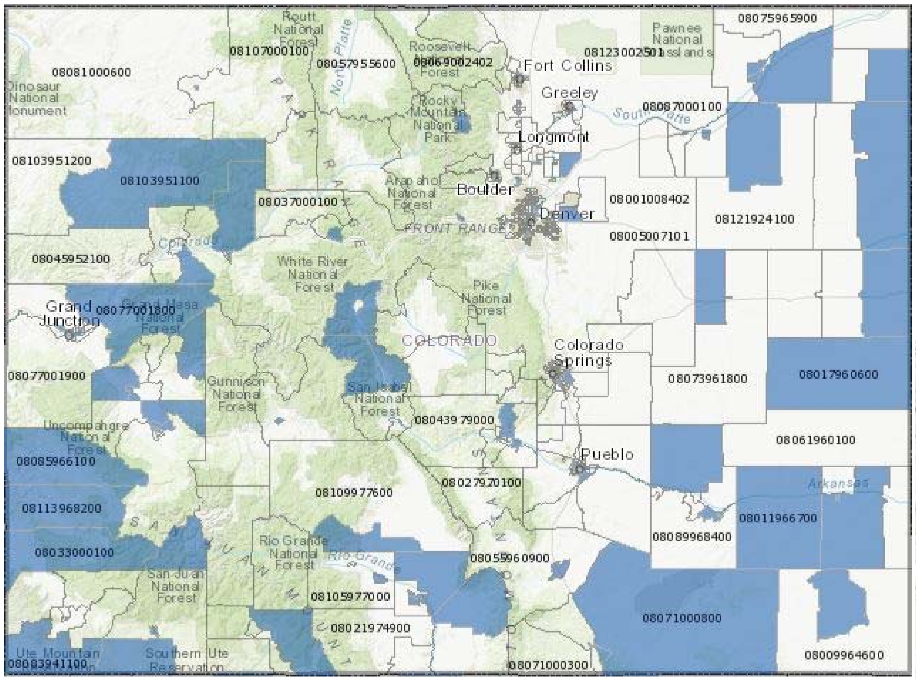
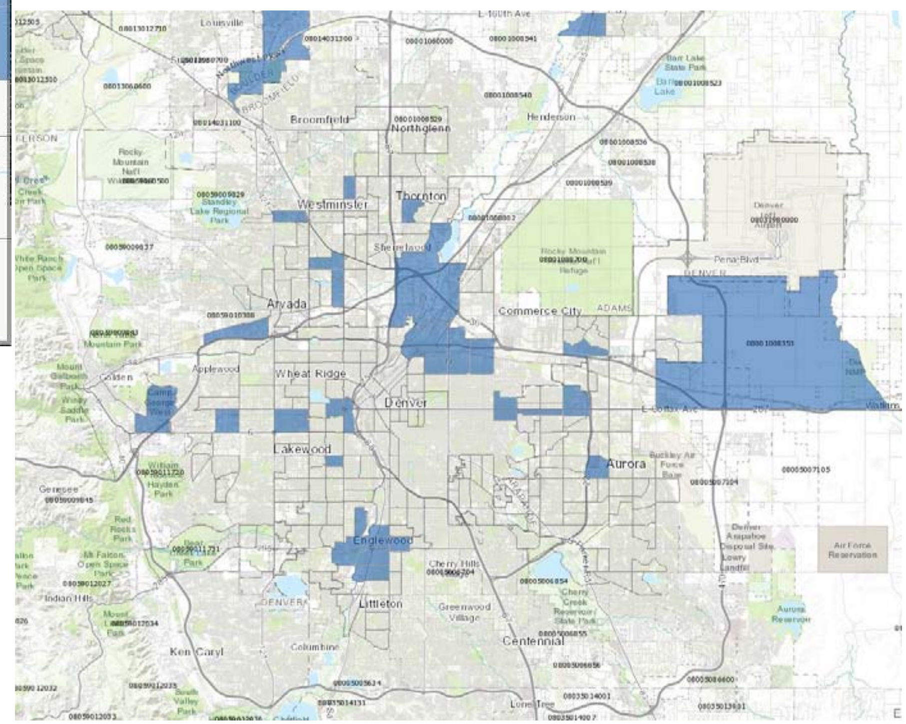
OPPORTUNITY ZONES

GAIN DEFERRAL AND ELIMINATION

ADAM M. COHEN

COLORADO OPPORTUNITY ZONES





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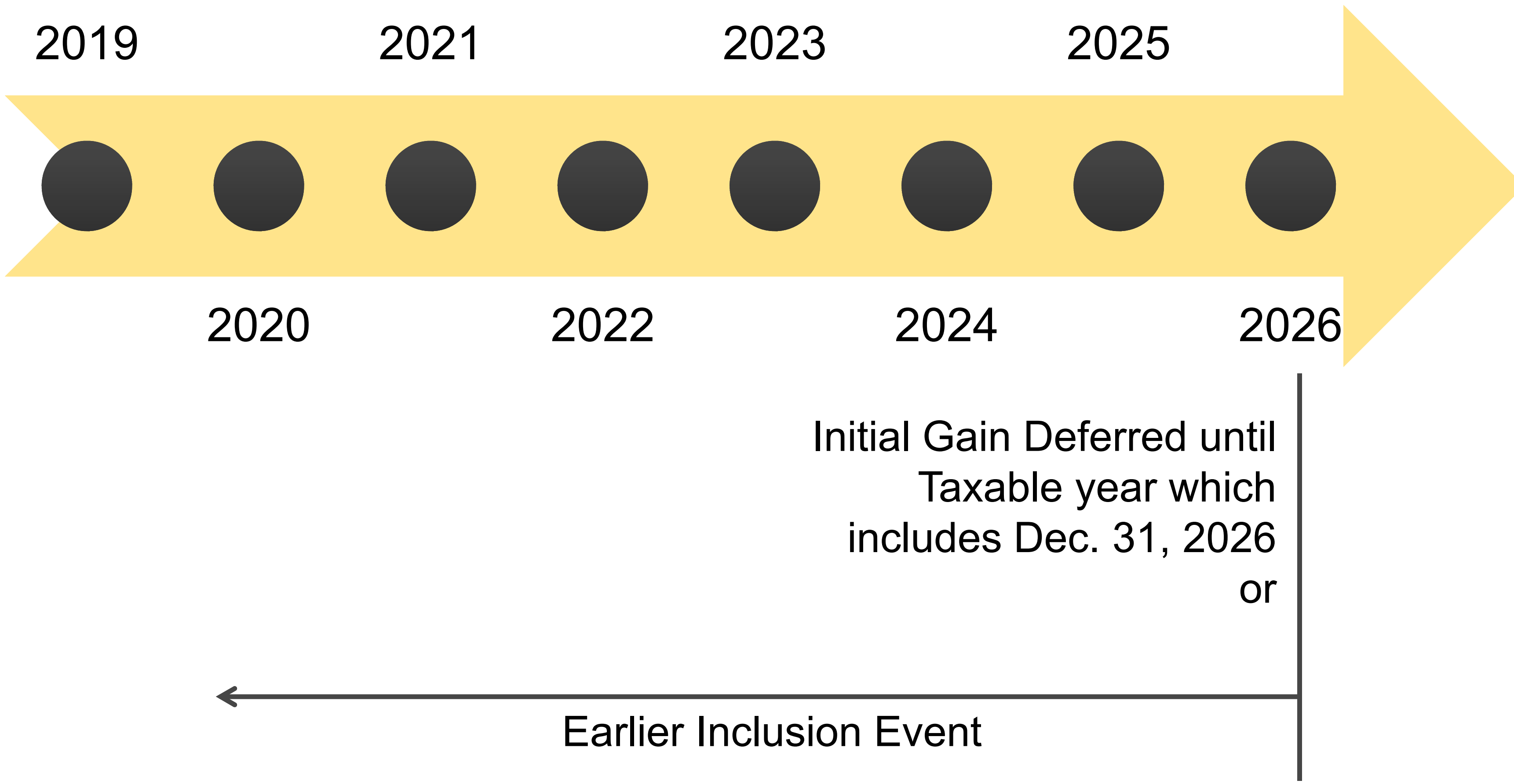
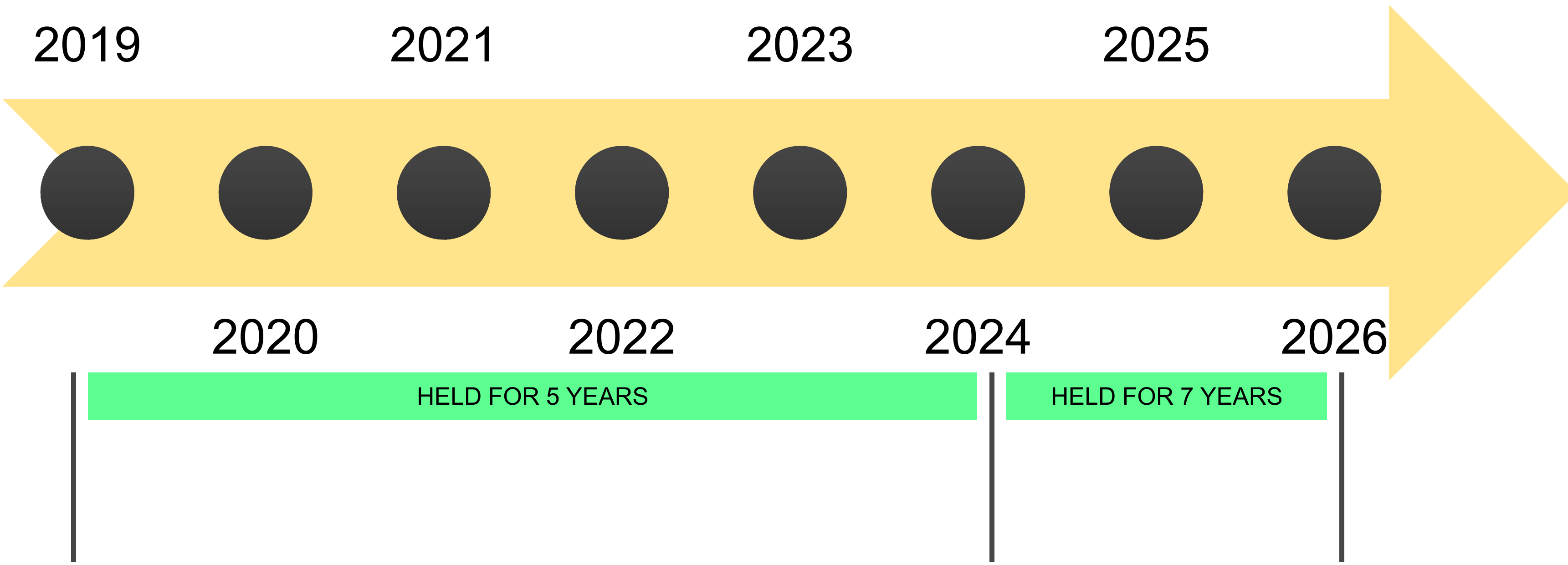
OPPORTUNITY ZONE BENEFITS

1. Initial Gain Deferral
2. Initial Gain Reduction
3. O-Zone Gain Elimination

GAIN DEFERRAL



INITIAL GAIN REDUCTION

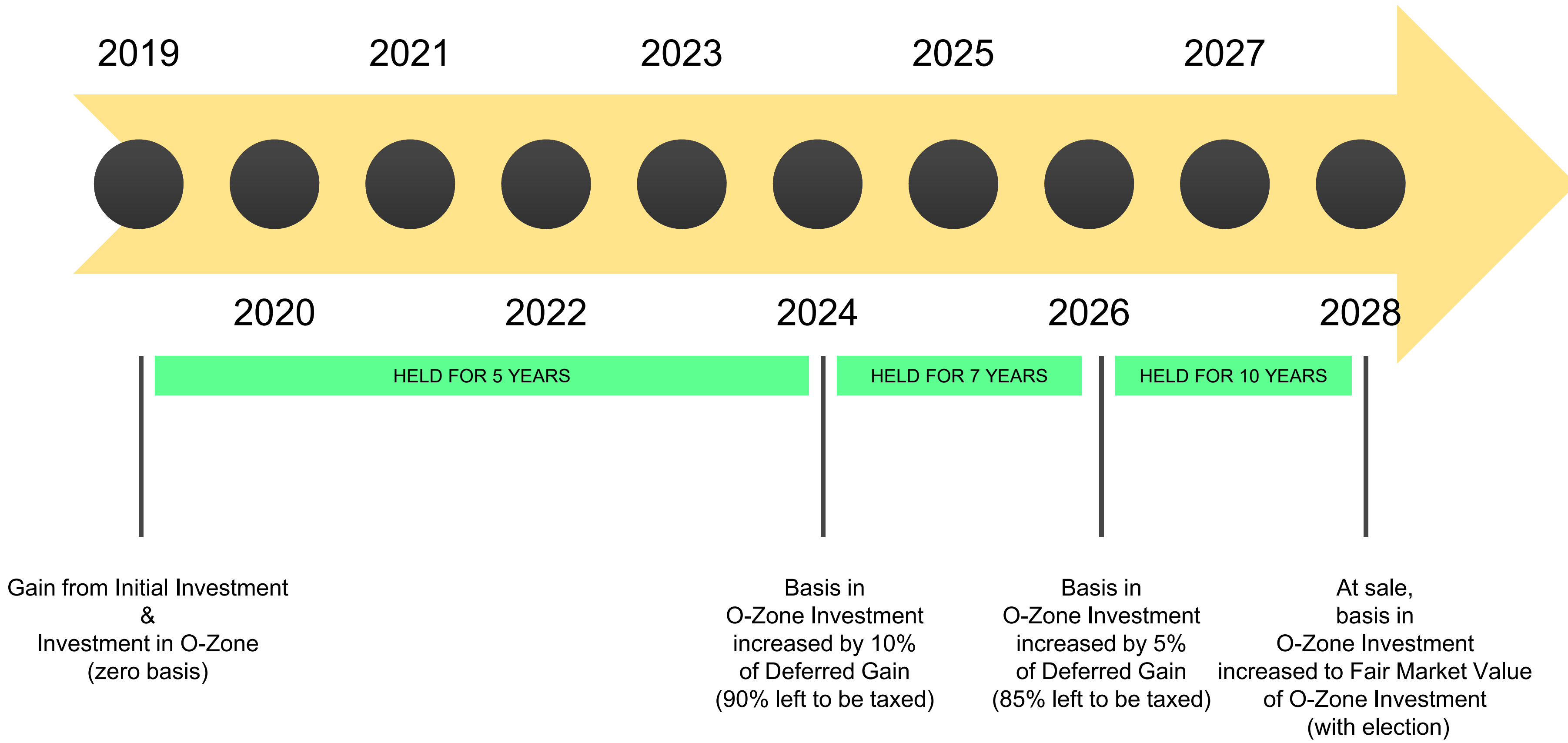


Gain from Initial Investment
&
Investment in O-Zone
(zero basis)

Basis in
O-Zone Investment
Increased by 10%
of Deferred Gain
(90% left to be taxed)

Basis in
O-Zone Investment
Increased by 5%
of Deferred Gain
(85% left to be taxed)

O-ZONE GAIN ELIMINATION



COMPARISON TO 1031

Benefit	O-Zone	1031
Deferral	Until 2026	Until Replacement Property Sold
Gain Elimination	10% at Year 5 5% at Year 7	None
Investment Gain Elimination	100% at Year 10 if sell QOF	None (unless further 1031)
Gains Eligible	Capital Gain only	Real Property gains/income only
Investment Required for Full Deferral	Gain Only	Entire Investment in relinquished property
Limitation on Location	O-Zone Only	Anywhere
Cash Tracking	Not Required	Required
Construction Allowed	31-months	Parking Transaction required

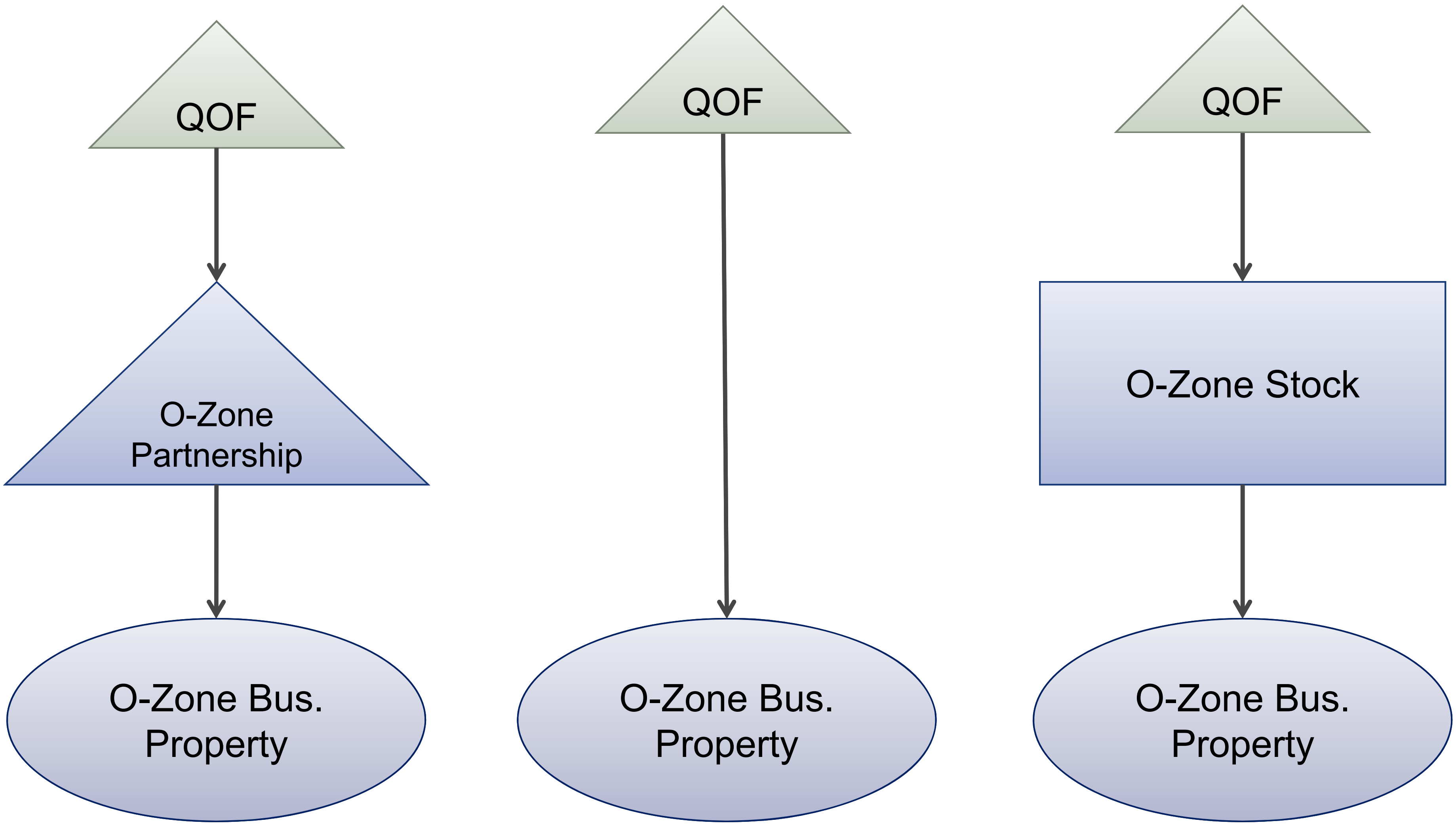
STATUTORY REQUIREMENTS

- Invest in “Qualified Opportunity Fund” (QOF)
- “Gains” invested
- During 180-day period
  - Generally, begins on date of sale/exchange
- Not for sales/exchanges after Dec. 31, 2026
- Only applicable to gains for which election made
  - Investments in QOF without election or not within 180-day period or without “gain” is a separate investment (and no basis step-ups [e.g., no gain elimination])

STATUTORY REQUIREMENTS (cont'd)

- Qualified Opportunity Zone Property (O-Zone Property)
  - Qualified Opportunity Zone Stock (O-Zone Stock)
  - Qualified Opportunity Zone Partnership Interests (O-Zone Pship Interest)
  - Qualified Opportunity Zone Business Property (O-Zone Bus. Property)

STRUCTURES TO MEET REQUIREMENTS



PROPOSED REGULATIONS

- "Gains" = "treated as capital gains"
  - LTCG
  - STCG
  - 1231 Gains
  - 1256 capital gain net income
  - No straddles (1092 or otherwise)
  - No ordinary income (e.g., 1245/1250 recapture)
  - Cannot arise from transaction with related party
  - Of passthrough entity or (if entity does not elect) of owner
    - For owner, transaction also cannot be with related party
  - Each gain can be taken apart (i.e., deferral is on portion invested)
  - Does not include gains realized on transfer of property to QOF

PROPOSED REGULATIONS

- 180-day period begins on date of recognition for tax
  - Regular-way stock trade = trade date
  - REIT/RIC dividend = dividend paid date
  - Undistributed REIT/RIC capital gains = end of REIT/RIC year
  - Partner in partnership = end of partnership year (or, electively, when partnership recognizes)
  - 1231 Gains = end of taxable year

PROPOSED REGULATIONS

- Investment
  - Cash
  - Property
    - Amount invested = lesser of net basis or net value
      - Built-in gain property → Mixed Fund investment
  - Not Services
    - Promote/carry is not eligible for O-Zone benefits
  - Can be acquired from QOF or from third party
- Partnership Rules
  - Transfers that are not contributions ≠ not investments
  - If distribution and contribution would be disguised sale ≠ not investment
    - Assume cash is non-cash property
    - If debt-financed, assume share of liabilities is zero

STATUTORY REQUIREMENTS

- "Qualified Opportunity Fund" (QOF)
  - Organized as (entity treated as) corporation or partnership
  - Purpose = investing in Qualified Opportunity Zone Property (but not another QOF)
  - Assets = at least 90% in Qualified Opportunity Zone Property
    - Average percentage held:
      - on last day of first 6-month period of QOF's taxable year; and
      - on last day of QOF's taxable year
    - Proposed Regulations: must use value in "applicable financial statements" <u>or</u> unadjusted basis
    - Proposed Regulations: may ignore contributions of cash (or equivalent) for up to 6 months
  - Certification
    - Self certification when files timely federal income tax return for the year (including extensions)

STATUTORY REQUIREMENTS (cont'd)

- O-Zone Stock
  - Acquired after Dec. 31, 2017
  - At initial issue from the corporation (or underwriter)
  - For cash
  - At issuance, corporation was Qualified Opportunity Zone Business (or, for a new corporation, organized for purpose of being such)
  - During substantially all of holding period, corporation was a Qualified Opportunity Zone Business
    - Proposed Regulations: Substantially All = 90%
  - No IRC § 1202(c)(3) redemption

STATUTORY REQUIREMENTS (cont'd)

- O-Zone Pship Interest (capital or profits)
  - Acquired after Dec. 31, 2017
  - From the partnership
  - For cash
  - At issuance, partnership was Qualified Opportunity Zone Business (or, for a new partnership, organized for purpose of being such)
  - During substantially all of holding period, partnership was a Qualified Opportunity Zone Business
    - Proposed Regulations: Substantially All = 90%

STATUTORY REQUIREMENTS (cont'd)

- O-Zone Business
  - – Trade or business
  - – Substantially all tangible property owned or leased is O-Zone Bus. Property
  - – Gross Income test
  - – Intangible Property test
  - – Nonqualified Financial Property test
  - – Active Conduct of Business
    - Includes ownership and operation (including leasing) of real property BUT NOT "merely" triple-net-leasing
  - – Disqualified Businesses

STATUTORY REQUIREMENTS (cont'd)

- O-Zone Business
  - Substantially all tangible property owned or leased is O-Zone Bus. Property
    - Proposed Regulations: "substantially all" = 70%
      - Proposed Regulations have special valuation rule for leased property
    - If the property ceases to be O-Zone Bus. Property, continues to be treated as O-Zone Bus. Property for lesser of 5 years or date O-Zone Business no longer holds

STATUTORY REQUIREMENTS (cont'd)

- O-Zone Business
  - Satisfies IRC § 1397C(b)(2), (4) and (8)
    - At least 50% of total gross income must be derived from active conduct of business
      - Operation/Management and Property
      - Hours
      - Compensation
      - Facts and Circumstances
    - Substantial portion of intangible property must be used in the active conduct of business
    - Less than 5% of average aggregate unadjusted basis of the property attributable to nonqualified financial property
      - Debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and similar property (but not including reasonable amounts of working capital held in cash, cash equivalents or 18-month or shorter debt instruments and not including accounts or notes receivable acquired in the ordinary course of for services rendered or sale of stock in trade or inventory or property held primarily for sale to customers in the ordinary course)
      - Proposed Regulations: If (1) designated in writing for acquisition, construction and/or substantial improvement, (2) written schedule consistent with ordinary startup to spend within 31 months and (3) actual use substantially consistent with #1 and #2
        - » Failure to use consistent with plan due to waiting for governmental approvals (that have been applied for) will not cause failure
        - » May be used multiple times (at same time or sequentially)

STATUTORY REQUIREMENTS (cont'd)

- O-Zone Business
  - Not described in IRC § 144(c)(6)(B): providing (including the providing land for)
    - any 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

STATUTORY REQUIREMENTS (cont'd)

- O-Zone Bus. Property
  - Tangible property
  - Used in a trade or business of QOF
  - Acquired by purchase (per IRC § 179(d)(2) [using 20% related party rules]) or leased
  - After Dec. 31, 2017
  - Original use in O-Zone commences with QOF or QOF substantially improves
    - "Substantially improves" if, during 30-month period beginning on acquisition, additions to basis exceed basis at beginning of the 30-month period
      - Proposed regulations: land value not counted for beginning basis
  - During substantially all QOF's holding period, substantially all use in O-Zone
    - Proposed Regulations: 90% as to holding period; 40% as to use in O-Zone

PROPOSED REGULATIONS (cont'd)

- O-Zone Bus. Property
  - Land Value not counted for "substantial improvement"
    - If buy property for $1000 and land is worth $400, to substantially improve, must spend additional $600 on the building
- O-Zone Investment "not impaired" solely because zone designation expires
  - Only for dispositions before January 1, 2048
- If QOF is partnership, 752 basis is not a separate investment

PROPOSED REGULATIONS (cont'd)

- Original Use
  - First placement in service in the Zone
    - If unused or vacant for > 5 years, first use after that in the Zone
    - Used tangible property if not previously used in the Zone
  - Improvements by lessee to leased property must satisfy original use
- Leased Real Property
  - Does not qualify if plan, intent or expectation for QOF to purchase at other than FMV at time of purchase
  - Does not apply to unimproved land
- Special Rules for Lease Qualification

NONCOMPLIANCE PENALTY

- If QOF fails to meet 90% requirement
  - Penalty for each month equal to
    - 90% of its aggregate assets over amount of O-Zone Property multiplied by
    - IRC § 6621(a)(2) underpayment rate
      - Federal short-term rate plus 3% (currently 5%)
  - Proposed Regulations
    - No failure if QOF reinvest proceeds in qualified opportunity zone property within 12 months
      - Failure to reinvest within 12-months excused if waiting for government action (if applied for)
    - Between distribution, sale or disposition and reinvestment, proceeds held in cash (or equivalent)

COMPARISON OF REQUIREMENTS

Requirement	Direct Investment	Indirect Investment
% of QOF asset in O-Zone Bus. Property	90%	N/A
% of QOF in O-Zone Stock or Pship Int.	N/A	90%
% of QOF that can be in cash or other assets	10% (no safe harbor for working capital)	10% at QOF + 5% at Issuer (plus reasonable working capital)
% of QOF in intangible property	10%	10% at QOF + unlimited at Issuer if used in business
% of QOF in tangible property	90%	No minimum
% of Gross Income from O-Zone	None	50%
Ineligible Businesses	No	Yes

PROPOSED REGULATIONS (cont'd)

- If multiple "fungible interests" in QOF
  - FIFO used to determine which disposed of
  - If FIFO results in multiple investments in QOF made on same day treated as sold, use pro rata method
- Example
  - Invest STCG to buy 10% interest in QOF
  - Invest LTCG later to buy additional 10% interest in QOF
  - Sell 50% of 20%, recognize STCG

PROPOSED REGULATIONS (cont'd)

- Partnership Dispositions after 10-Years
  - Sell interest in QOF
    - No tax (including as to debt-basis)
    - Asset basis step-up inside QOF
  - Sell QOF's assets (with election)
    - No tax on capital gains (including net 1231 gains)

PROPOSED REGULATIONS (cont'd)

- Early Inclusion Events
  - Reduce Interest in QOF
  - Distributions by QOF
    - For Partnerships: in excess of basis
      - Mixed Funds must track interests separately (only for O-Zone purposes)
  - Claim Worthlessness Deduction
  - QOF ceases to exist
  - Transfers by gift
  - Conversion of grantor trust to non-grantor trust
  - Remaining Deferred Gain Reduction Rule
  - S Corp 25% Aggregate Change in Ownership
- <u>Not</u> Early Inclusion Events
  - Transfer by reason of death (recipient continues OZ holding period)
  - Contribution to grantor trust
  - Transfer to disregarded entity
  - Section 721 (capital contribution) transactions
  - Mergers/consolidations under Section 708(b)(2)(A)

PROPOSED REGULATIONS (cont'd)

- Anti-Abuse Rule
  - OZ Rules must be applied "consistent with the purpose of section 1400Z-2"
    - Preamble: Purpose is to "increase business activity and economic investment in qualified opportunity zones"
  - If significant purpose is to achieve inconsistent tax result, IRS can recast
  - Facts and Circumstances test

COMBINING TAX INCENTIVES

- Other incentives that can combine with Opportunity Zones
  - Low-Income Housing Tax Credit
  - New Markets Tax Credit
  - Historic Tax Credit
  - Renewable Energy Tax Credits
  - Small Business Stock Gain Exclusion (1202)
  - Like Kind Exchanges (1031)

FUTURE PROPOSED REGULATIONS?

- TBD
  - Failure to maintain required 90% investment
  - Information Reporting
  - Form 8996 Revisions to require additional reporting
  - Anti-“land banking”
  - Substantial Improvement on Aggregate Basis