# Opportunity Zone Program Tax Cuts and Jobs Act

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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?

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• 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.

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#### **Opportunity Zone Program**

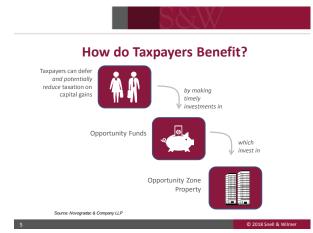
- Opportunity Zone Program
  - The Investment in Opportunity Act was included in the Tax Cuts and Jobs Act.
- December 22, 2017
- New York Times and USA Today



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The New york Times



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### **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

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- 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

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# 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:

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- 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

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#### Partial Reduction of Deferred Gain (Tax Basis)

- Taxpayer has an Initial Basis in the O-Fund of Zero
- Hold for 5 Years

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- Investor's tax basis in the O-Fund is increased by 10% of the amount of the Deferred Gain
- Hold for 7 Years

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 Investor's tax basis in the O-Fund is increased by an additional 5% of the amount of the Deferred Gain

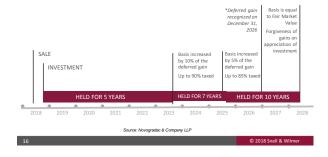
#### **Full Forgiveness**

- 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
   Conference there much large 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





#### 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

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#### 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

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- 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

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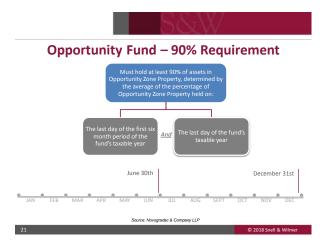
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#### What is an Opportunity Fund (O-Fund)

- 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



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#### 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

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Failure to meet the 90% Requirement:

Monthly penalty for failing to meet the 90% Requirement	% Shortfall <u>x Underpayment Rate*</u> <b>Penalty</b>	No penalty if it is shown failure is due to <b>reasonable</b> cause
	*Federal short-term rate plus 3%) – <b>Currently 5%</b> Annually	
	Source: Novogradac & Company LLP	

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#### **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).
   <u>Direct Approach</u>: Direct purchase of Opportunity Zone Business Property (O-Zone Business Property).



#### **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

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· 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:







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At least 50% of Substantial portion of income derived from active conduct of intangible property used in active conduct of business trade or business



Source: Novogradac & Company LLP

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### **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.

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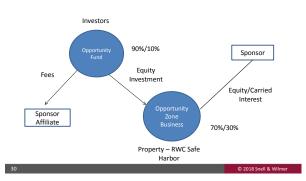
#### **Excluded Businesses**

#### 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

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#### **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

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#### 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

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#### 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)

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- · 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?



#### **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 early 2019

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