
McGINNIS LOCHRIDGE
Tax Law Seminar
Austin

Qualified Opportunity Zones

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Background: part 1

- Enacted as part of the 2017 Tax Cuts and Jobs Act.
- Meant to spur investment in “downtrodden” census tracts with the goal of kick starting economic development in these areas.
- Tax benefits provide incentive for making long-term investments in these areas.

Background: part 2

- Many media reports of high interest in investment, but not enough deals to go around.
- Origin Investments, a Chicago-based real estate firm, raised $105 million from 425 investors within 17 hours of launching a qualified opportunity fund.
- Amazon's second headquarters in NYC is located in Long Island City in an opportunity zone.

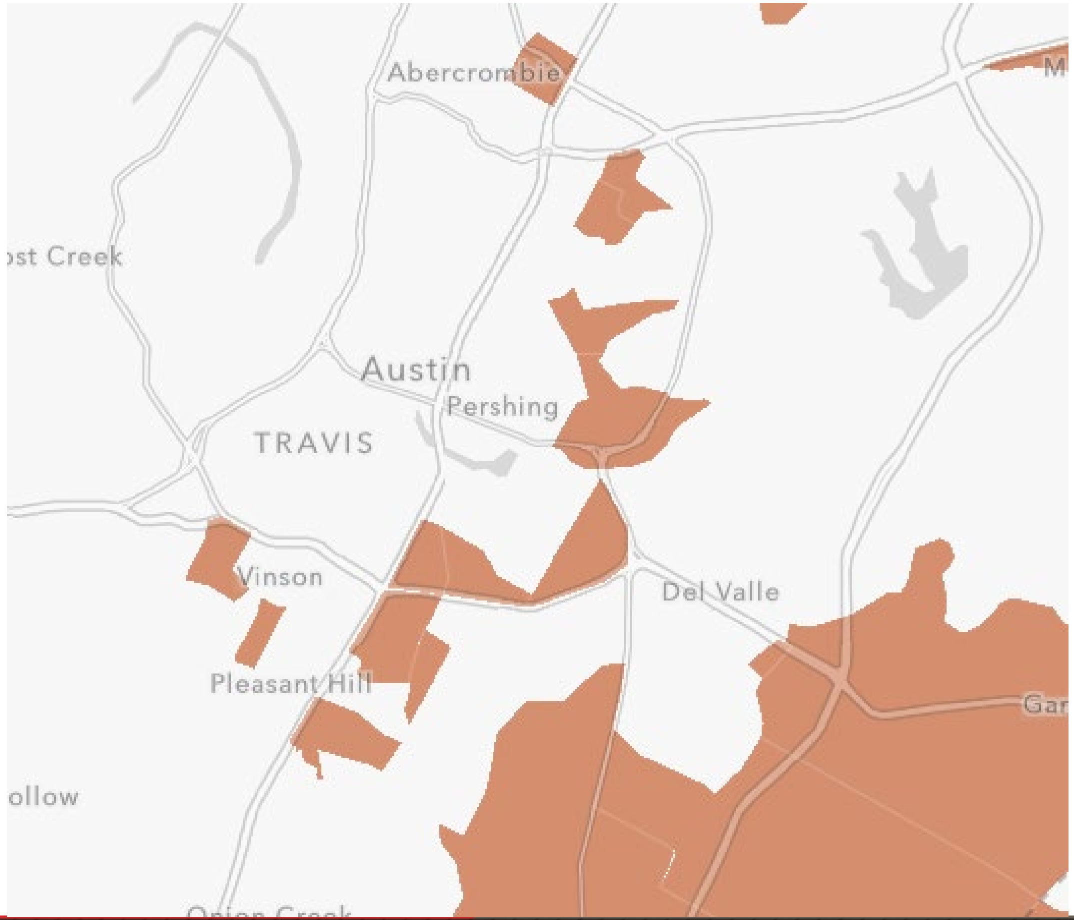
Where are the Opportunity Zones?

- More than 8,700 all over the country.
- A map of the entire country can be found at:

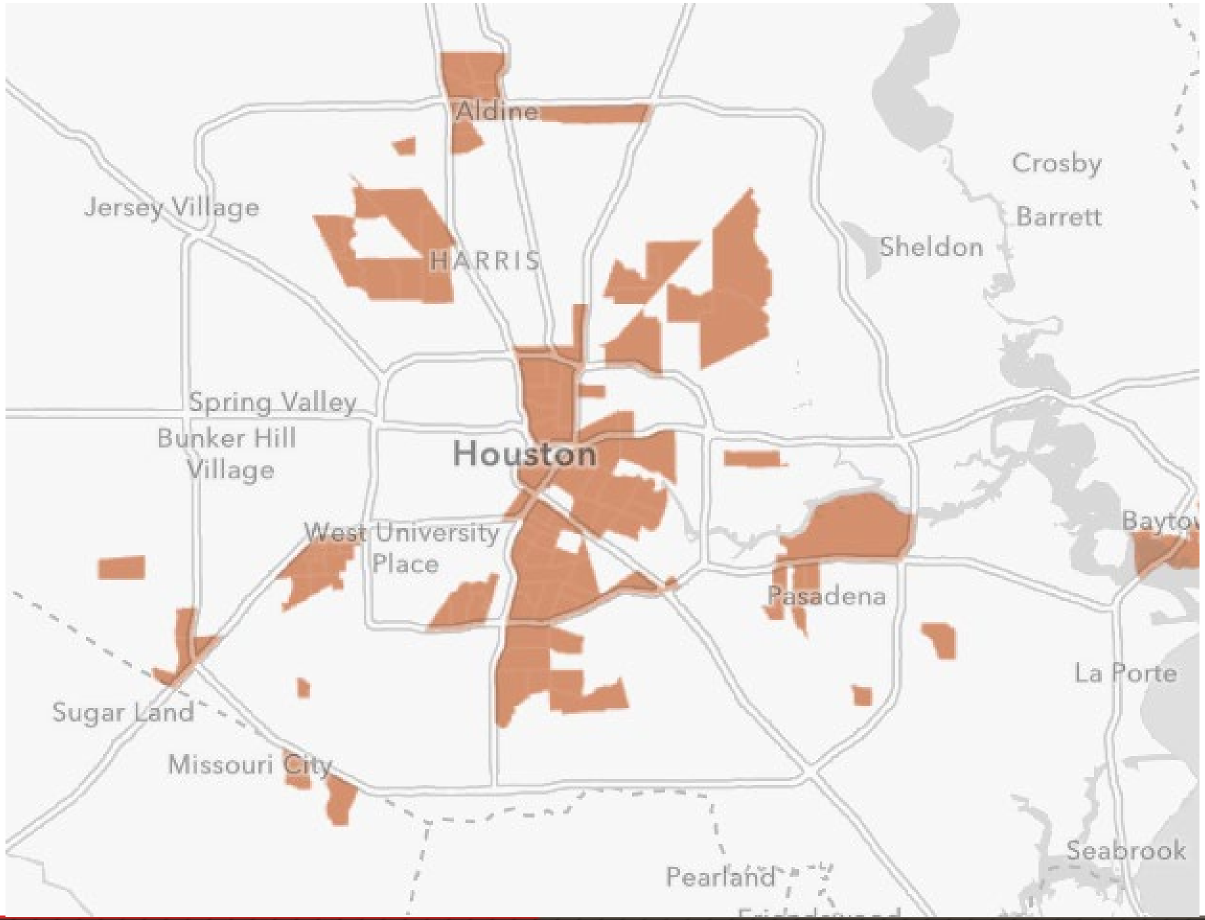
  https://eig.org/news/opportunity-zones-map-comes-focus

  (or just google "opportunity zone map")
- Travis County has 21 opportunity zones and the Austin metro area has 35.

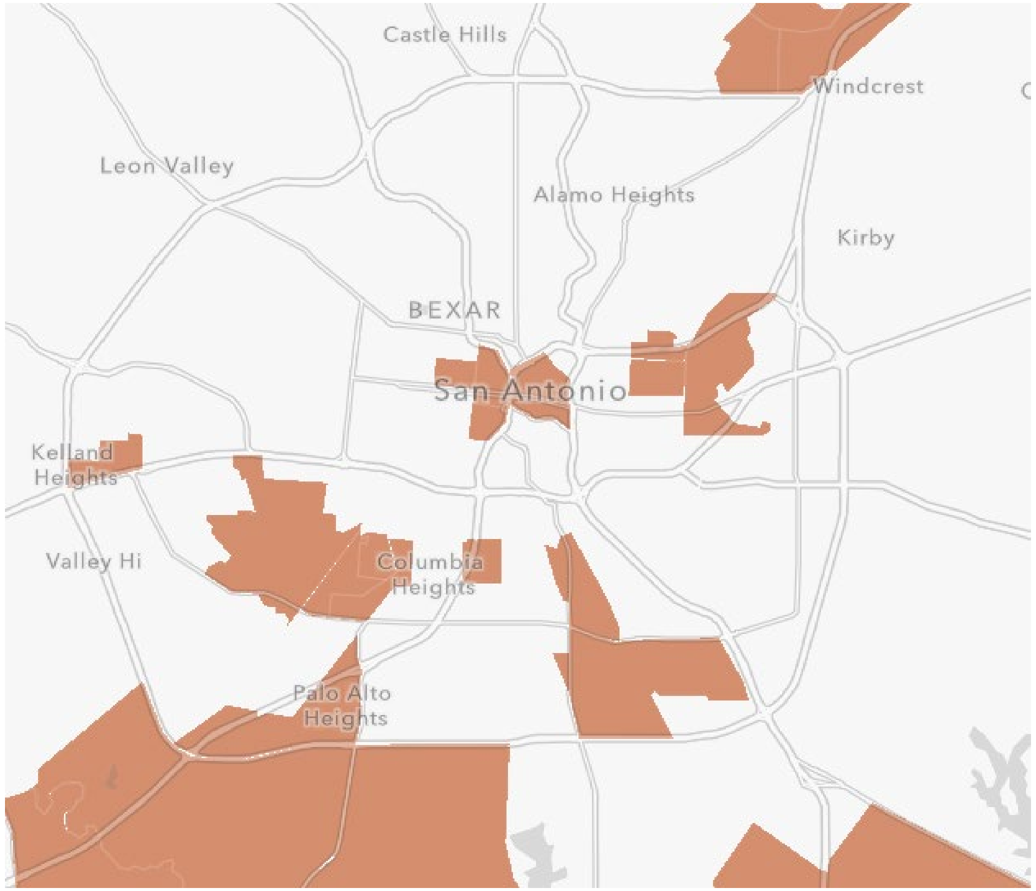
Austin Area O Zone



Houston Area O Zone



San Antonio Area O Zone



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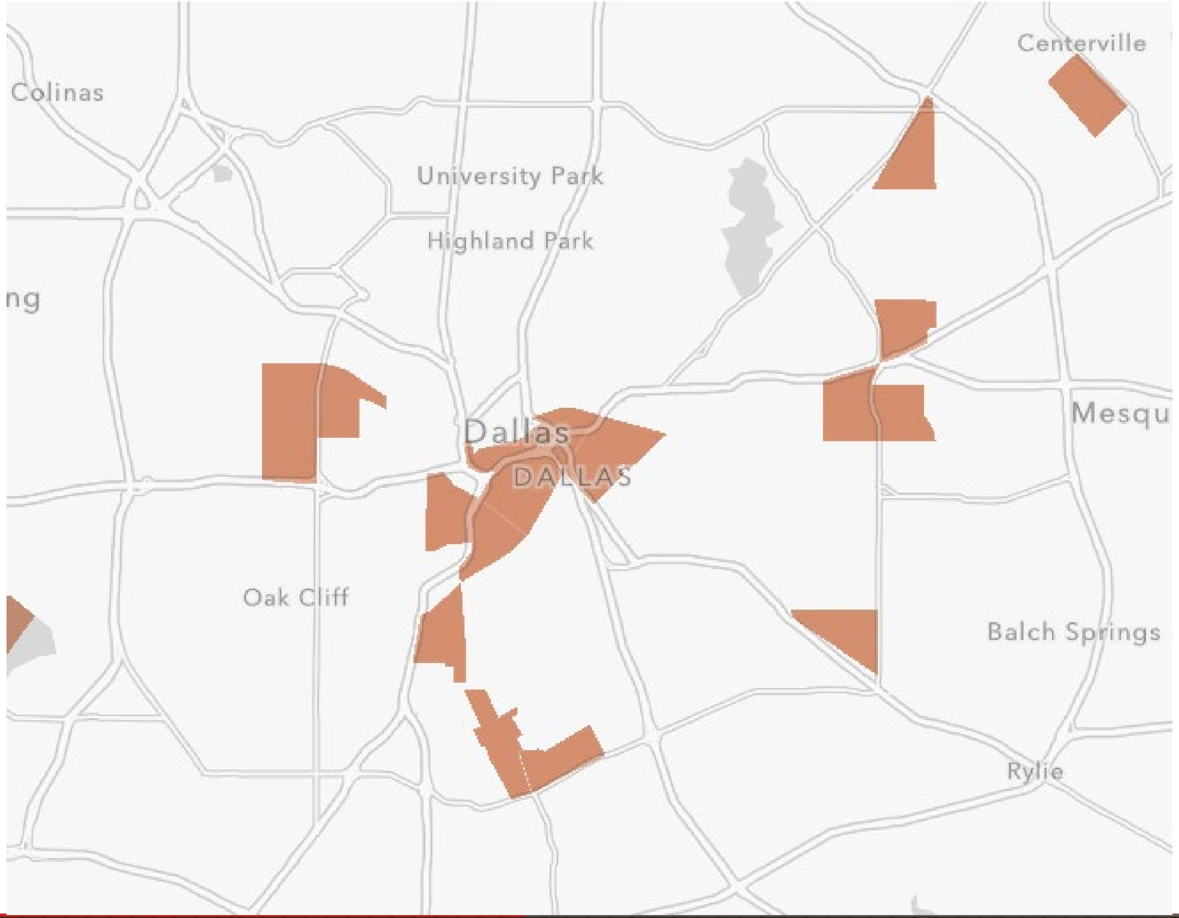
Dallas Area O Zone



Tax Benefits: Simple Example

- Tim holds Apple stock with a basis of $1 million and FMV of $2 million.
- Tim is in the highest tax bracket, if stock was sold today Tim would have a $1 million gain and would pay (approximately) $230,000 in tax.
- Instead, if after Tim sells the stock, Tim invests an amount equal to his gain ($1 million, not $2 million) in a qualified opportunity fund, Tim may be eligible for 3 tax benefits.

Tax Benefit 1: Gain Deferral

- If Tim sold his Apple stock and did not invest in a qualified opportunity fund, he would pay $230,000 in tax in the year of the sale.
- If Tim invests the amount of the gain ($1 million) in a qualified opportunity fund, Tim could defer payment of tax on his gain until the earlier of (1) December 31, 2026 or (2) the date Tim sold his investment in the qualified opportunity fund.
- For reference, the present value of a $230,000 payment, 7 years in the future (assuming a discount rate of 4.5%), is approximately $170,000. So, here the gain deferral is worth about $60,000.
- This demonstrates one reason why there is time pressure to get deals done sooner rather than later. There is no deferral beyond 12/31/26. The more time you have to defer gain, the more valuable this benefit is.

Tax Benefit 2: Small Basis Step Up

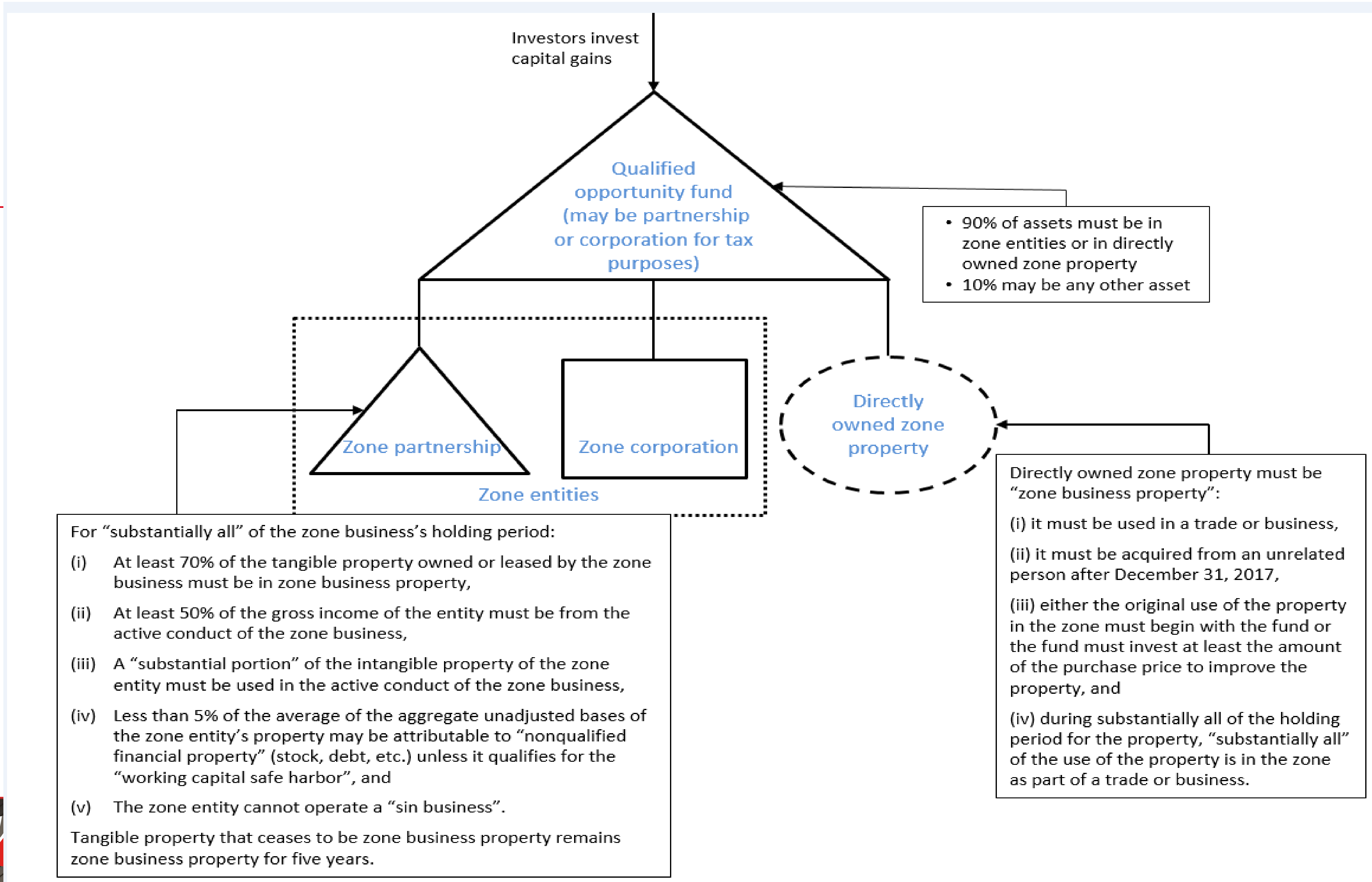
- If Tim holds his investment in the qualified opportunity zone fund for 5 years, some of the gain that is deferred will be eliminated due to a deemed increase in the basis of Tim's Apple stock.
- At 5 years, Tim's basis in his Apple stock will be deemed to increase by 10%.
- At 7 years, Tim's basis in his Apple stock will be deemed to increase by an additional 5%.
- So, after a 7-year hold, Tim's $1 million basis in his Apple stock will be deemed to increase to $1,150,000. This means that when the deferred gain is recognized, Tim will pay $195,500 of tax instead of $230,000.
- Note: The statute (§ 1400Z-2(b)(2)(B)) could be read so as to apply the 10% and 5% basis increases only to Tim's investment in the qualified opportunity fund. The Conference Report, however, makes it clear that these basis increases also apply to Tim's basis in the Apple stock.

Tax Benefit 3: 100% Basis Step Up on Fund Investment After 10-Year Hold

- If Tim holds his investment in the qualified opportunity fund for 10 years, he may sell it and pay NO tax.
- This is because Tim may make an election to raise his basis in the qualified opportunity fund investment up to the FMV at the time he sells the qualified opportunity fund investment.
- However, this too has a time limit. Such election must be made before December 31, 2047.
- Note: § 1400Z-1(f) states that opportunity zone designations expire after 10 years (approximately 2028). There was originally some uncertainty whether the 10-year hold benefit would also expire at this time. The proposed regulation make it clear that this election can be made at any time prior to 2048.

Timing of Investment in QOF

- After assets generating gain are sold, proceeds must be invested in a QOF within 180 days from such sale.
- In order to take advantage of the 10-year hold basis step up, the gain deferral election must be made with respect to the initial investment in the QOF.
- If the gain that is to be deferred is in a partnership, either the partnership or the partner may make the election to defer the gain.
  - If the partner makes the election, the 180-day period begins on the last day of the partnership's taxable year in which the gain is passed through to the partner.
  - Note the opportunity to delay the 180-day period.


Investors invest capital gains
Qualified opportunity fund (may be partnership or corporation for tax purposes)
• 90% of assets must be in zone entities or in directly owned zone property
• 10% may be any other asset
Zone partnership
Zone corporation
Zone entities
Directly owned zone property
For "substantially all" of the zone business's holding period:
(i) At least 70% of the tangible property owned or leased by the zone business must be in zone business property,
(ii) At least 50% of the gross income of the entity must be from the active conduct of the zone business,
(iii) A "substantial portion" of the intangible property of the zone entity must be used in the active conduct of the zone business,
(iv) Less than 5% of the average of the aggregate unadjusted bases of the zone entity's property may be attributable to "nonqualified financial property" (stock, debt, etc.) unless it qualifies for the "working capital safe harbor", and
(v) The zone entity cannot operate a "sin business".
Tangible property that ceases to be zone business property remains zone business property for five years.
Directly owned zone property must be "zone business property":
(i) it must be used in a trade or business,
(ii) it must be acquired from an unrelated person after December 31, 2017,
(iii) either the original use of the property in the zone must begin with the fund or the fund must invest at least the amount of the purchase price to improve the property, and
(iv) during substantially all of the holding period for the property, "substantially all" of the use of the property is in the zone as part of a trade or business.

90% test

- Measured on the last day of the first 6-month period of the fund AND
- On the last day of the taxable year of the fund.
- If the first month of a QOF's existence is in the 7th month of the year or later, then only the test at the end of the year applies for the first year.
- Valuation of assets is based off of applicable financial statements, if no financial statement applies, then based on the cost of the asset.

Penalty for Failure to Meet 90% Test

- QOF pays a penalty for each month it fails to meet the test.
- Penalty = the underpayment rate times
  - The excess of 90% of assets less the aggregated amount of qualified opportunity zone property.
- Example: QOF hold 70% qualified opportunity zone property. Total assets worth $1 million.
  - 5% x (90% of $1 million – 70% of $1 million) = $10,000.
- There is an exception to this penalty for reasonable cause.

Zone Partnerships and Zone Corporations

- In addition to requirements about the types of income and assets of such entities:
  - The equity in the entity must be acquired after December 31, 2017 at original issue from the entity solely in exchange for cash.
  - At the time the equity is issued, the entity must be a qualifying zone business or, in the case of a new entity, it was organized for the purpose of being a zone business.

Substantial Improvement Requirement

- The Regulations and Revenue Ruling 2018-29 deal with how you substantially improve a parcel of land with a building on it. Essentially, only the building, not the land, need be improved.
- Example:
  - QOF purchases a parcel of land with a building on it for $5 million. The land is worth $2 million and the building $3 million.
  - The QOF must spend $3,000,001 on improvements to the building for it to be considered substantially improved.

Timing of Substantial Improvement

- Qualifying expenses must be made within the 30-month period beginning on the acquisition date of the property.

Gotcha! : Redemptions

- For Zone Corporations (but not for Zone Partnerships), certain redemptions could disqualify stock in a Zone Corporation from the 90% test.
- See Section 1400Z-2(d)(2)(B)(ii) and Section 1202(c)(3) and watch out for:
  - If, at any time during the 4-year period beginning on the date 2 years before the QOF acquired the stock, the Zone Corporation purchased (directly or indirectly) **any** of its stock from a related person (e.g., substantial owners or entities related through substantial common ownership), or
  - If, at any time during the 2-year period beginning on the date 1 year before the QOF acquired the stock, the Zone Corporation purchased (directly or indirectly) its own stock exceeding 5% of the aggregated value of all of its stock.

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QOF Structure

- A QOF may not own an interest in another QOF and have it count toward the 90% test.

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Working Capital Safe Harbor

- A QOF with a substantial amount of working capital could be problematic for the requirement that no more than 5% of the aggregated unadjusted bases of a zone partnership or zone corporation property may be attributable to "financial property" (i.e., liquid investments and cash).
- So, there is a safe harbor for reasonable amounts of working capital if:
  - There is plan in writing for how the working capital is to be spent (for example, on substantially improving property),
  - This plan has a reasonable schedule for when these amounts will be spent, and
  - The working capital assets are actually used per the plan.
- This safe harbor also applies to income generated by the safe harbor working capital for purposes of the 50% of income being derived from a trade or business requirement.

Congressional Critique of Proposed Regulations

- A bipartisan group of 16 House and Senate lawmakers drafted a letter to Treasury critiquing parts of the Proposed Regulations.
- The main target was the requirement that 50% of a business's gross income must come from a trade or business operating within a qualified opportunity zone in order for such business to qualify for investment by a QOF.
- This could be an impediment to many businesses that earn income from the sale of goods or services outside of a single census tract. Even if the requirement is met, this will require businesses to keep track of the geographic source of all of its income and this is an administrative burden.
- The letter stated that this requirement "runs contrary to congressional intent" and that a better requirement would be to simply require that a business derive 50% of its gross income from any trade or business.

Open Issue: Depreciation Recapture

- O Zone tax benefits are designed to exclude gain to stimulate investment. But does this extend to also eliminating depreciation recapture?
- Are taxpayers supposed to be able to take depreciation losses over the 10-year hold and then step-up basis after a 10-year hold thereby eliminating the normal deprecation recapture?
- Some commentators think not, but this is the way the statute reads.

Depreciation Recapture Example

- X invests $3 million in non QOF. Starts with $3 million basis but over time claims $2 million in losses due to depreciation reducing basis to $1 million. Then X sells at a loss for $2.9 million.
- $2.9 M (amount realized)
- Less $1 M (basis)
- Equals $1.9 M (gain)

- Same facts, except X invests in a QOF and makes election to raise basis up to FMV after a 10-year hold.
- $2.9 M (amount realized)
- Less $2.9 M (basis)
- Equals 0 gain

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Open Issue: Multiple Assets in One QOF

- Statutory language requires sale of an interest in a QOF, not the assets of a QOF. Would a multi-asset QOF be feasible if not all assets will be sold at the same time?
- Commentators believe Treasury has authority to allow sales of assets, but open question if they will.

Open Issue: Operating Businesses

- 70% of property owned or leased by a business must be property where substantially all the use of such property is in an opportunity zone.
  - What is the situs test for this?
- 50% of gross income must be from the active conduct of zone business.
  - What about a company located in an opportunity zone that sells products online all over the country?

Open Issue: Netting of Gain and Loss in a Partnership

- If a partnership realizes both gains and losses during a year, it may elect to invests the gains in a QOF and pass the losses through to partners.
- However, if the partnership declines to make this election, the gains and losses will be netted and passed through to partners. Now, if the partners elect to invest gains in the QOF, they will only be able to invest the net gains.
- Why should this be different?

Common Problem: Prior Ownership of Opportunity Zone Property

- To count as "zone business property" property must be purchased from unrelated parties after 12/31/2017.
- Can an taxpayer who has owned property in an opportunity zone prior to 12/31/2017 take advantage of the opportunity zone tax benefits? Yes, but…
  - One common solution is to have the QOF lease the land from the taxpayer and then build and own only the improvements on the land.
  - Another would be to bring in partners to the QOF (at least 80% new partners) so that the QOF and the taxpayer would not be considered related.

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