

Opportunity Zone Program Tax Cuts and Jobs Act

Marc Schultz

602.382.6358

mschultz@swlaw.com

Jason Brinkley

303.634.2066

jbrinkley@swlaw.com

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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



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

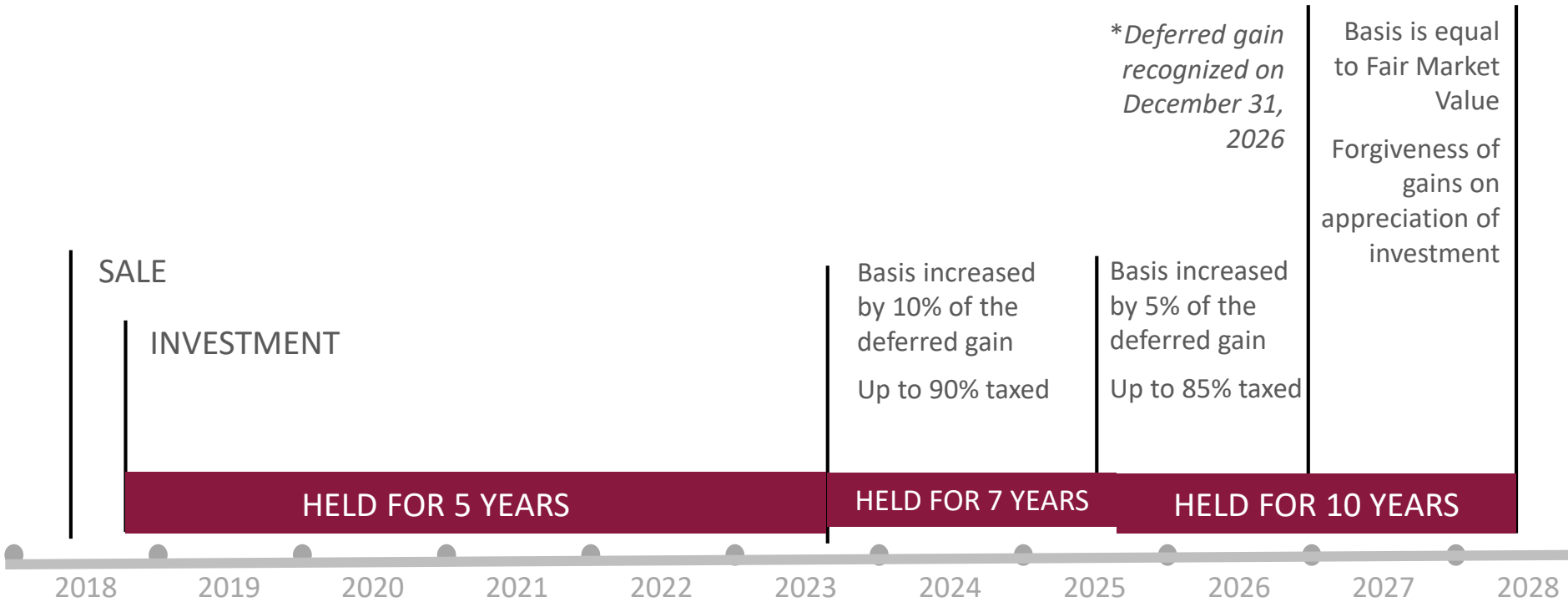
Partial Reduction of Deferred Gain (Tax Basis)

- 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

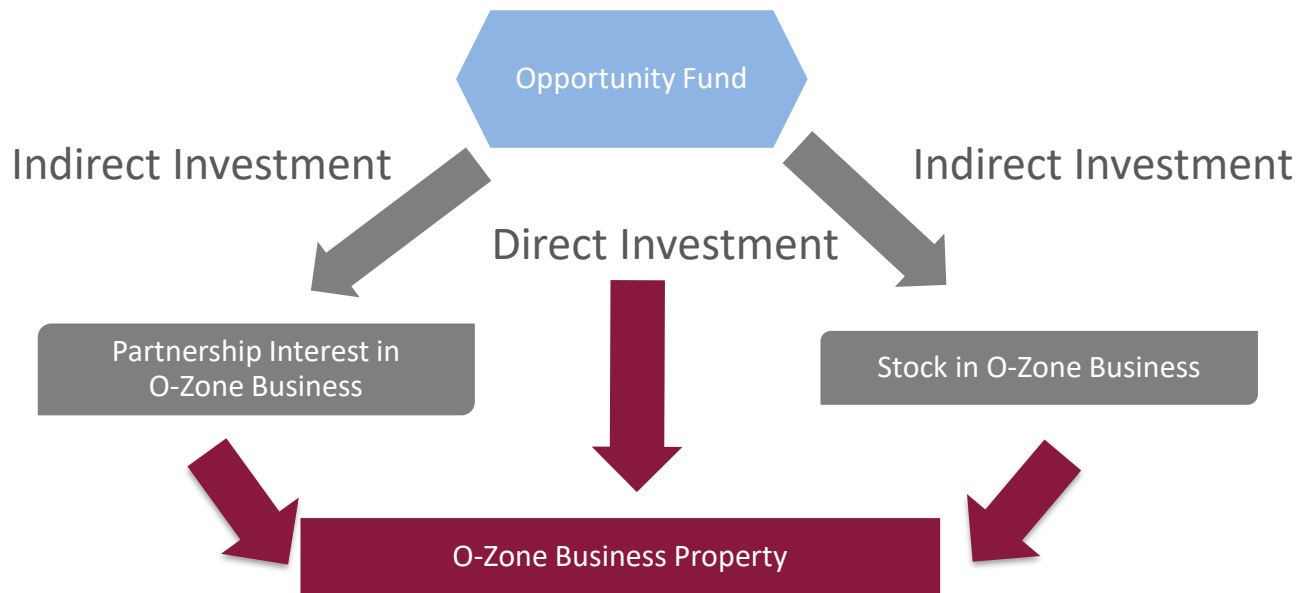
$$\frac{\% \text{ Shortfall} \times \text{Underpayment Rate}^*}{\text{Penalty}}$$

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

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

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).



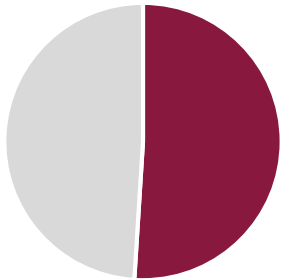
Source: Novogradac & Company LLP

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

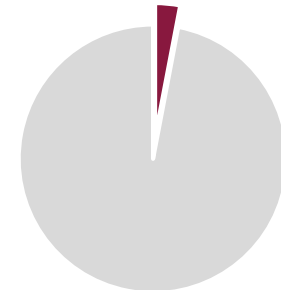
*A trade or business in which **substantially all** of the **tangible property** owned or leased by the taxpayer is **O-Zone Business Property** and:



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

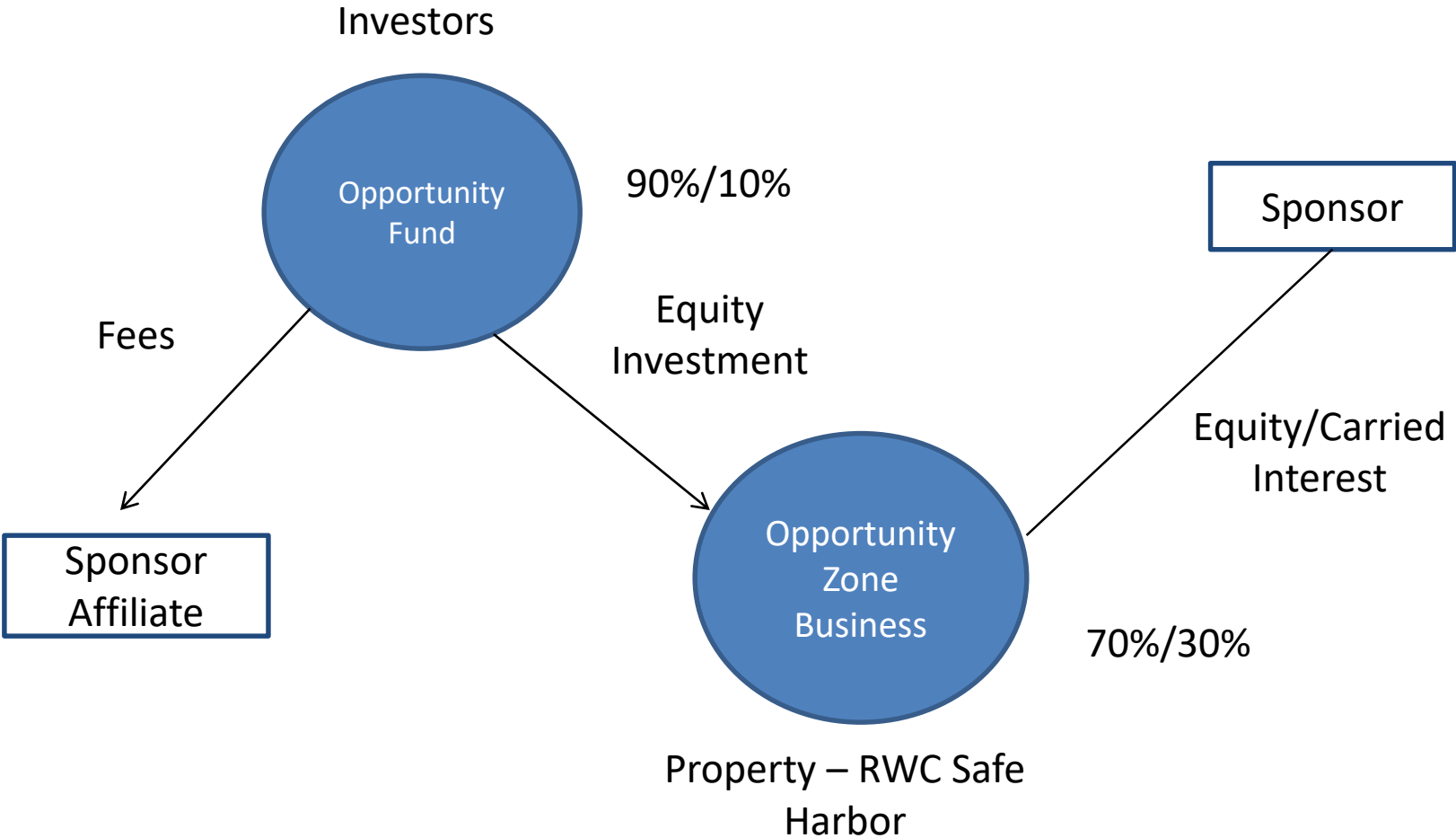
- Non-Qualified Financial Property
 - Less 5% of average of its assets can be cash or “cash type” assets
 - Does not include Accounts/Notes Receivable
 - Exception to NQFP for **reasonable amounts of working capital** (RWC) in cash, cash equivalents, or short term debt instruments (Working Capital Assets)
- **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**

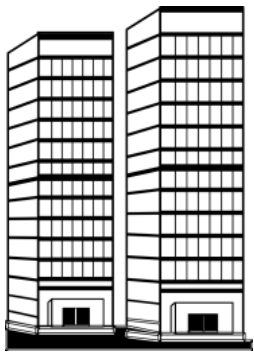
Alternative to the Original Use Requirement

- 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



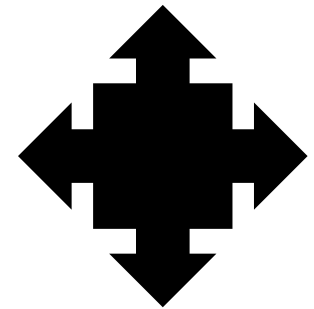
**Real Estate
Development and
Significant
Rehabilitations in
Opportunity Zones**



**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

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