Opportunity Zones: The Latest

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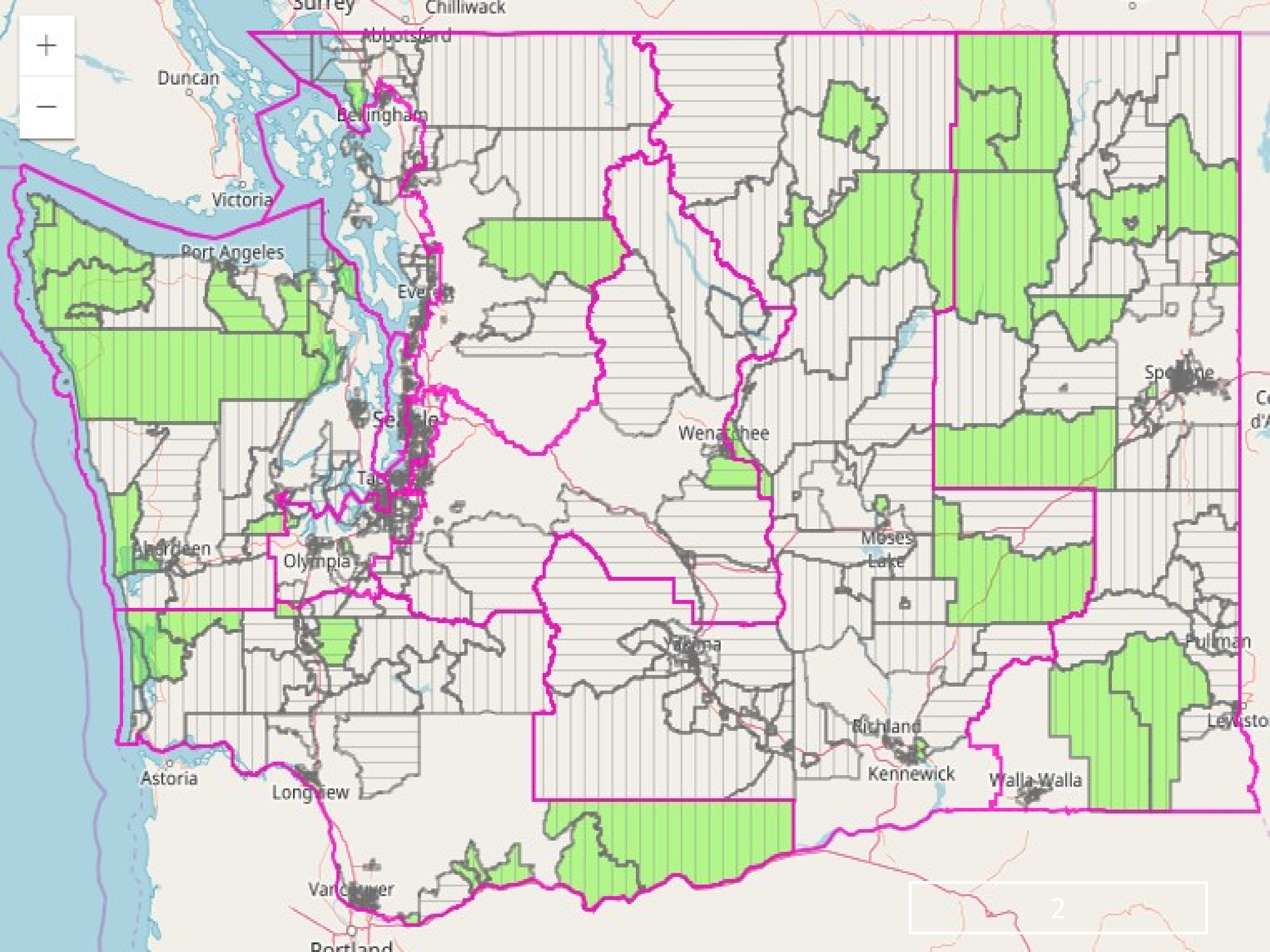
National Development Council

FEDERAL RESERVE BANK OF SAN FRANCISCO

Department of Commerce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Agenda

- Why invest in an Opportunity Zone fund?
- How did Opportunity Zones come to be?
- Steps in the Opportunity Zone Process
- Opportunity Zone Property
- "Substantial Improvement"
- Some of the Things to Think About
- Questions?

Why invest in an Opportunity Zone Fund?

- The short answer . . . If the investor meets the requirements they can:
  - Defer federal income tax on current recognized capital gains.
  - Have a portion of that deferred capital gain forgiven.
  - Avoid federal income tax on appreciation in Opportunity Fund investment.

How did Opportunity Zones come to be?

- Creation of the Tax Cuts and Jobs Act of 2017.

- Goal is revitalization of economically depressed geographies.

- Attempt to implement lessons learned from prior efforts:
  - Requisite long-term investment to maximize benefits.
  - Attempt principally to capture investor’s gains from other successful investments.
  - Broad, but not unlimited categories of qualifying investments.
  - To fully benefit from the Opportunity Zone provisions, the taxpayer needs to make astute opportunity zone investments.

Steps in the Opportunity Zone Process

- Step 1: A taxpayer realizes and recognizes any capital gain.
  - Shares of stock
  - Real estate
  - Partnership interest that result in capital gain
  - Other property
- Step 2: The taxpayer invests the gain dollars in a "Qualified Opportunity Fund" (Fund).
  - Timing: Investment within 180 days for realization/recognition event.
  - Taxpayer cannot invest directly in property, even if it's in opportunity zone.
  - The Fund can self-certify.

Steps in the Opportunity Zone Process

- Step 2: The taxpayer invests the gain dollars in a "Qualified Opportunity Fund" (continued).
  - Fund must be "organized as a corporation or partnership."
  - Purpose of the entity must be to invest in opportunity zone property.
  - Initial adjusted basis in the Fund is 0.
- Step 3: Fund makes equity investment in "opportunity zone property."
- Step 4: Fund must hold 90% of its assets in opportunity zone property.
  - Twice annual testing
  - Penalty for failure to comply
  - Draft IRS Form 8996 is out

Steps in the Opportunity Zone Process

- Step 5: If the taxpayer holds its Fund interest for 5+ years, the taxpayer receives an increase in his/her adjusted basis of 10% of the deferred gain.

- Step 6: If the taxpayer holds its Fund interest for 7+ years, the taxpayer receives an increase in his/her adjusted basis of 5% of the deferred gain.

Steps in the Opportunity Zone Process

- Step 7: On 12/31/2026, there is a "deemed disposition," so that all the deferred gains related to the investment in the Fund ends and gain is recognized.
  - The gain is the lesser of:
    - The original deferred gain, or
    - The FMV of the taxpayer's Fund investment.
  - Reduced by the taxpayer's basis the Fund investment.

Steps in the Opportunity Zone Process

- Step 7 (continued): Putting the "deemed disposition" rule in context . . .
  - The deferred gain is the building block for the tax on the deemed disposition.
  - So, protecting the cash on sale attributable to the adjusted basis from the originating transaction is paramount.
  - The basis adjustment (up to 15%) essentially is free.
  - Taxpayer has interest-free use of the adjusted basis dollars until, say, April 15, 2027.
  - What is the value of free use of that cash on a discounted present value?

- Step 8: If the taxpayer holds the Fund investment for 10+ years, the taxpayer is permanently exempt from capital gains from the sale of his/her Fund interest

Opportunity Zone Property

- Category 1: Opportunity Zone Business Property

- Tangible property used in trade or business of the Fund:
  - Real property
  - Land and improvements to real property
  - Equipment and other personal property
  - Acquired by purchase after December 31, 2017

- Tangible property needs to be in the opportunity zone during "substantially all" of the Fund's holding period.

Opportunity Zone Property

- Category 2: Opportunity Zone Stock or Partnership Interests
  - Fund is not limited to direct ownership of real estate.
  - The stock or partnership interest can be an investment in a domestic operating business.
  - “Substantially all” of the business tangible property must be:
    - Acquired by purchase from unrelated third parties after 2017, and
    - Used in the opportunity zone during “substantially all” of the business’s holding period.
    - Substantially all in this case is 70% of the entity’s tangible property.
  - Among other things, at least 50% of the business’s gross income comes from the “active conduct” of the business in the QOZ.
  - A “substantial portion” of the intangible property of the entity is used in the active conduct of the trade or business.

Opportunity Zone Property

Category 2: Opportunity Zone Stock or Partnership Interests:

- The balance sheet cannot contain too much financial property, which would imply the business's focus is investment speculation, rather than economic development.
  - Less than 5% of average aggregate unadjusted basis is "nonqualified financial property."
  - Clarification on cash expected to be used over up to 30 months.
- By statute, certain businesses don't qualify (golf courses, country clubs, massage parlors, hot tub or sun tan facilities, race tracks, gambling, package liquor stores).

“Substantial Improvement”

- An Opportunity Zone Fund has a 30-month window to improve property.
- Amount of improvements must exceed acquisition basis in the building.
- When does 30-month period start? Still open.
- Basis allocable to land excluded.
- How does this apply to operating businesses?

Some of the Things to Think About

- Does this make sense for a given investor or gain?
  - Incremental benefit
  - Comparative after-tax returns

- State law conformity/nonconformity

- Who is the taxpayer?
  - S corporations and/or their shareholders? Either.
  - Partnerships or their partners? Either.

- Mixed fund investments

Some of the Things to Think About

- How does an investor think about opportunity fund investment versus a like-kind exchange?
- Does deferred gain mean roll-over investors start with an adjusted basis of $0?
  - Investor's allocable share of annual tax loss?
  - Taxation of operating cash flow distributions?
- Does partnership-level nonrecourse borrowing solve all the problems?
- What is the tax result from a distribution of refinance proceeds?
- In a mixed fund, can the partnership make special allocations?

Some of the Things to Think About

- How best to structure Funds with multiple properties? How does the Fund structure an exit?

- How should developers and sponsors think about the related party rules?
  - Can/should the Fund purchase of assets owned by the developer?
  - Can the Fund pay the developer property management or asset management fees?

Questions?

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