

Overview of OZ Program and New Guidance

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Taxpayers can get
capital gains
tax deferral
(& more)



*for making
timely
investments in*

Qualified
Opportunity Funds
(QOFs)



*which
invest in*

Qualified
Opportunity Zone
Property



3 Tax Incentive Benefits

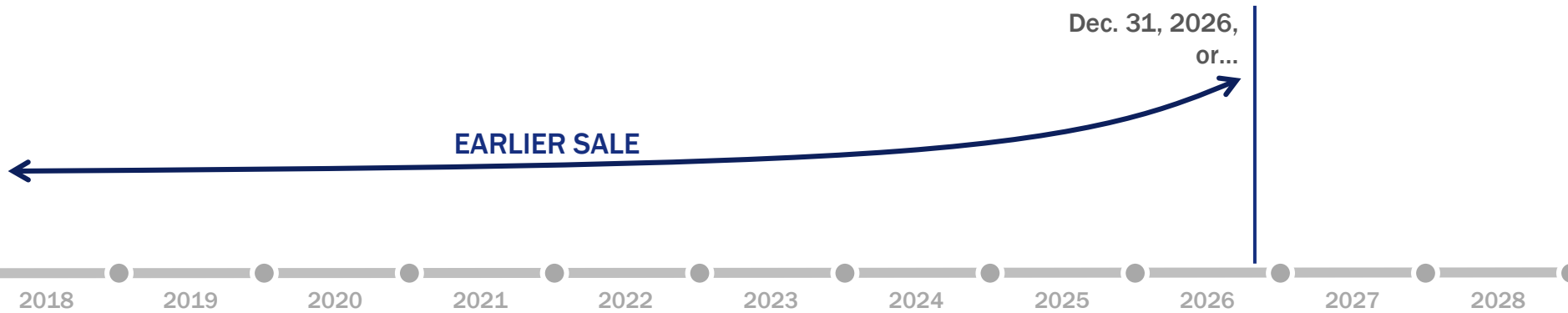
1. Gain
Deferral

2. Partial
forgiveness

3. Forgiveness of
additional gains

Period of Deferral

The period of capital gain tax deferral ends upon the earlier of:



Amount Recognized

THE LESSER OF:

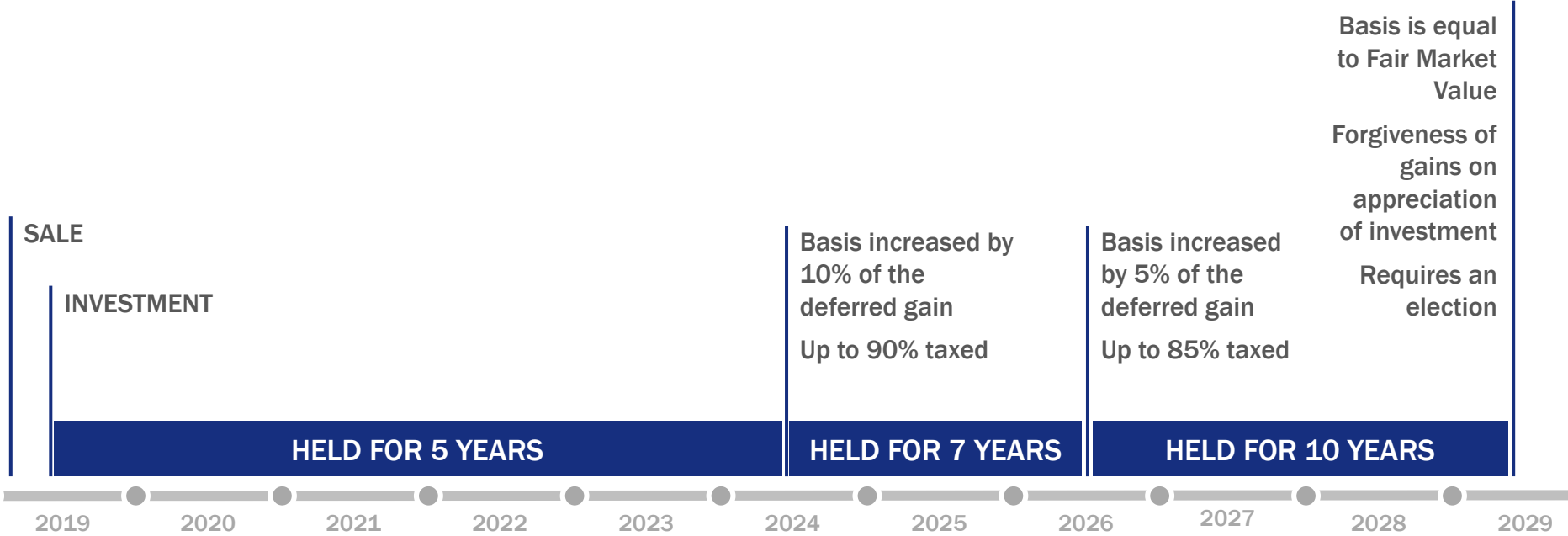
1. Amount of gain deferred
or
2. The fair market value of investment in QOF interest

MINUS:

Taxpayer's basis in the QOF interest

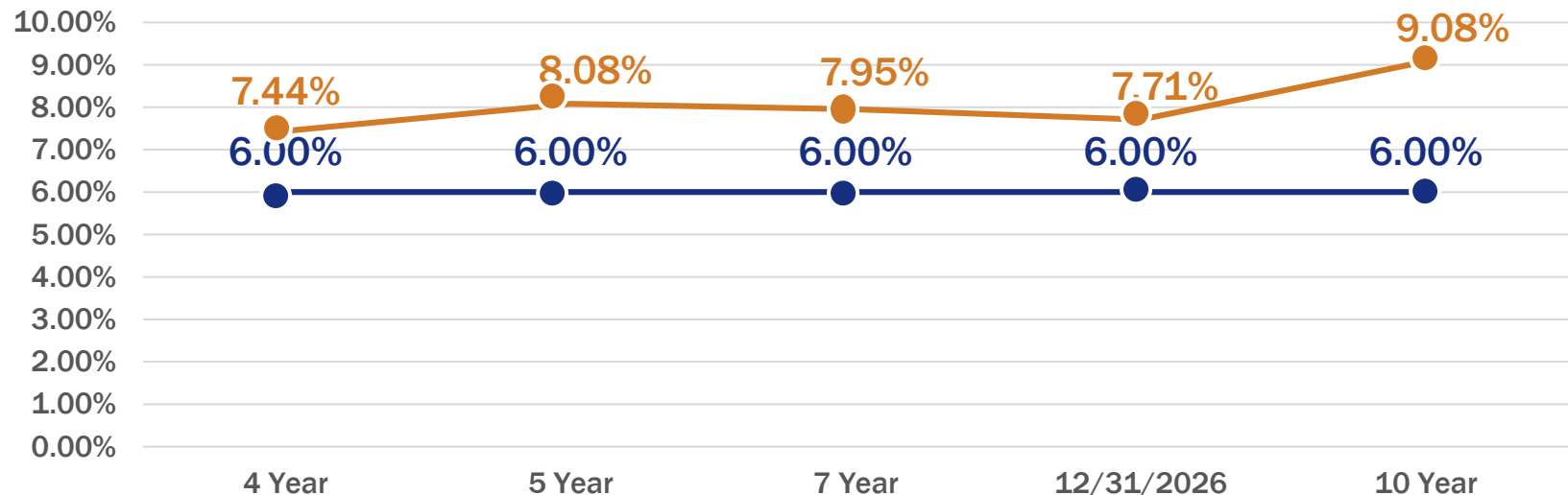
Note: The taxpayer's basis in the Opportunity Fund is initially deemed to be zero.

Partial Forgiveness and Forgiveness of Additional Gains



Opportunity Zone Incremental Benefit

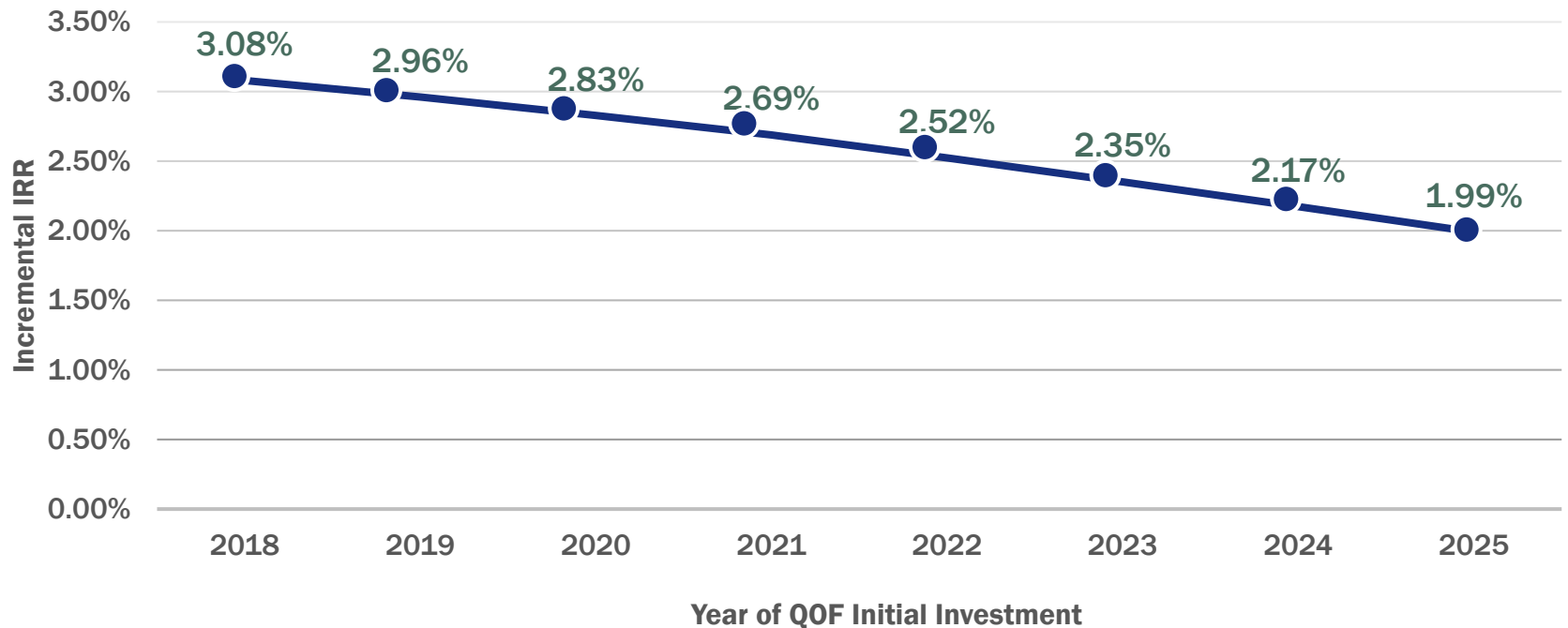
— Standard After Tax IRR — Total IRR



23.8% Tax Rate	4 Year	5 Year	7 Year	12/31/2026	10 Year
Standard After Tax IRR	6.00%	6.00%	6.00%	6.00%	6.00%
Incremental OZ Benefit	1.44%	2.08%	1.95%	1.71%	3.08%
OZ Investment IRR	7.44%	8.08%	7.95%	7.71%	9.08%
Percentage Increase	24%	35%	32%	29%	51%

*Rates and prices displayed in this and next slides are for demonstration purposes only and may not be indicative of actual figures available at market, depending on type of taxpayer, location of investment, and various other factors.

Perishability of Incentives



***In order to maximize benefits, gain must be invested in QOF by 12/31/2019.**

Eligible Gains

- Limited to gains treated as capital gains for Federal income tax purposes
 - Recognized before January 1, 2027
 - Multiple elections can be made for various parts of a single source of gain
- Includes additional deferral of previously deferred gains recognized
- Deemed gains under 1256 contracts, but only net gains for a year

Attributes of Gains

- Deferred gains triggered have the same attributes in taxable year of inclusion that they would have had if tax on the gain had not been deferred
- Including attributes taken into account by
 - §1(h) – Maximum capital gains rate
 - §1222 – Term of Capital Gains
 - §1256 – Mark to Market Contracts
 - Other applicable provisions of the code

Eligible Taxpayer

A person that may recognize gains for purposes of Federal income tax accounting. Includes:



Individuals



C corporations



RICs



REITs



S Corporations



Trusts and
Estates

Opportunity Zone Designation

- More than **8,700 census tracts** located in each State, DC and possessions have been designated (approx. **11% of the country by census tract**)
- The Opportunity Zones meet basic low income criteria, but some contiguous census tracts not meeting low income requirement were also designated
- **List is final** and essentially unchanging
- The list is available from IRS organized by state
- States also have interactive websites for confirming address in a QOZ
- **Novogradac Mapping Tool:** www.novoco.com/OZMap
- **100% of low income census tracts in Puerto Rico qualify as QOZs**

QOF Contributions

- Investments in QOFs must be cash, or property, and does not include services
- Property contributions – deferral election is limited to tax basis of property contributed
- Value received by an investor for appreciated property or provision of services is treated as property contributed for which an election is not made
 - Results in a mixed funds investment

Special Rules for Pass-through Entities

- A partnership (or other pass-through entity) may elect to **defer capital gains at the entity level**
- If a partnership (or other pass-through entity) does not elect to defer some or all of gains realized, a partner (or other owner) **can elect to defer their distributive share of the gain**
 - Generally, beginning of 180-day period is **last day of the pass-through entity's taxable year**
 - Partner (or other owner) may elect to use pass-through entity's 180-day period.

Qualified Opportunity Funds (QOFs)

Two requirements for eligibility:

1. Investment vehicle to be organized as a corporation or a partnership for the purpose of investing in Qualified Opportunity Zone Property
2. At least 90 percent of its assets is held in Qualified Opportunity Zone Property

*Funds can be structured to invest in multiple assets, or as a single-asset special purpose vehicle. However, Opportunity Funds cannot be structured to invest in other funds, thereby prohibiting a 'fund-of-funds' model.

**Failure to meet 90% threshold causes a monthly penalty equal to the federal underpayment rate (6% for April – June) multiplied by the excess of 90% of fund assets over fund QOZP, subject to a reasonable cause exception – no penalty imposed if failure due to reasonable cause. Failure not covered by reasonable cause could result in penalty or possibly decertification.

Certification of QOF

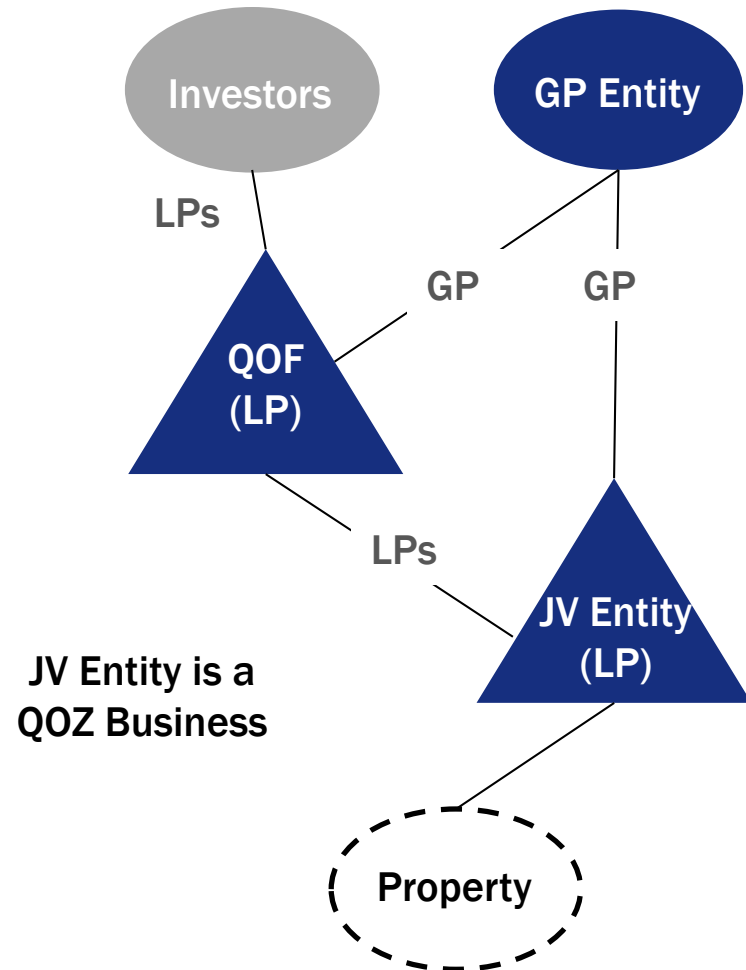
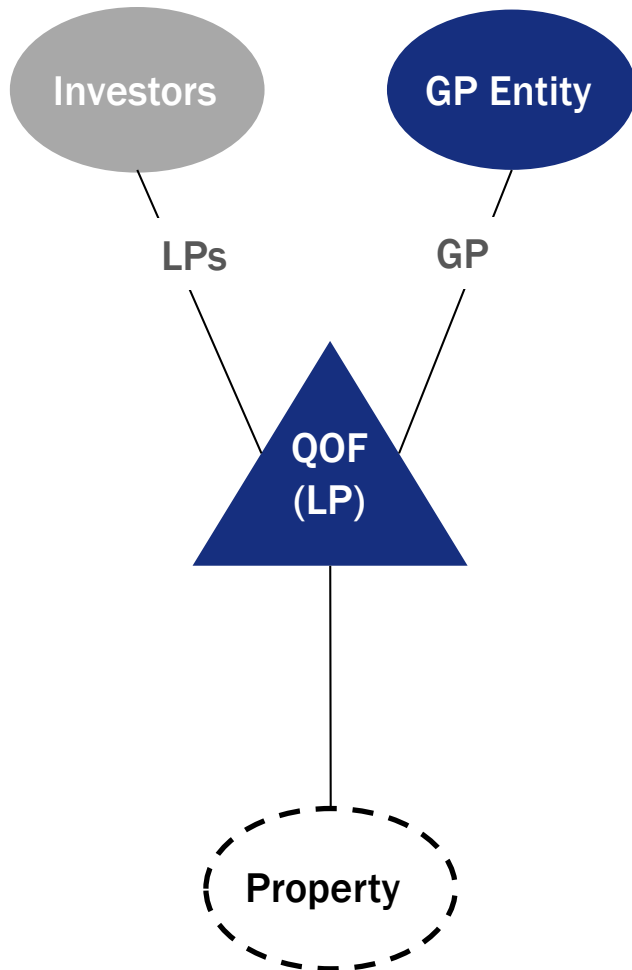
- Entity classified as a **corporation or partnership for Federal tax purposes** is eligible – LLCs taxed as corporations or partnerships OK
- Self-certification using **Form 8996**
 - Identify **first taxable year** the entity wants to be a QOF
 - Identify the **first month** the entity wants to be a QOF
 - Anticipated additions to 8996 = EINs of QOZBs and \$\$ invested in QOZs
- Investments before “first month” **not eligible for deferral**
- QOFs have 6-months to invest proceeds, even if QOF investment is made during second half of QOF tax year (new provision; must be cash or debt due ≤ 18 mos)
- Penalty doesn’t apply to months before the “first month”
- No legal barrier to pre-existing entities becoming a QOF (or QOZB)

Qualified Opportunity Zone Property: Direct and Indirect Investments

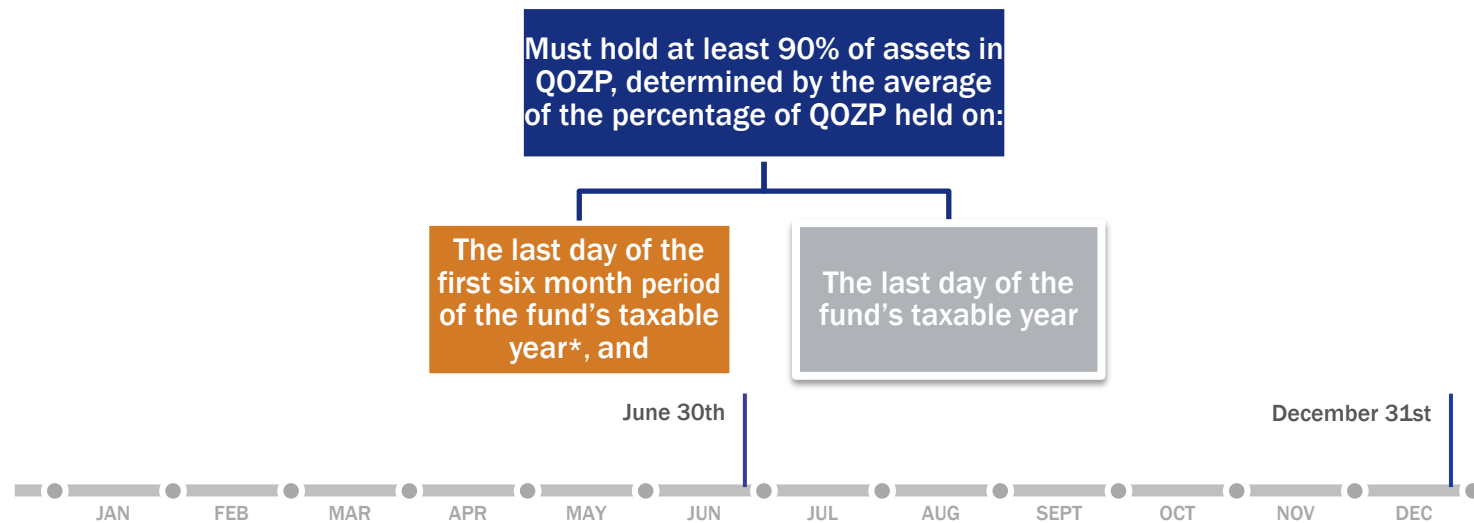


- The investment must be **acquired after December 31, 2017** solely in exchange for cash;
- Must be a **qualified opportunity zone business**, or is being organized for the purpose of being a qualified opportunity zone business;
- Must remain a qualified opportunity zone business for **substantially all** of the qualified opportunity fund's holding period
 - Now defined by new proposed regulations as 90% of the holding period

Direct Investment v. Indirect Investment



Qualified Opportunity Fund – Assets Test

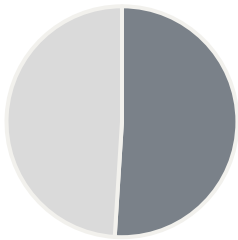


*If proceeds are held as cash, cash equivalents, and debt instruments with terms of 18 months or less, QOFs with contributions in later half of tax year may apply 90% test excluding contribution in first year.

**QOF has a reasonable time to reinvest interim gains from sale of QOZP. Reasonable time is defined as 12 months.

Qualified Opportunity Zone Businesses (QOZB)

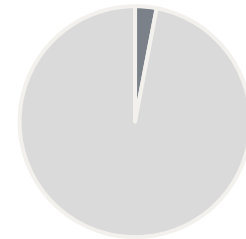
A trade or business in which **substantially all (70%)** of the tangible property owned or leased by the taxpayer is **qualified opportunity zone business property (QOZBP)** and:



At least 50% of income derived from Active Conduct of a business [in an QOZ]



Substantial portion (40%) of intangible property used in active conduct of business [in an QOZ]



< 5 percent unadjusted basis of property is nonqualified financial property

*Non-qualified financial property is, generally, debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, etc. that do not relate to the OZ investment.

Operating Businesses - Non-qualifiers

- What types of operating businesses are NOT likely to qualify as either a Qualified Opportunity Fund (QOF) or a Qualified Opportunity Zone Business (QOZB)?



Businesses such as financial institutions - hold large amounts of NQFP



Businesses holding intangible property not actively used in the Trade or Business (TOB)



Sin businesses cannot be QOZBs

- *Sin business are a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

Qualified Opportunity Zone Business Property (QOZBP)

- ✓ **Tangible property used in a trade or business**
- ✓ Acquired by **purchase from an unrelated party** (20% standard) after **December 31, 2017**
- ✓ During **substantially all (90%)** of holding period, substantially all the use is **in a QOZ (70%)**
- ✓ **Original use in the QOZ** commences with the taxpayer (PIS date for depreciation or amortization)

OR

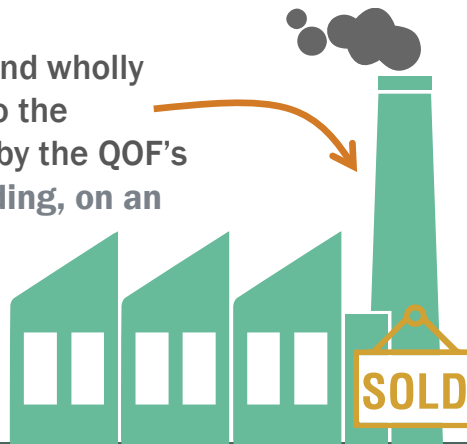
- ✓ **Taxpayer substantially improves the property**
 - ✓ during any 30-month period after acquisition, additions to basis exceed an amount equal to the adjusted basis of such property at the beginning of such period



Special Rules for Land and Improvements on Land

If a QOF purchases a building located on land wholly within a QOZ, a substantial improvement to the purchased tangible property is measured by the QOF's additions to the adjusted basis of the building, on an asset by asset basis.

*Note that property vacant for at least 5 years is not subject to the substantial improvement requirement.



QOZ

QOF is not required to separately substantially improve the land upon which the building is located. Land not subject to original use test (subject to active conduct and anti-abuse provisions)

Valuation of Assets for the 90% / 70% Tests (pre-2nd tranche):

If QOF / QOZB has an applicable financial statement under §1.475(a)-4(h) (AFS):

The value of each asset is the value of the asset reported on the AFS for the relevant reporting period

If no AFS:

90% Test: Value equals cost of the asset
70% Test: Special Rule

Valuation of Assets for the 90% / 70% Tests (post-2nd tranche):

QOFs may elect to use the unadjusted cost basis

Active Conduct of a Trade or Business and Leasing Considerations

Proximity of Active Conduct Tests

- 50% of gross income of a QOZBs must be derived from the active conduct of a trade or business in the qualified opportunity zone
- A substantial portion of the intangible property of an opportunity zone business must be used in the active conduct of a trade or business in the qualified opportunity zone
 - Substantial portion is now defined as 40%

Measurement of 50% Gross Income Test

- At least 50% of services performed (**based on hours** of employees / independent contractors) are performed within the qualified OZ;
- At least 50% of services performed (**based on amounts paid** to employees / independent contractors) are performed in the qualified OZ; or
- **Tangible property** of the business that is in a QOZ **and the management / operational functions performed** for the business in the QOZ are each necessary to generate 50% of trade or business gross income.

Taxpayers not meeting any of the above may meet the 50% requirement if, based on all the facts and circumstances, at least 50 percent of gross income is derived from the active conduct of a trade or business in the qualified OZ.

Leased Property – Original Use and Substantial Improvement

- Improvements made by a lessee to leased property satisfy the original use requirement and are considered purchased property
- Original use requirement does not apply to leased tangible property
- There is no “substantially improvement” requirement for leased tangible property

Leased Property – Qualified OZ Business Property (QOZBP)

- Leased tangible property may be treated as QOZBP for the 90% and 70% tests, if:
 - Leased tangible property is acquired under a lease entered into after December 31, 2017.
 - Substantially all of the use of the leased tangible property is in a QOZ during substantially all of the period for which the business leases the property.

Leased Property – Related Parties

- Leased tangible property does not need to be acquired from an unrelated lessor. However,
 - The lease must be a “market rate lease.”
 - If the lessor and lessee are related,
 - Leased tangible property is not QOZBP if the QOF / QOZB makes a prepayment to the lessor (or person related to the lessor) relating to a period that exceeds 12 months
 - Leased tangible personal property is not treated as QOZBP unless the lessee becomes the owner of tangible property that is qualified OZ business property and that has a value not less than the value of the leased personal property
 - The proposed regulations include an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases of real property (other than unimproved land)

Leased Property – Lease Valuation Methodology

- Leased tangible property may be valued using either an applicable financial statement valuation method or an alternative valuation method, if applied consistently to all leased tangible property during the taxable year:
 - *Financial statement valuation method* – The value of leased tangible property is the value of that property as reported on the applicable financial statement, prepared according to U.S. GAAP and which requires recognition of the lease of the tangible property
 - *Alternative valuation method* – The value of tangible property is determined based on a calculation of the “present value” of the lease payments for the use of the tangible property

Leased Property – Residential Rental and NNN Leasing

- The new proposed regulations provide that the ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business
- However, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business

Nonqualified Financial Property and Working Capital Safe Harbor

Non-Qualified Financial Property (NQFP)

- NQFP is, generally, debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations.
- Certain assets may be recast as NQFP for tax purposes, such as IRC Section 467 leases (prepayments in excess of \$250,000).

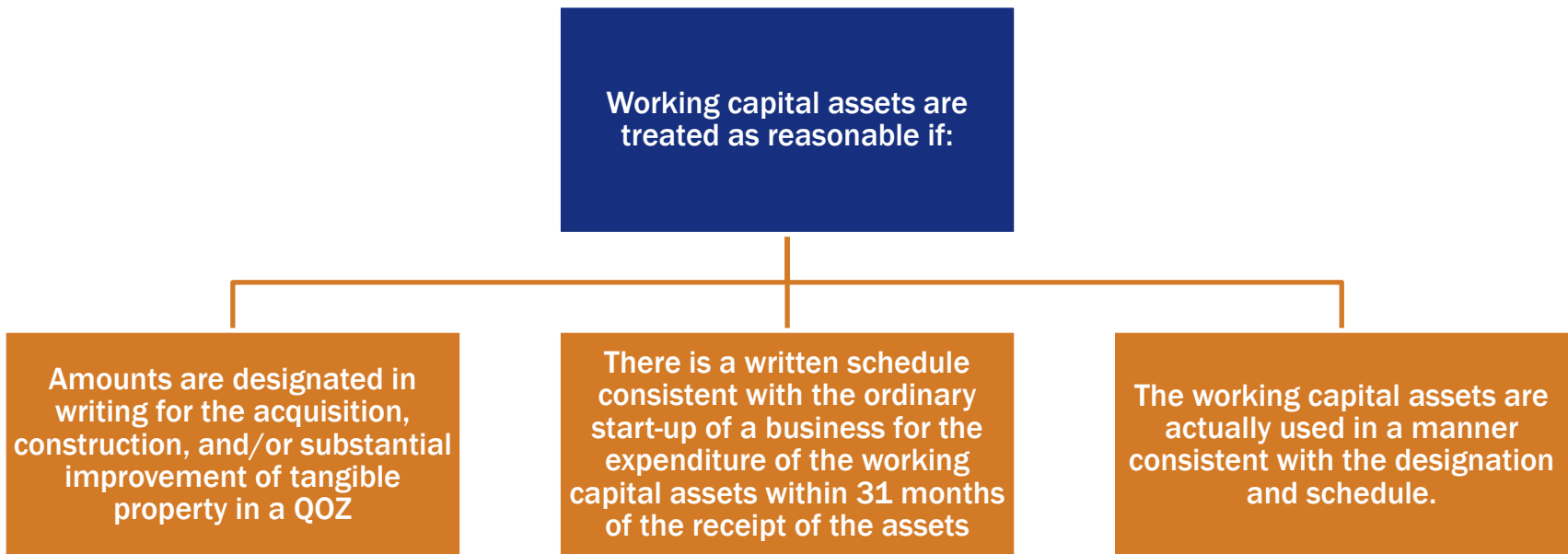
NQFP Exclusions

NQFP excludes:

1. Reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less
2. Accounts or notes receivable acquired:
 - i. In the ordinary course of the TOB for services rendered
 - ii. From the sale of stock in trade of the taxpayer
 - iii. Inventory of the taxpayer at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of the TOB

Although possibly not covered by the working capital safe harbor, discussed as follows, certain assets may still not be considered NQFP.

Safe Harbor for Reasonable Working Capital



Safe Harbor for Gross Income Earned on Reasonable Working Capital

Gross income earned on **working capital** during the **reasonable working capital period** is counted toward satisfaction of the **50% active conduct test**

Safe Harbor for use of Intangible Property

Intangible property held during the **reasonable working capital period** is treated as used in the **active conduct of the OZ business** in the qualified opportunity zone.

Safe Harbor for Property on which Working Capital is being Expended

Planned expenditures of reasonable working capital assets that are expected to satisfy QOZBP requirements are **not treated** as failing to satisfy the requirements because the **consumption of working capital is not yet complete.**

Working Capital Safe Harbor Operating Business Considerations

Second tranche of proposed regulations change the written designation for planned use of working capital to now include the **development of a trade or business in the qualified OZ** as well as acquisition, construction, and/or substantial improvement of tangible property.

Working Capital Safe Harbor – Extended Development Periods

The second tranche makes clear that businesses may benefit from **multiple** overlapping or sequential **applications of the 31-month working capital safe harbor.**

Working Capital Safe Harbor – Issues Beyond Taxpayer’s Control

The new proposed regulations provide that **exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action** the application for which is completed during the 31-month period.

2nd Tranche of Proposed Regulations – Additional Updates

Reinvestment of Interim Gains

If qualified OZ property is sold for cash, it is no longer a qualified investment for the 90 percent test—but the OZ statute allows a reasonable time to reinvest. Treasury has clarified that a “reasonable time,” is within **12 months**.

Gain Recognition / Inclusion Events

- **11** inclusion events with the 11th being another 11 “certain nonrecognition transactions”
- Transfers by gift are one of the 11 inclusion events
 - However, transfers by gift to a grantor trust, which the taxpayer owns, are allowed
- Transfer of a deceased owner’s estate are not inclusion events, subject to further disposition by the recipient
- Distributions in excess of basis: “an actual or deemed distribution of property (including cash) by a QOF partnership to a partner with respect to its qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of the partner’s basis in its qualifying investment.”

Contiguous Tracts Straddling a QOZ

If the amount of real property square footage located within the QOZ is substantial, compared to the square footage outside the QOZ, and the real property outside of the QOZ is contiguous, then all property is deemed to be located within a QOZ.

Basis Step-Up on 10-Year Sale

- **10-Year Basis Step-Up** – the bases of QOF assets are adjusted with respect to the transferred QOF interest, similar to adjustments made with a valid IRC Section 754 election in effect
 - To avoid the creation of capital losses and ordinary income on the sale, basis adjustments may include those to inventory and unrealized receivables

Exit Approach

- The proposed regulations provide a special election for certain sales of assets of a QOF partnership or QOF S corporation. A taxpayer that holds a qualifying QOF partnership interest or qualifying QOF stock of a QOF S corporation may make an election to exclude from gross income some or all of the capital gain from the disposition of qualified OZ property reported on Schedule K-1 of such entity, provided the disposition occurs after the taxpayer's 10-year holding period.
- Special rule for REITS - The proposed rules authorize QOF real estate investment trusts (QOF REITs) to designate special capital gain dividends, not to exceed the QOF REIT's long-term gains on sales of qualified OZ property.

Anti-Abuse Rules

The Treasury Department and the IRS intend to implement targeted anti-abuse provisions with respect to the following:

- Leases used to circumvent the substantial improvement requirement
- Election to exclude gains from sale of QOZP / QOZBP
- Lack of substantial improvement requirement for land

Consolidated Group Rules

- Gains may not be aggregated under a single deferral election by the consolidated return group – each corporation must separately invest in a QOF
- A QOF C corporation can be the common parent but not a subsidiary member of a consolidated group
- The same member of the consolidated group must:
 1. Sell a capital asset to an unrelated person, the gain of which the member elects to be deferred; and
 2. Invest an amount of such deferred gain from the original sale into a QOF

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