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Qualified Opportunity Zones Update

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Agenda

- Opportunity zones background
- Tax benefits for QOF investors
- Final regulations and rules for compliance
- Ohio QOZ Credit
- Recent developments

Background

- Economic Innovation Group is a bipartisan public policy organization, founded in 2013. EIG is based in Washington DC and convenes experts from the public and private sectors, develops original research and works to advance creative policy proposals that will bring new jobs, investment and economic growth to U.S. communities.

- Fundamental concepts of the OZ language were originally in a bipartisan bill entitled the Investing in Opportunity Act, which was sponsored by Senators Tim Scott (R-SC) Corey Booker (D-NJ) and Congressmen Pat Tiberi (R-OH) and Ron Kind (D-WI). 100 Congressional co-sponsors. This concept was then enacted into law with the Tax Cuts and Jobs Act enacted on December 22, 2017.

- Post-recession, the economy has done very well. However, it has been uneven. 1/6 of Americans (more than 52 million people) live in economically distressed communities. The idea is to counteract an increasing poverty rate with incentives for private investment.

- The main objective behind the Opportunity Zones (O-zones) is to promote and help unlock private investment in certain economically distressed communities nationwide, and promote long term economic growth without using direct government funding.

Background

- Created through the passage of the TCJA of 2017.
- New Section 1400Z-1 and 1400Z-2 of the IRC.
- The main objective behind the Opportunity Zones (O-zones) is to promote and help unlock private investments in certain economically distressed communities nationwide, and promote long-term economic growth without using direct government funding.
- Specifically designed to drive more equity capital from private sources into markets that are generally being overlooked.
- O-zones are not the first federal tax incentive programs for distressed communities. Prior programs include empowerment zones (EZs), enterprise communities (ECs) and the New Market Tax Credit (NMTC), but it's the first new national community investment program in over 15 years.
- EIG research shows than more than half of America's most economically distressed communities contained both fewer jobs and businesses in 2015 than they did in 2000's, and new business formation in these areas is near a record low. The average distressed community saw a 6% decline in local businesses during the prime years of the national economic recovery.
- U.S. investors currently hold $2.3 trillion+ in unrealized capital gains, representing a huge untapped resource for economic development. OZ's will incentivize investors to use some of this capital in exchange for significant tax benefits.

The Designation of Opportunity Zones

- Each state has been tasked with the nomination of census tracts to be designated as O-Zones. Nominations were due by March 21, 2018.
- To qualify for nomination as O-Zone, the population census tract had to qualify as a "low income community" (LIC).
- Tracts that were selected are home to more than 31 million people, many of which are located within zip codes experiencing employment growth, and majority within metropolitan areas.

Qualified Opportunity Zone - A low-income census tract (LIC) designated by the governor of the state or territory, in which it is located and approved by U.S. Treasury.

- Up to 25% of LICs (as designated by the New Markets Tax Credit program) may be designated as Opportunity Zones (states or territories, in which there are fewer than 100 LICs that may be designated up to 25 LICs as Opportunity Zones).
- Census tracts contiguous with LICs may be designated as Opportunity Zones if the median family income of the census tract does not exceed 125% of the median family income of the LIC to which the tract is contiguous. No more than 5% of a state or territory's LIC-contiguous census tracts may be designated as Opportunity Zones.

The Designation of Opportunity Zones

- Designation process has been completed and the end result is roughly 8,700 designated O-Zones. Entire territory of Puerto Rico is designated as an Opportunity Zone.

- For the map of *Ohio* O-Zones go to https://odsa.maps.arcgis.com/apps/webappviewer/index.html?id=3a818135dd654821b78d889a833e31b9

- For the map of *national* O-Zones go to https://www.enterprisecommunity.org/opportunity360/opportunity-zone-eligibility-tool

Three Tax Benefits of Investing in Opportunity Zones

1. A temporary deferral of tax for capital gains reinvested in a Qualified Opportunity Fund. The deferred gain must be recognized on the earlier of December 31, 2026 or the date on which the OZ investment is disposed.

   NOTE: no investor tax benefits are available unless the transaction starts with a capital gain deferral.

2. An increase in basis of 10% if the investment is held for more than five years, and an additional 5% if held for at least seven years, thereby permanently excluding up to 15% of the original gain from tax.

Three Tax Benefits of Investing in Opportunity Zones

3. Elimination of capital gains tax on appreciation of the investment held within the Qualified Opportunity Fund if it is held for 10 years or more.

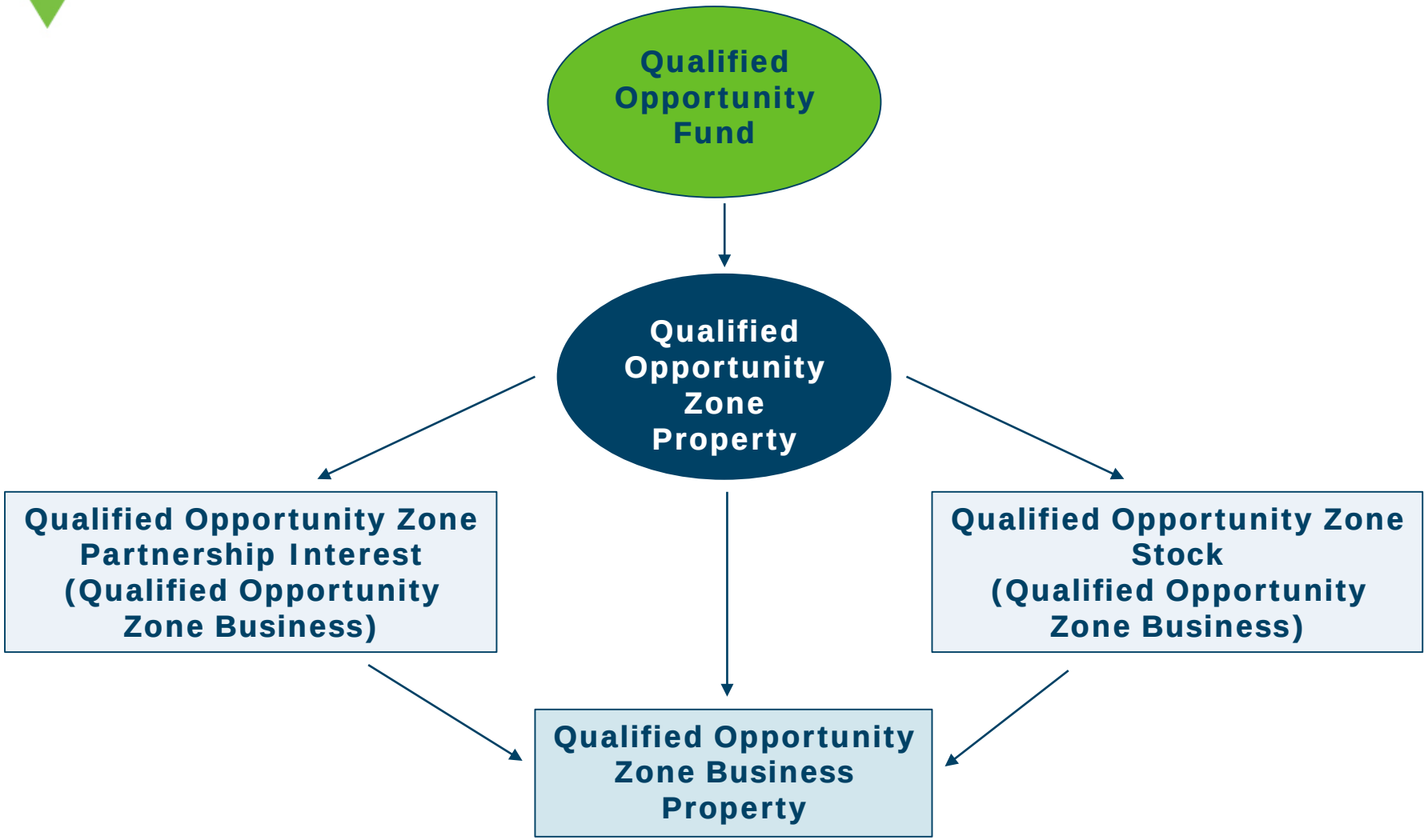
In combination, these tax benefits significantly enhance ROI.

OZ's Compared to 1031 Exchanges

	1031 Exchange	Qualified Opportunity Zone
Eligible Taxpayer	Any owner of Real Property (but see "Same Taxpayer" Rule)	Anyone with capital gains looking to invest in a "Qualified Opportunity Zone"
Relinquished Property	Real Property only (after TCJA)	Any property that is sold at a "capital gain"
Replacement Property	Real Property only; no geographic limitations (except foreign)	Real Property or interest in Business that is (a) Within Zone, and (b) Substantially Improved (or Original use/Vacant)
Timeline	45 days to ID replacement property, 180 days to purchase property and make improvements	180 days to invest in QOF, QOF has 30 months to make improvements
Benefits (generally)	Deferral of tax on gain from sale of Relinquished Property until (a) sale, or (b) death (step-up)	(1) Deferral of Gain on sale of RQ, and possible 15% permanent reduction of such gain; (2) Permanent Exclusion of Appreciation Gain
Benefits (full)	Full benefits - need to (a) purchase property of equal value, and (b) roll over all equity	Just need to reinvest GAIN, you can structure QOZ investments to allow for cash outs, unlike 1031
Need Agent?	Funds from the sale of RQ need to be held by "Qualified Intermediary"	No Agent/Qualified Intermediary Needed

Opportunity Zones Versus Other Tax Incentives

- Flexible
  - Any kind of asset sale that generates a capital gain
  - Real estate, stocks, bonds, art, coins, etc.
  - Invest in real estate, companies, equipment
  - Invest via a partnership or corporation
- Simple
  - Self-certification process for fund (90% assets invested) (Form 8996)
  - Self-certification process for investor (filed with tax return Form 8949 and Form 8997
- Scalable
  - No competitive process to take advantage (like other credits)
  - No limit as to how big the investment is
  - No limit on the tax benefits that can be realized


Qualified Opportunity Fund
Qualified Opportunity Zone Property
Qualified Opportunity Zone Partnership Interest (Qualified Opportunity Zone Business)
Qualified Opportunity Zone Stock (Qualified Opportunity Zone Business)
Qualified Opportunity Zone Business Property

Definitions

- **Qualified Opportunity Fund** – an investment vehicle organized as a corporation or partnership for the purpose of investing in OZ property. Opportunity Funds are private sector entities required to invest 90 percent or more of their resources in Qualified Opportunity Zones.

- **Qualified Opportunity Zone Property** – property which is:
  - *Qualified opportunity zone stock* – stock in a domestic corporation that is a qualified opportunity zone business during "substantially all" (at least 90%) of the applicable holding period, and the stock is acquired after December 31, 2017, at its original issue in exchange for cash,
  - *Qualified opportunity zone partnership* – a capital or profits interest in a domestic partnership that is a qualified opportunity zone business during "substantially all" (at least 90%) of the applicable holding period, and the interest is acquired after December 31, 2017, in exchange for cash, or
  - *Qualified opportunity zone business property* – tangible property used in the trade or business of a qualified opportunity zone business if the original use of the property commences with the qualified opportunity fund or the fund "substantially improves" the property, and the property is acquired by purchase after December 31, 2017 from an unrelated party.

Definitions

Qualified opportunity zone business – a trade or business in which:

- Substantially all (70%) of its tangible property, owned or leased, is qualified opportunity zone business property;
- At least 50 percent of its total gross income is derived from the active conduct of its business;
- A substantial portion (40%) of its intangible property is used in the active conduct of its business;
- Less than five percent of the average of its aggregate unadjusted bases of the property is attributable to nonqualified financial property; and
- No portion of its proceeds is used to fund certain types of businesses: a 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.

Example Showing the Potential for Enhanced ROI

Assumptions:

- Investor has capital gain of $1,000,000 in 2020, that he/she has an option to reinvest in the O-Zone investment or traditional investment for ten years;
- The cash invested grows on average 7% a year in both types of investments;
- Capital gain tax rates remain unchanged or 23.8% (20% capital gain rate and 3.8% NIIT rate) for ten years;
- Assume for simplicity that gain is not subject to state and local taxation;

QOF INVESTMENT		TRADITIONAL INVESTMENT	
Long term capital gain	$1,000,000	Long term capital gain	$ 1,000,000
Tax on gain	0	Tax on gain	($238,000)
Funds left to invest	$1,000,000	Funds left to invest	$ 762,000
12/31/2026 tax (90% x 1,000,000 x 23.8%) paid with outside funds	($214,200)	12/31/2026 tax	0
2030 value (more than 10 years after original investment)	$1,967,151	2030 value (more than 10 years after original investment)	$1,498,969
Tax in 2026 and lost earnings on 2026 payments	($245,238)	Tax on the sale in 2028 (1,498,969-762,000)x23.8%	($175,399)
Cash left with after 10 years	$1,721,913	Cash left with after 10 years	$1,323,570

How it Works

- Step 1: Qualified Opportunity Fund (QOF) is formed and can self certify with the IRS.
- Step 2: An investor realizes capital gain and within 180 days of the gain being realized invests the gain (only gain required to be invested for the tax deferral) into QOF. Investor defers the tax on gain and has initial basis in QOF of zero.
- Step 3: QOF uses the investment to acquire or substantially improve 'Qualified Opportunity Zone Property'.
- Step 4: Once the investor holds QOF interest for five years, the investor gets a basis allocation equal to the 10% of deferred gain that will offset some of his/her capital gain when it gets recognized.

- In any event, the investor's capital gain deferral period ends on 12/31/2026, and if the investment is still outstanding, the deferred capital gain (less the basis step up) is recognized.
- If the investor holds his interest in the QOF for more than ten years, he/she is entitled to a FMV basis step-up so that any appreciation in the value of his interest can be excluded from income when QOF interest gets sold.

Final Treasury Regulations

- First set of Proposed Regulations issued by Treasury on October 19, 2018, along with Revenue Ruling 2018-29 and two new tax forms: Form 8949 for an investor to report the gain deferral, and Form 8996 for a QOF to report the 90% Asset Test.

- Second set of Proposed Regulations were issued on April 17, 2019, and offer guidance on questions that remained unanswered such as the treatment of land as QOZBP, and treatment of leased property.

- Final regulations were published on January 13, 2020 and offer additional flexibility for the investment timing and disposals after ten year holding period, as well as guidance on triggering events and reinvestments of proceeds on the sale among others.

Final Treasury Regulations

Eligible Gains

- An investment in a QOF must be an equity interest – corporate stock, a partnership interest or a membership interest in a limited liability company. The investment cannot be any form of debt instrument.

- Only gains that are capital in nature may be deferred into QOF projects.

- The character of the eligible capital gain will carry through the investment period. For example, if an investor has short-term capital gains that are invested in a QOF, the gain will be taxed as short-term capital gain at the end of the deferral period.

- Any type of taxpayer that recognizes capital gains is eligible to defer those gains. Eligible gains may not arise from a transaction with a related party.

Final Treasury Regulations

- An individual partner or shareholder in a pass-through entity may begin the 180-day reinvestment period on three different dates. This provides significant flexibility for an individual investor.
- Partnerships may defer gain by investing in a QOF. If a partnership chooses not to defer the gain, one or more of the individual partners in the partnership may elect to defer his/her share of the gain into a QOF. S-corporations, trusts and estates that are taxed as pass-through entities are treated the same way - an election at the entity or individual level may be made.

Qualified Opportunity Fund Issues

- A QOF will use the asset values reported on the entity's applicable financial statement to calculate the 90% Asset Test. If the entity does not have financial statements, the QOF will use the cost basis of the assets for the test.

Final Treasury Regulations

- QOFs may accept non-capital gain rollover funds from investors. However, only investments of rollover gains will be eligible for the tax incentives of the QOZ. Separate accounting will be required.
- QOZ's are set to expire at the end of 2047. To receive the benefit of the tax-free gain, the taxpayer must sell QOZ investment before 1/1/2048.

Working capital safe harbor (subsidiary only)

- Given that many QOZ projects will involve construction and/or significant remodeling or rehabilitation, a safe harbor has been provided for a QOZ business to hold working capital and qualify those liquid assets as part of the 90% Asset Test for a period of up to 31 months, assuming that there is a schedule and a plan that is followed for the expenditures of cash.
- Applies to real estate development as well as operating trade or business in the QOZ.
- Working capital safe harbor is not violated if delay is due to government action (i.e. permits or other government approval).

Final Treasury Regulations

Active Conduct of Trade or Business

- Ownership and operation of real property is treated as active conduct of trade or business. Exception are triple-net leases.

Land

- Vacant land purchased after 12/31/2017, used in trade or business is treated as QOZBP and does not have to satisfy original use or substantial improvement test.
- Land purchased with no intention or expectation to materially improve is not considered QOZBP.
- Land acquired prior to 12/31/2017 is not eligible for the special rule.

Final Treasury Regulations

Leased Property

- Both QOF and QOZB can qualify leased property as QOZBP without meeting original use or substantial improvement requirement.
- Requirements: (a) Lease entered into after 12/31/17; (b) Lease terms are arms length; (c)) during at least 90% of the QOF's or QOZB's holding period for such leased property, 70% of the leased property's use is in a QOZ;
- If the lease is between related parties, special rules apply.
- Lease valuation for purposes of calculating QOF 90% and QOZB 70% test is based on the financial statement method or by calculating present value of lease payments.

Inclusion Events

- Sale of all or part of interest in QOF. Gain is also triggered if a partner sells interest in partnership that is invested in QOF.
- Termination or liquidation of QOF.
- Transfer of QOF interest by gift.

Final Treasury Regulations

Non-Inclusion Events

- Transfer of interest in QOF by death.
- Contribution of QOF interest to a grantor trust.
- Sec 721 and 381 transactions.
- DFD (excluding DFD in the first two years of investment) to extent of basis in QOF.

Deferred gain that is triggered upon an inclusion event is the LESSER OF:

1. The percentage of the investment sold * the remaining deferred gain (counting any basis adjustments at the five or seven year mark), or
2. The gain that would have been recognized on a fully taxable sale of that portion of the investment in the QOF that was disposed of in the inclusion event.

Final Treasury Regulations

Sale of QOF interest or sale of assets by QOF

- Gain from sale of QOF interest or assets held by QOF is excluded from tax for qualified investors after a ten year holding period. Only ordinary income from the sale of inventory is recognized.

Sale of QOZBP during the ten year holding period

- Final regulations provide that QOF has 12 months to reinvest the proceeds from the sale of QOZBP and during this time they will be counted as QOZBP for the 90% asset test.
- However, while the sale of assets does not restart the ten year holding period, any gain recognized by QOF on the sale of asset is fully taxable.

Sale of QOF interest during the ten year holding period

- Sale of QOF interest does not trigger gain recognition if the proceeds are reinvested into another QOF within 180 days.

Final Treasury Regulations

Original Use Test

- Original use of an asset starts on the date when the property is first placed in service in the QOZ for purposes of depreciation or amortization.
- A building or structure that was vacant for at least five years prior to being purchased by the QOF or QOZB will satisfy the original use requirement (reduced to three and one year vacancy requirement in certain circumstances).
- Leasehold improvements made by a lessee are treated as original use property.

Substantial Improvement

- If not original use property, QOF has a 30 month window to improve the acquired Opportunity Zone property.
- Taxpayer has to double the basis of property during the 30 moth period.
- The substantial improvement requirement is made on an asset by asset basis.
- Rev. Rul. 2018-29 stated that land can never have original use; however, land will not be required to be substantially improved if it is used in an active trade or business.

Other Tax Considerations

- Capital gains rate when gain is recognized – not when deferred
- If the taxpayer dies, the capital gain is still recognized on the original investment – no step up at death.
- Combine with other Federal tax credits – NMTC, historic tax credits, low income housing.
- Combine with other state credit and incentive programs.
- Several states have already conformed to the Federal tax benefits and others are coming up with state specific QOZ benefits.
- Taxpayers should evaluate their investments regardless of tax benefits.

Ohio QOZ Credit

- Equal to 10% of the taxpayer's investment in a prior year, up to a $10 million investment.
- Available for investments made with QOFs that are 100% invested in Ohio QOZs.
- Application process opens on January 1 and available on a first come-first serve basis.
- Transferable.

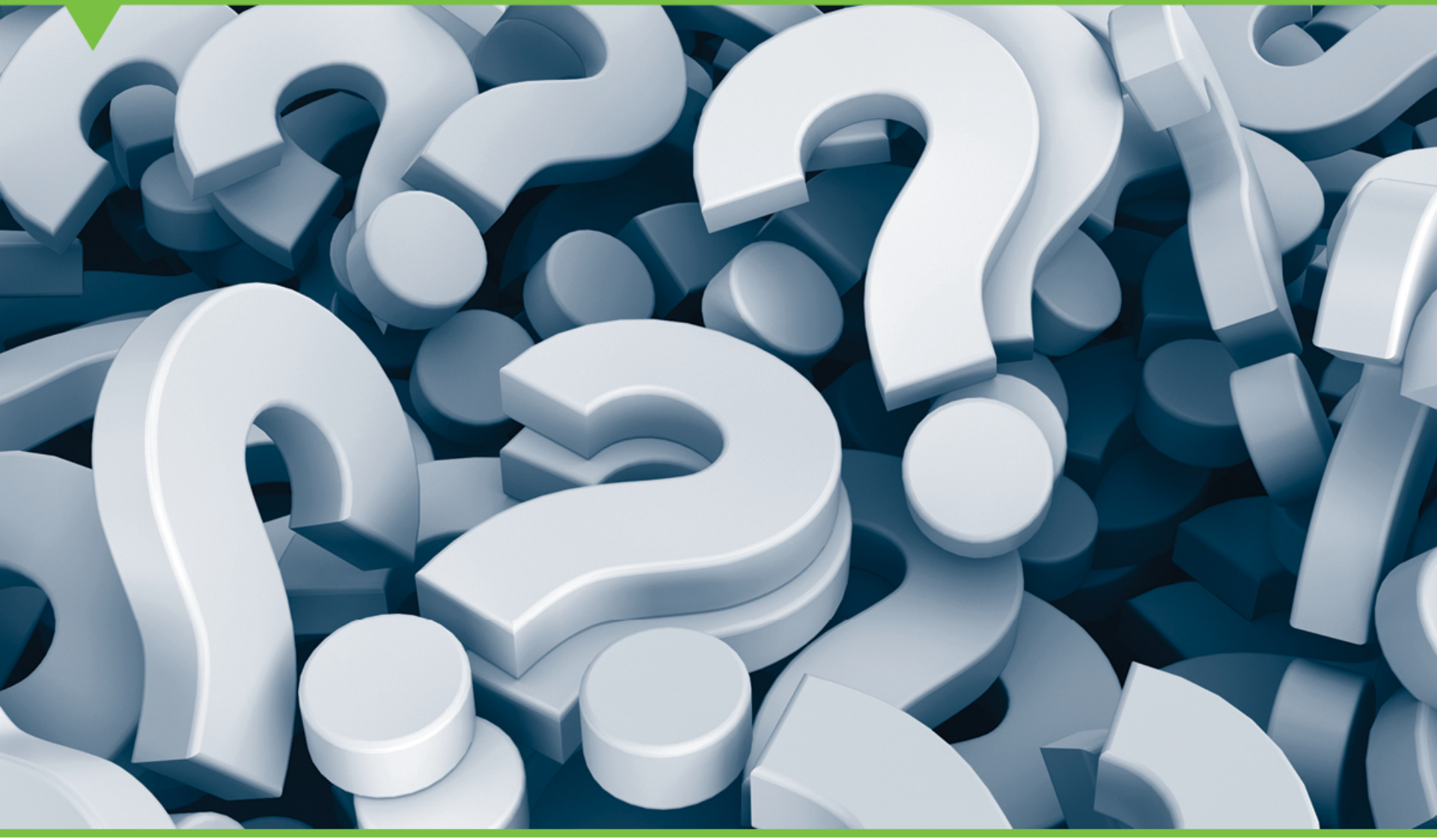
COVID-19 Deadline Extensions

- 180 day QOF investment period is extended for certain taxpayers until July 15, 2020 pursuant to Notice 2020-23

- Working Capital Safe Harbor generally provides 31 months to convert invested capital into an asset used in trade or business. If a business is located in a QOZ within a federally declared disaster area, the business may receive additional 24 months to convert capital into a qualifying asset. Exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action.

- Failure to meet 90% asset test – regulations provide reasonable cause exception for QOFs that fail the test. No bright-line standard, but given the unprecedented nature of the current economic situation, may be applicable. No specific procedure for applying for reasonable cause relief, but funds should maintain contemporaneous records of time and resources spent during this period.

Questions



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