 2020-39, the QOF will not be subject to civil penalties.
  - The 90% Investment Test relief under IRS Notice 2020-39 is automatic; however, despite the automatic relief, a QOF still must accurately complete and timely file IRS Form 8996 (except that the penalty line may remain at zero) with its federal tax return for the affected taxable year(s).

What is QOZ Property?

- There are three categories of QOZ Property permitted under IRC Section 1400Z-2(d)(2)(A):
  - Qualified opportunity zone stock (“QOZ Stock”);
  - Qualified opportunity zone partnership interest (“QOZ Interest”); or
  - Qualified opportunity zone business property (“QOZ Business Property”).
- QOF cannot acquire an interest in another QOF.

QOZ Stock

- Any stock in a domestic corporation if:
  a. the QOF acquired the stock **after December 31, 2017** at its **original issue** for cash;
  b. at the time of issue, the corporation was a qualified opportunity zone business (“QOZB”) or was organized to be a QOZB; and
  c. during **substantially all** of the time the QOF held the QOZ Stock, the corporation qualified as a QOZB.
- Corporation must qualify as a QOZB during **90% of the holding period** to satisfy the “substantially all” requirement for QOZ Stock.
- QOF will be acquiring an **equity interest** in the QOZB.

QOZ Interest

- Consists of any capital or profits interest in a domestic partnership (including an LLC treated as a partnership for federal tax purposes) if:
  a. the QOF acquired the interest **after December 31, 2017** in exchange for cash;
  b. at the time the QOF acquired the interest in the partnership, the partnership was a QOZB or was organized to be a QOZB; and
  c. during **substantially all** of the time the QOF held the interest, the partnership qualified as a QOZB.
- Partnership must qualify as a QOZB during **90%** of the holding period to satisfy the “substantially all” requirement for a QOZ Interest.
- QOF will be acquiring an **equity interest** in the QOZB

QOZB Property

- Tangible property that a QOF or QOZB purchased **after December 31, 2017** and that is used by the QOF/QOZB in a trade or business operating in a QOZ for **<u>substantially all</u> (70%)** of the time that the QOF/QOZB owns the property.
- The **<u>original use</u>** of the property in the QOZ must begin with the QOF or QOZB, **<u>or</u>** the QOF/QOZB must **<u>substantially improve</u>** the property.
  - "Original use" – placed in service for purposes of depreciation or amortization – acquire prior to issuance of CO?
  - Unimproved land – does not need to be substantially improved. Can be treated as QOZ Business Property as long as it is used in a trade or business activity AND more than insubstantial improvement. – "Land Banking" is prohibited.

QOZB Property – Substantially Improve

- Property will be treated as "substantially improved" if the basis of the QOF or QOZB in the property increases over a 30-month period beginning at acquisition by an amount that exceeds its initial basis (i.e., the purchase price) in the property.
    - The improvement expenditures of the QOF or QOZB in the property over the 30-month period must **exceed** the original acquisition price.
    - Not required to improve underlying land – capital investment attributable to purchase price of building.
    - **COVID-19 Relief –** The 30-month "clock" is effectively stopped until December 31, 2020.
- Property must be used in the OZ at least 70% of the time to satisfy the "substantially all" use requirement for QOZ Business Property.

QOZB Property – Related Party Restriction

- To qualify as QOZB Property, the QOF or QOZB can only acquire the property from an **unrelated party** (no more than 20% common ownership).
- Property that a QOF or QOZB purchases in a transaction involving certain prohibited relationships such as individuals from the same family, entities related through common ownership or control, or entities from the same controlled group, may **NOT** be considered QOZB Property.

What is a QOZB?

REQUIREMENTS:

1. The activity must be a trade or business in which **at least 70%** of the tangible property owned or leased by the taxpayer is QOZB Property.
2. 50% Gross Income Test
   - Entity must derive at least 50% of its total gross income from the active conduct of a trade or business within a QOZ.
   - Safe Harbors and a facts and circumstances test for evaluating compliance.
3. No “Sin Business”
4. Limitation on Nonqualified Financial Property

Encouraging Investment in a QOZB

- Leasing of real property confirmed to be considered an active trade or business activity for OZ purposes. – However, simply entering into triple-net lease is not an active trade or business (purely passive) – permitted as part of larger leasing business.
- Reasonable working capital safe harbor for operating business - planned use of working capital now includes development of trade or business – expanded under final regulations – **COVID-19 RELIEF – additional 24 months**
- Increased working capital safe harbor period for start-up businesses – 62 months in the aggregate – working plan and schedule – COVID-19 Relief?
- Real property straddling a zone may be considered in the QOZ if the cost of the real property inside the QOZ is greater than the cost of the real property outside the QOZ (can also qualify based on square footage).

Encouraging Investment in a QOZB

- Inventory in Transit - Inventory (including raw materials) of a trade or business does not fail to be "used" in an OZ solely because the inventory is in transit from a vendor to a facility of the trade or business that is in an OZ, or from a facility of the trade or business in an OZ to customers located outside the OZ.
- Leased tangible property can be treated as QOZB property.
    - Lease entered into after 12/31/2017
    - Substantially all of the use of the leased property must be in the QOZ.
    - Market-Rate Lease – arms length terms consistent with market (IRC § 482).
    - No "original use" requirement = No requirement to substantially improve
    - Related party – prepayment restriction; personal property (30-month acquisition requirement)

Encouraging Investment in a QOZB

- No grace period for QOF starting an operating business – likely limits structuring QOF to own QOZB Property and conduct operating business.
- QOZB satisfies 70% QOZB Property test at the end of its taxable year.
- QOZB cure period – one-time, six-month cure if it fails to meet 70% test.
- QOZB prohibited from leasing 5% or more of its property to "sin businesses."
- QOZB intangible property restrictions – "used in the qualified opportunity zone in the performance of an activity of the trade or business."
- Relaxed "original use" requirement – brownfield sites, vacant property, property purchased from local government – no "substantial improvement"
- Aggregation of original use property/buildings for substantial improvement purposes.

Encouraging Investment in a QOZB

- **<u>Vacant Property</u>**. Property that was vacant prior to and on the date of the publication of the QOZ designation notice that listed the designation of the QOZ in which the property is located (TN QOZs were listed in IRS Notice 2018-48, 07/09/2018), and through the date on which the property was purchased by an eligible entity and was vacant for a period of at least one year, is considered "original use" property.
- If the property was not vacant at the time of the QOZ designation but later became vacant, the property must be vacant continuously for at least three (3) years before it will convert to "original use" property.
- The Final Regulations provide that real property, including land and buildings, will be considered vacant for purposes of the OZ Program if the property is "significantly unused." The Final Regulations define "significantly unused" as a building or land where more than 80 percent (80%) of the building or land, as measured by the square footage of usable space, is not currently being used.

Encouraging Investment in a QOZB

- **Brownfield Sites**. An eligible entity that purchases a parcel of land that is a "brownfield site" under federal law, may treat all of the property composing the brownfield site (including the land and structures on the property) as satisfying the original use requirement as long as the eligible entity makes investments in the brownfield site to ensure that all property composing the site meets basic safety standards for both human health and the environment.
- **Property Owned by Local Government**. An eligible entity that purchases real property from a local government that the local government holds as the result of an involuntary transfer (including through abandonment, bankruptcy, foreclosure, or receivership) may treat all property composing the real property (including the land and structures thereon) as satisfying the original use requirement.

Miscellaneous Provisions

- Distributions of property (including cash) are an inclusion event (investor required to include some portion of its deferred gain investment into income) only to the extent that the property distributed has a FMV in excess of the investor’s basis in its qualifying investment.
- Can an investor receive a profits interest in a QOF in exchange for services? – Profits interest partner in exchange for services are ineligible for Opportunity Zone tax incentive/benefit. Interest received for services is considered a non-qualifying investment.

Miscellaneous Provisions

- Investor can acquire an eligible QOF interest from another investor.
- Proceeds that a QOF receives from the sale of QOZ Business Property during the 10-year investor hold period are treated as qualifying property so long as the proceeds are reinvested into other qualifying property within 12 months. – does not shield the QOF investors from any taxable gain on the sale of the property.
- Transfer at Death? – Distribution of a qualifying investment to a beneficiary by the estate or by operation of law is not an inclusion event.

Attracting OZ Investment Capital

- Tax incentives under the OZ Program are different from other development-related tax credits because they apply to both residential and commercial real estate as well as to investments in an operating business (for example, retail, manufacturing, restaurants, etc.), and because there is no cap on the amount of the tax incentives that a QOF investor could potentially claim.
- The OZ Program tax incentives are also different from other development-related tax credits in that they are market-driven. That is, the incentives are entirely dependent upon private investors freely investing deferred capital gain in any qualifying real estate or business-related project within a designated QOZ - without first having to obtain approval from a governmental entity or non-profit intermediary
- Accordingly, because the OZ Program incentives require, and are completely dependent upon, private investment, communities looking to leverage the OZ Program incentives to generate interest in specific community projects or encourage economic development, generally, must identify effective ways to attract private investment.

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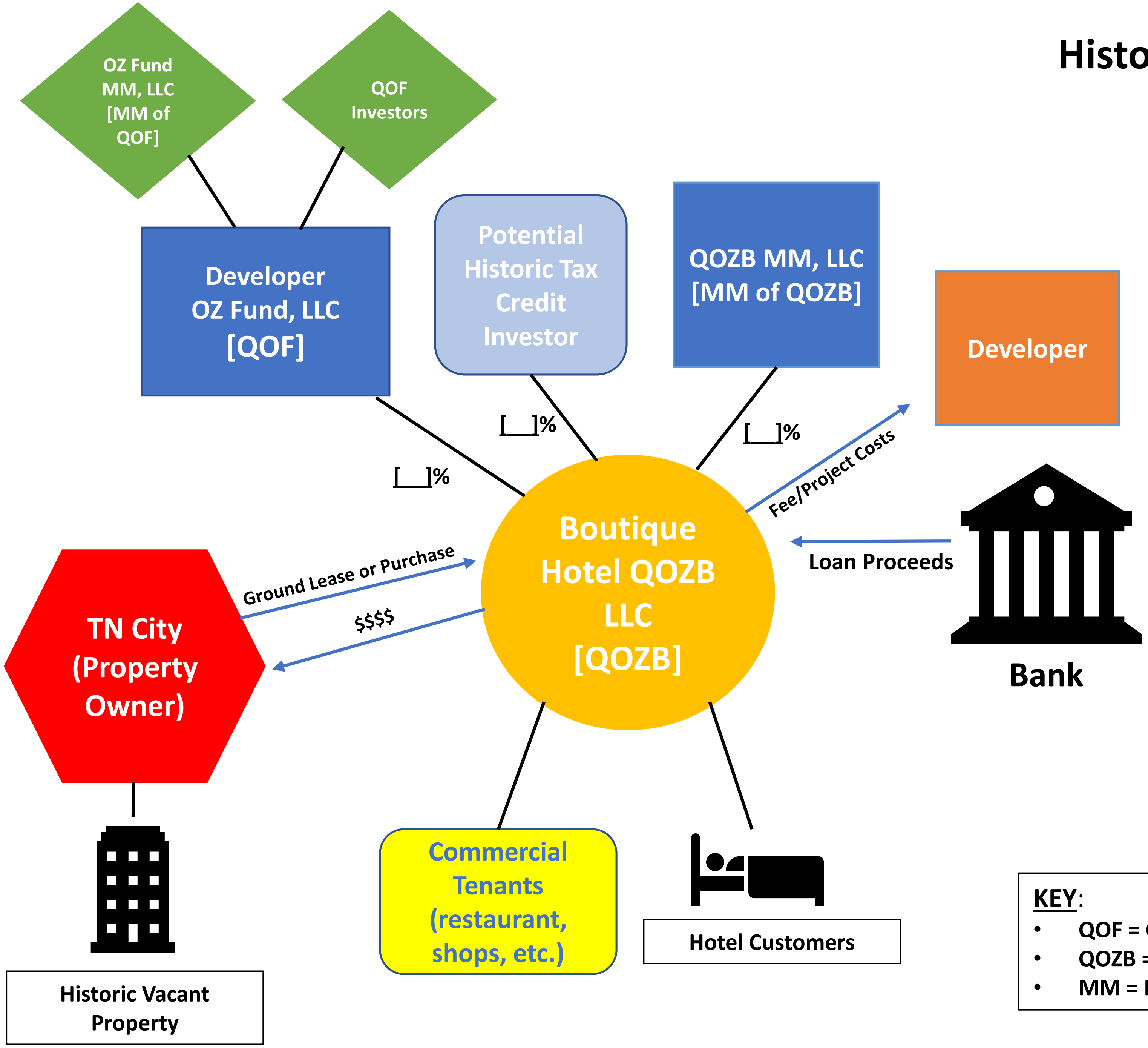
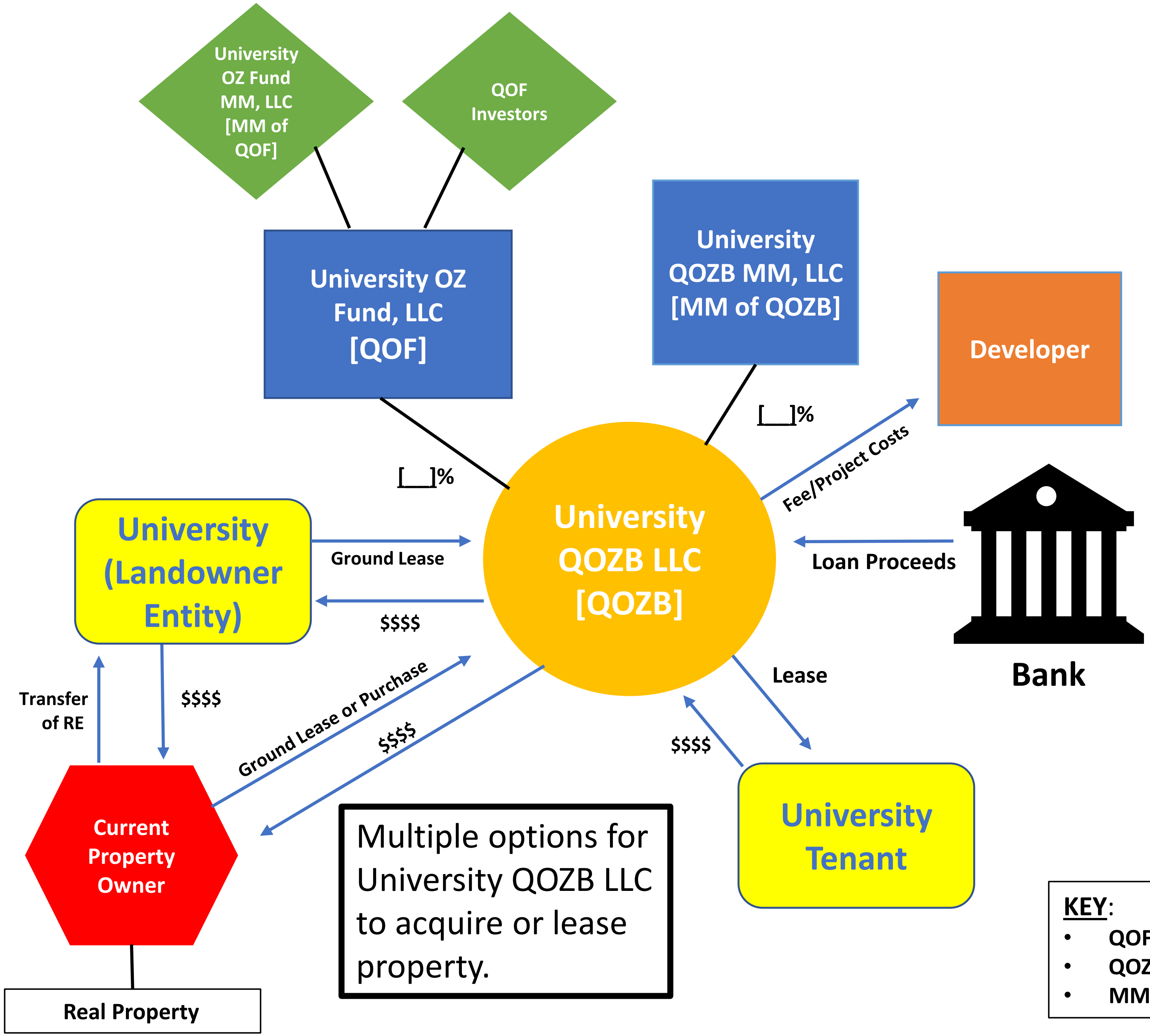
Historic Property Development Project



- City could make historic vacant property available to developer at below market rate amount consistent with agreement by purchaser/lessee to develop.
- Vacant property does not require substantial improvement (See Playbook page [#])
- MM of QOF and QOZB could be same entity. Also could be a third-party manager (e.g., the project Developer). MM of QOF or QOZB does not have to be affiliated with Developer or the City.
- QOF will own an interest in the QOZB.
- Lease from Hotel QOZB to commercial tenants cannot be a triple net lease.
- Multiple QOFs or non-QOF sources of capital could invest in QOZB.
- Hotel QOZB could receive other tax credits and incentives related to project.
- Historic Tax Credit investor could bring additional necessary capital to the project.

KEY:
- **QOF = Qualified Opportunity Fund [IRC 1400Z-2(d)(1)]**
- **QOZB = Qualified Opportunity Zone Business [IRC 1400Z-2(d)(3)]**
- **MM = Managing Member**

University Dormitory Project



- Property may be purchased or leased from current owner. However, if property to be developed is currently owned by University then parties must consider related party issues (See page [#] of Playbook).
- If QOZB and current owner are related parties, only option is for QOZB to lease the property. Must be at market rate.
- MM of QOF and QOZB could be same entity. Also could be a third-party manager (e.g., the project Developer). MM of QOF or QOZB does not have to be affiliated with University.
- QOF will own an interest in the QOZB.
- QOZB would construct dormitory and lease the property to the University. Lease from QOZB to University tenant cannot be a triple net lease.
- University could obtain financing to purchase the property/improvements at fair market value from QOZB after 10-year OZ hold period.
- Multiple QOFs or non-QOF sources of capital could invest in QOZB.

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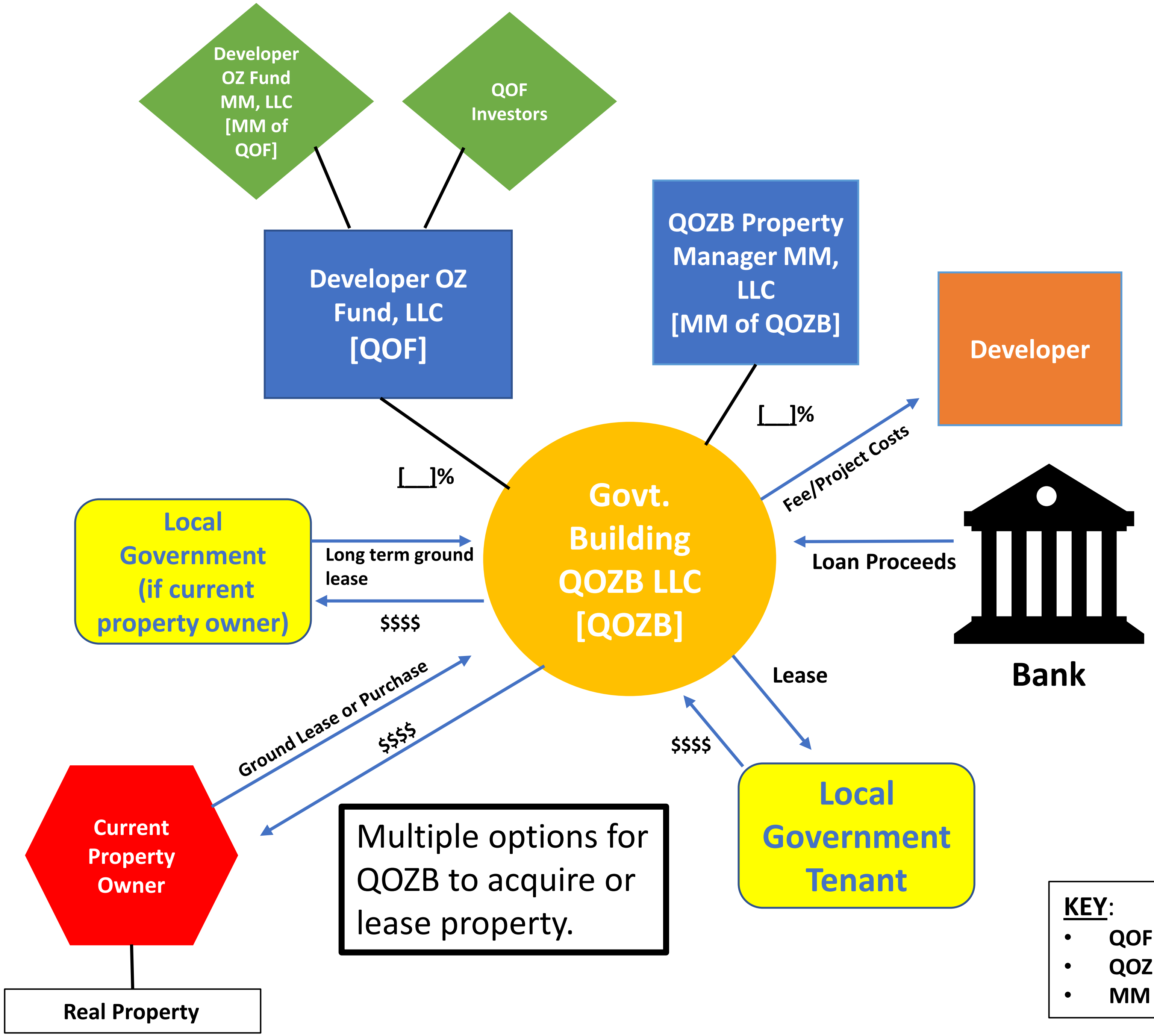
Government Building Project



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- If QOZB and current owner are related parties, only option is for QOZB to lease the property. Must be at market rate.
- MM of QOF and QOZB could be same entity. Also could be a third-party manager (e.g., the project Developer). MM of QOF or QOZB does not have to be affiliated with University.
- QOF will own an interest in the QOZB.
- QOZB would construct building and lease property to local government for use. Lease from QOZB to local government cannot be a triple net lease.
- Local government could obtain financing to purchase the property/improvements at FMV from QOZB after 10-year OZ hold period.

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- **QOF = Qualified Opportunity Fund [IRC 1400Z-2(d)(1)]**
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Questions?

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