The Tax Cuts and Jobs Act's New Incentive for Investment in Distressed Communities Investment in Opportunity Zones

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Overview of Opportunity Zone Incentive

The Tax Act's "Sleeper" Provision: The Investment in Opportunity Zones Incentive

- Tax reform's Senate Bill included new provisions previously introduced in 2016 and 2017 as freestanding bipartisan legislation (the "Investing in Opportunity Act") to encourage private investment in distressed communities.
- The earlier legislation was sponsored by Senators Tim Scott (R-SC) and Cory Booker (D-NJ) and Representatives Pat Tiberi (R- OH) and Ron Kind (D-WI), with a group of almost 100 bipartisan co-sponsors.
- As passed in the Tax Cuts and Jobs Act, the law follows the Senate Bill with few exceptions.
- Two features of the Senate Bill that did not make it into the Law were additional criteria Governors would have been required to take into account in nominating tracts, and ongoing reporting requirements.

Overview of Opportunity Zone Incentive

Key Tax and Investment Concepts

- Incentive for both corporate and individual investors: Deferral (until December 31, 2026) and partial exclusion (up to 15%) of gain on sale of existing property (stock, real property, etc.) to the extent of capital invested in a Qualified Opportunity Fund.
- Additional incentives are available for investments in Qualified Opportunity Funds held for at least 10 years (e.g., basis step-up for appreciation in Opportunity Zone Fund investment over deferred gain amount, resulting in gain exclusion).
- Investment must be made through a Qualified Opportunity Fund.
- Responsibility for administering the Opportunity Zone program is primarily with the IRS/Tax side of the U.S. Department of Treasury, but the CDFI Fund has responsibility of identifying qualifying Opportunity Zones.
- Regulations and guidance from the U.S. Department of Treasury will be important to implement, clarify, and potentially correct certain provisions of the law.

What are the Benefits?

Temporary Deferral of Gain:

A temporary deferral of inclusion in taxable income of gain from the sale or exchange of property to the extent of funds invested in a Qualified Opportunity Fund.

» The Opportunity Zone investment must be made within 180 days after the sale or exchange that triggered the gain to be deferred (“Deferred Gain”).

» Deferred Gain is recognized upon disposition of the Qualified Opportunity Fund Interest or on 12/31/2026 (whichever come first).

What are the Benefits?

Step-Up in Basis:

Basis in Investor’s Interest in a Qualified Opportunity Fund starts at zero.

A partial step-up in basis for investment in a Qualified Opportunity Fund is available depending on the Investor’s holding period.

- » After five years, basis increased by 10% of the Deferred Gain.
- » After seven years, basis increased by an additional 5% of the Deferred Gain, or an aggregate of 15%.

What are the Benefits?

Permanent Exclusion:

An Investor may elect a permanent exclusion from taxable income of post-deferral gain from the sale or exchange of an investment in a Qualified Opportunity Fund.

- Qualified Opportunity Fund Interest must be held for at least 10 years.
- Exclusion only applies to appreciation/gain above the gain deferral represented by the original investment.

Where are the Opportunity Zones?

Opportunity Zones Nominated by State Governors and Designated by Treasury

» 25% of the Low-Income Community Census Tracts in each State and Territory were eligible for nomination.

- Exception: Up to 5 percent of the tracts designated may be contiguous to designated LIC Census Tracts if they don't qualify as LIC Census Tracts themselves
- Exception: States with less than 100 LIC Census Tracts may designate 25 LIC Census Tracts
- Exception: All LIC Census Tracts in Puerto Rico are automatically designated

Where are the Opportunity Zones?

Opportunity Zone Nominations and Designations

Determination Period

Each Governor had 90 Days from enactment of the Tax Act to nominate (possible 30 day extension) (March 21, 2018)

Consideration Period

Treasury had 30 Days from submission by Governor to approve (possible 30 day extension)

Designation Period

Opportunity Zone designations last for a period of 10 years

Where are the Opportunity Zones?

Opportunity Zone Nominations and Designations

» As of June 14, 2018, Opportunity Zones have been designated in all fifty states, Washington, D.C., Guam, American Samoa, Puerto Rico, the U.S. Virgin Islands and the Northern Mariana Islands. See IRS Notice 2018-48 and www.cdfifund.gov/pages/opportunity-zones.aspx.

Opportunity Funds

Qualified Opportunity Funds: An Investment Intermediary:

- Must be organized as a domestic corporation or a partnership ("Entity Test").
- Purpose must be to invest in Opportunity Zones ("Purpose Test").
- Must hold at least 90 percent of assets in stock or partnership interests in Qualified Opportunity Zone Business and/or tangible Qualified Opportunity Zone Business Property ("Assets Test").
- Statute appear to authorize a regulatory process for certification of Qualified Opportunity Funds by Treasury.
- Treasury announced in April that Qualified Opportunity Funds will "self-certify" by filing a form with their tax return.
- There is no limit on the number of Qualified Opportunity Funds that can be created.

Opportunity Funds

Assets Test:

» Whether 90% of an Opportunity Fund's Assets are invested in Qualified Opportunity Zone Property in a taxable is tested by averaging the percentage of the Qualified Opportunity Zone Property held on the last day of the first six months of the taxable year and on the last day of the taxable year.

Opportunity Funds

Assets Test:

Penalty for Failure to Maintain the Assets Test:

- A monthly penalty equal to the shortfall multiplied by the IRC underpayment rate (currently 4 percent).
- Exception if failure was due to reasonable cause.

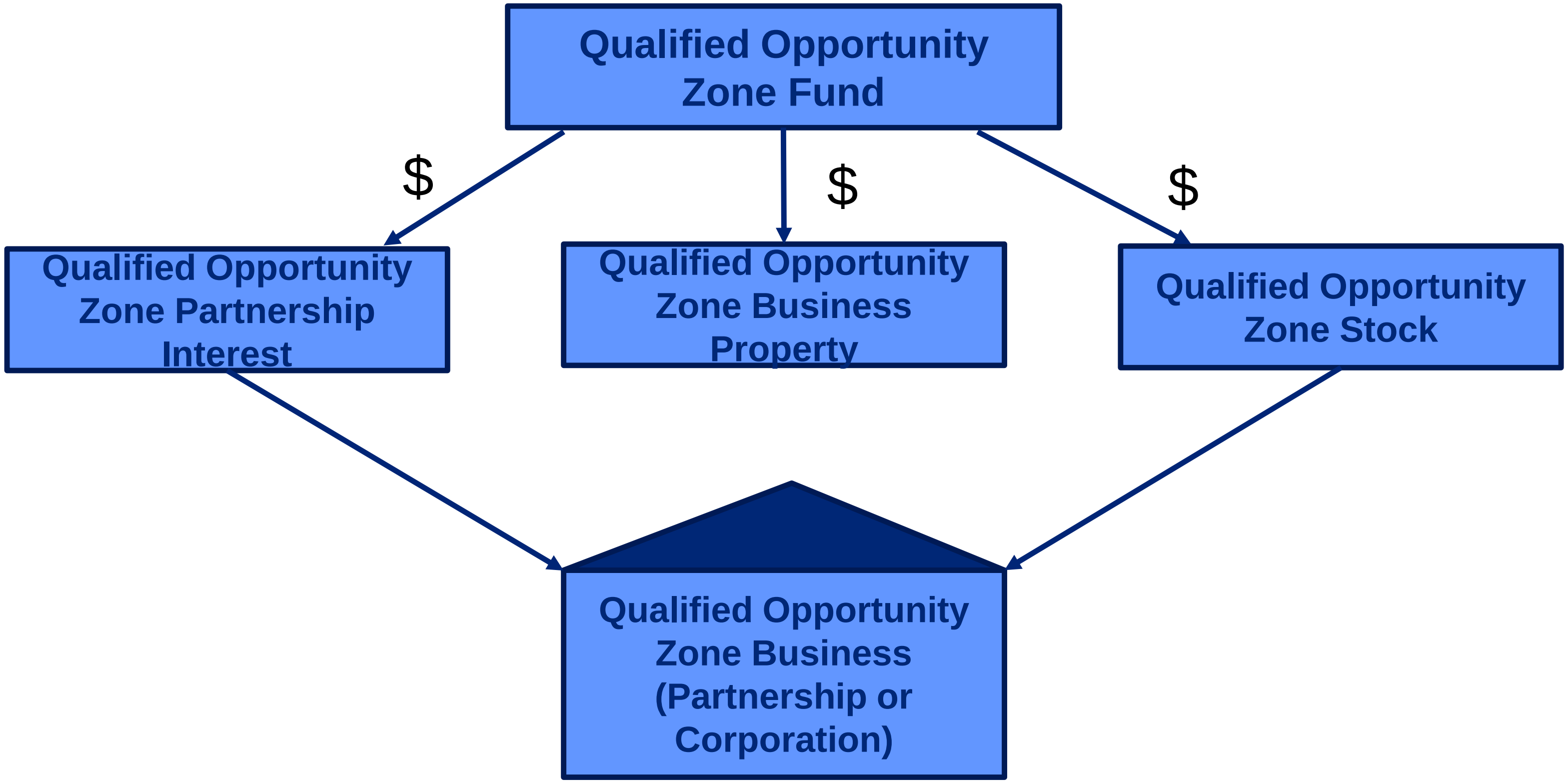
Investments in Qualified Opportunity Zone Property

Opportunity Funds Must Invest in Qualified Opportunity Zone Property:

- Qualified Opportunity Zone Stock
- Qualified Opportunity Zone Partnership Interest
- Qualified Opportunity Zone Business Property

Note: Funds must maintain 90 percent of their assets in Qualified Opportunity Zone Property to continue to qualify as a Qualified Opportunity Fund.

Investments in Qualified Opportunity Zone Property



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Investments in Qualified Opportunity Zone Property

Qualified Opportunity Zone Stock or Partnership Interest

- Qualified Opportunity Zone Stock must be stock in a domestic corporation.
- Qualified Opportunity Zone Partnership Interest must be a capital or profits interest in a domestic partnership.
- Qualified Opportunity Zone Stock or Partnership Interest must be acquired **from the corporation or partnership** by the Opportunity Fund after December 31, 2017 solely in exchange for **cash**.
- Must be stock or a partnership interest in a Qualified Opportunity Zone Business **or** a business that is being organized for the purpose of being a Qualified Opportunity Zone Business.
- During **substantially all** of the holding period of the Qualified Opportunity Stock or Stock or Partnership Interest, the corporation or partnership must continue to qualify as a Qualified Opportunity Zone Business.

Qualified Opportunity Zone Business:

- A trade or business.
- **Substantially all** of its tangible property (whether owned or leased) is **Qualified Opportunity Zone Business Property**

AND

Investments in Qualified Opportunity Zone Property

- At least 50 percent of its gross income must be from the **active** conduct of a trade or business in an Opportunity Zone.
- A substantial portion of its intangible property must be used in the **active** conduct of its business in an Opportunity Zone.
- No more than 5 percent of the average unadjusted basis of its assets may consist of “non-qualified financial property.”
- Cannot be a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off-premises.

Investments in Qualified Opportunity Zone Property

Qualified Opportunity Zone Business Property is tangible property used in a trade of business if:

- It is acquired by purchase (as defined in Section 179(d)(2) related party rules, but using a 20% related party test instead of 50%) after December 31, 2017;
- The original use in the Qualified Opportunity Zone commences with the Qualified Opportunity Zone Business

  or

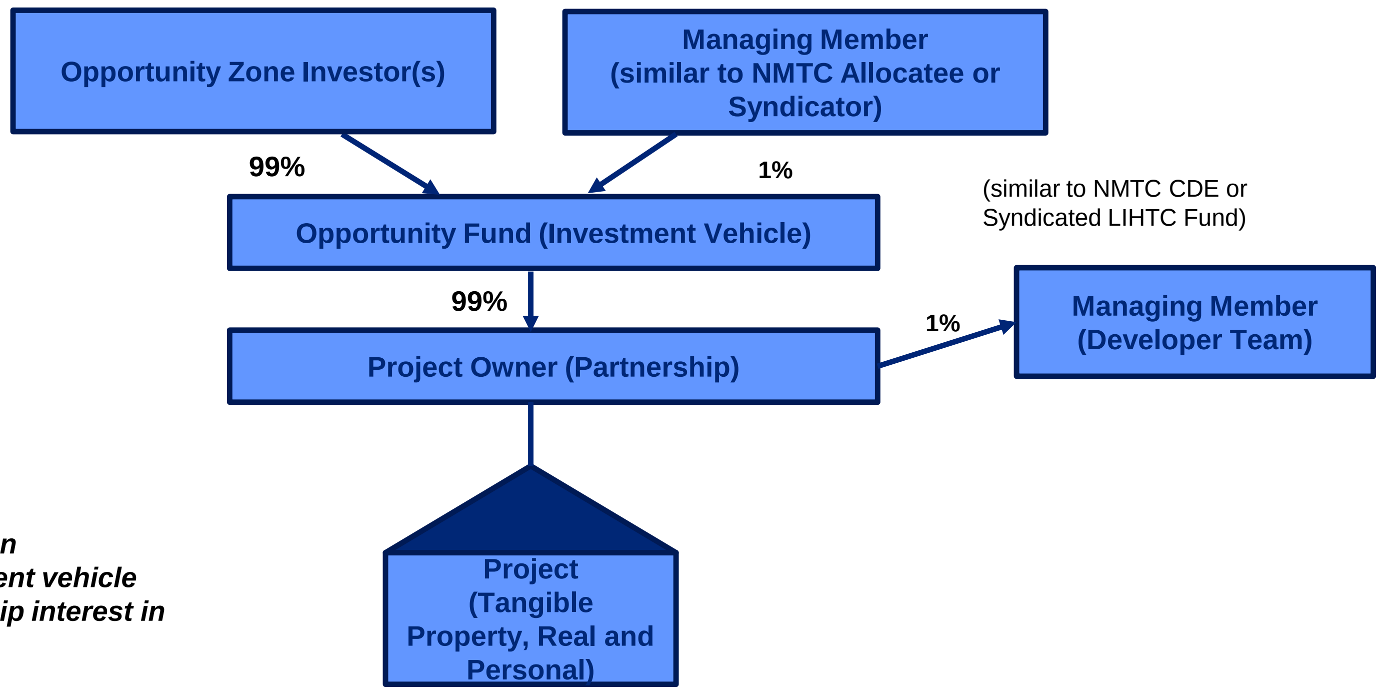
  The Qualified Opportunity Zone Business **substantially improves** the property; and
- During **substantially all** of the holding period for such property, **substantially all** of the use of such property is in an Opportunity Zone.

Substantial Improvement Test:

Property is treated as “substantially improved” if, during any 30-month period beginning after the acquisition of the property, additions to basis of the property exceed an amount equal to the adjusted basis of the property at the beginning of such period.

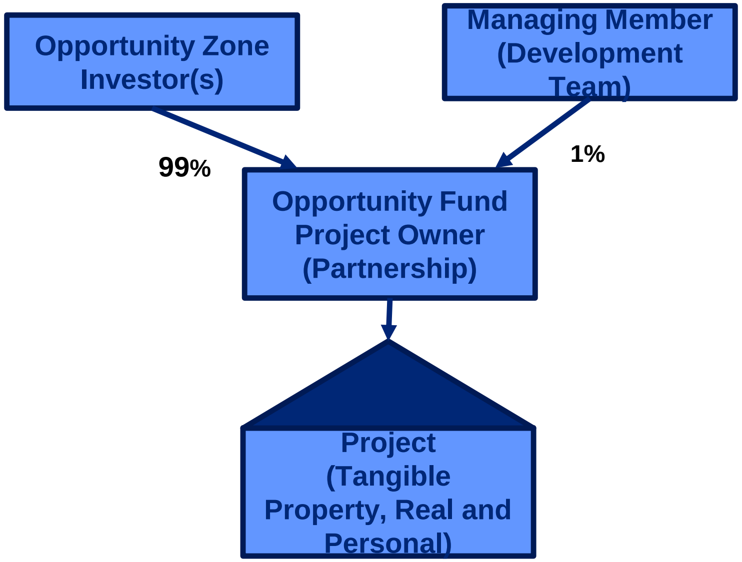
Investments in Qualified Opportunity Zone Property

Opportunity Zone Investment Structure 1



Opportunity Fund is an Intermediary investment vehicle and owns a partnership interest in the project owner.

Opportunity Zone Investment Structure 2



Opportunity Fund is the developer of the project and owns the project's tangible property.