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# Investment in Federal Opportunity Zones

# Opportunity Zones – Overview

- What is the basic concept behind the legislation?
  - A new community development program established by Congress that encourages long-term investment in low-income communities by providing investors with tax deferral and avoidance incentives to re-invest their capital gains into investment vehicles dedicated to investing in Opportunity Zones.

# Opportunity Zones – History

- Brief Legislative History – how did we get here?
  - Originally developed in 2015, the program is based on the Investing in Opportunity Act and was adopted under the Tax Cuts and Jobs Act of 2017



# Tax Incentive Benefits – How the deferral works

- 1. Deferral of Gain**
  - 2. Partial Forgiveness of Deferred Gain**
  - 3. Forgiveness of Additional Gains**
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## Deferral of Gain

- Time value of money – Defer until earlier of:
  - Date the investment is sold or exchanged; or
  - December 31, 2026

# Partial Forgiveness of Existing Capital Gains

- Gain recognition
  - Amount of gain (or FMV)
  - less: the taxpayer's basis in the fund (initially zero)
- Partial Forgiveness of Gain – Step up in basis
  - 5 year (10%)
  - 7 year (15%)

# Forgiveness of Additional Gains

- Forgiveness of additional gain
  - Timing – 10 years
  - Basis

# Qualified Opportunity Zone Sample Investment

**Jan. 2, 2018**

Taxpayer enters into a sale that generates \$1M of capital gain

**June 30, 2018**

(Within 180 days), Taxpayer contributes entire \$1M of capital gain to a Qualified Opportunity Fund

- Taxpayer is deemed to have a \$0 basis in its QOF investment
- QOF Invests the \$1MM in Qualified Opportunity Zone Property



# Qualified Opportunity Zone Sample Investment

**June 30, 2023**  
(After 5 years),  
Taxpayer's basis in  
investment in QOF  
increases from \$0 to  
\$100k

**June 30, 2025**  
(After 7 years),  
Taxpayer's basis in  
investment in QOF  
increases from  
\$100k to \$150k

**Dec. 31, 2026**  
\$850K of the 1MM  
of deferred capital  
gains are taxed and  
the basis in QOF  
investment increases  
to \$1MM

**June 30, 2028 (10  
years later),**  
Taxpayer sells  
investment for  
\$2.0MM. Basis is  
deemed to be FMV.  
Thus, no tax on  
appreciation

2023

2024

2025

2026

2027

2028

# Qualified Opportunity Funds

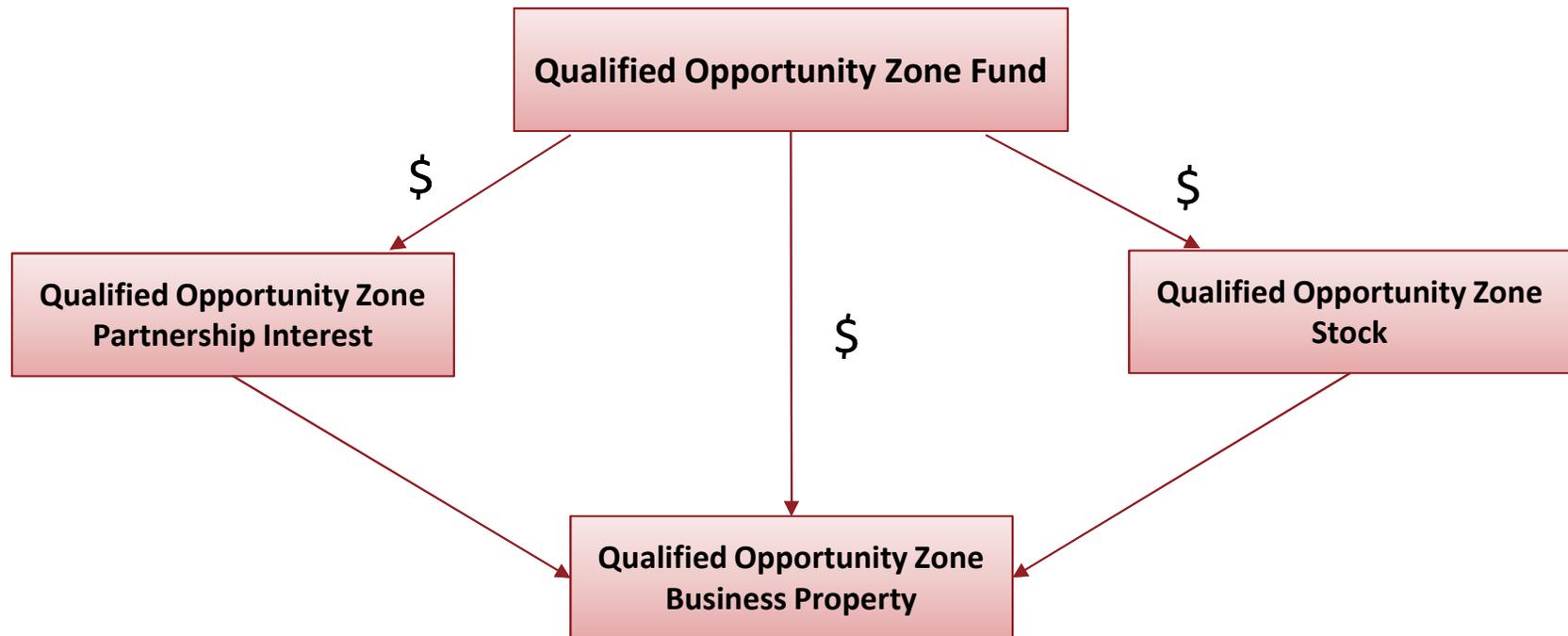
- Qualified Opportunity Funds – an Investment Intermediary
  - Must be organized as a domestic corporation or a partnership (“Entity Test”)
  - Purpose must be to invest in Opportunity Zones (“Purpose Test”)
  - Must hold at least 90 percent of assets in qualified opportunity zone property (“Assets Test”)



## Investments in Qualified Opportunity Zone Property

- **Asset Test: Opportunity Funds Must hold at least 90% of its assets in Qualified Opportunity Zone Property:**
  - Qualified Opportunity Zone Stock
  - Qualified Opportunity Zone Partnership Interest
  - Qualified Opportunity Zone Business Property

# 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.
  - 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, and must continue to qualify during substantially all of the holding period
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# Qualified Opportunity Zone Business Property

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

AND

- 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

# Qualified Opportunity Zone Business Property

- Qualified Opportunity Zone Business Property is tangible property used in a trade or business if:
  - It is acquired by purchase after December 31, 2017; and
  - 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.

Note purchase requirement is subject to Section 179(d)(2) related party rules, but using a 20% related party test instead of 50%



## Qualified Opportunity Zone Business Property

- **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.

# Qualified Opportunity Funds

- **Assets Test: How is it determined?**
  - **Timing: 90 percent investment requirement is tested by averaging the percentage of the Qualified Opportunity Zone Property held:**
    - On the last day of the first 6 months of tax year, and
    - On the last day of the taxable year

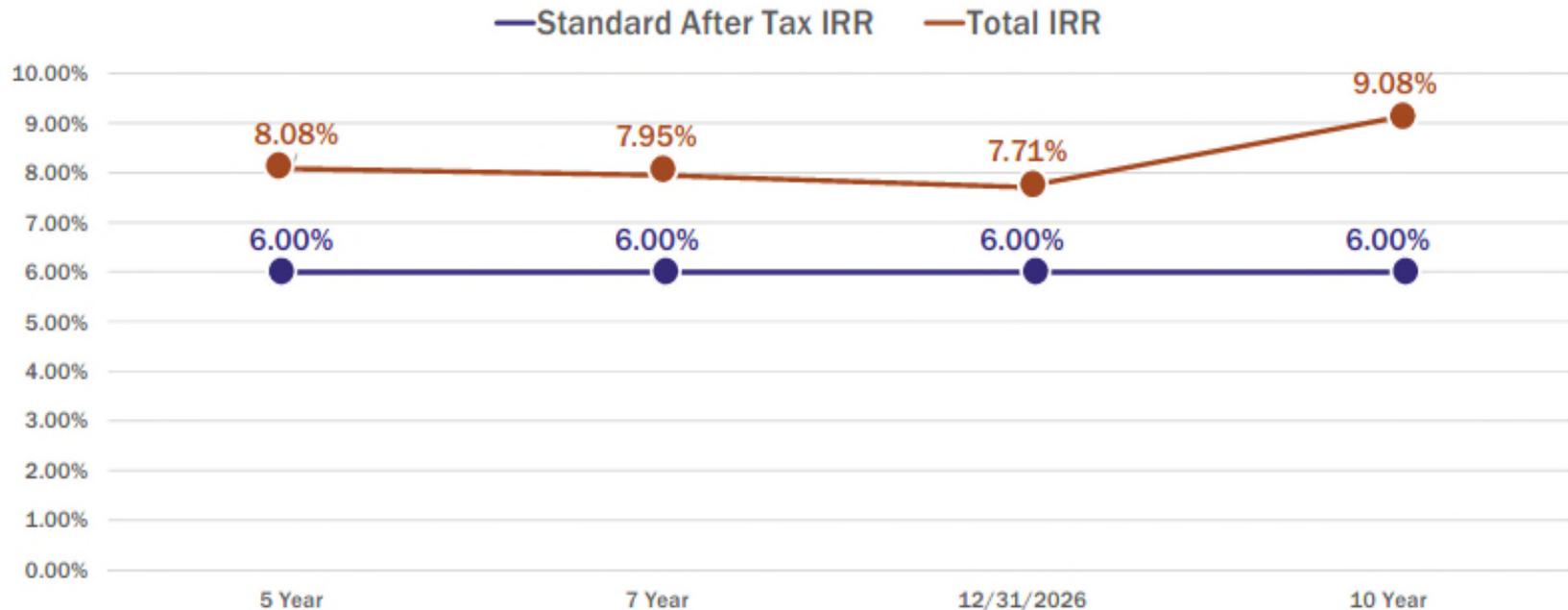
# Qualified Opportunity Funds

- **Penalty for Failure to Maintain the Assets Test:**
  - A monthly penalty equal to the shortfall multiplied by the IRC underpayment rate (currently 5 percent)
  - Exception if failure was due to reasonable cause
  - Seeking guidance from Treasury for on-ramps and off-ramps

# Qualified Opportunity Funds

- Certification of Opportunity Funds
  - Statute authorizes a regulatory process for certification of Qualified Opportunity Funds by Treasury
  - Treasury announced that Qualified Opportunity Funds will “self-certify” by filing a form with their tax return
  - Form to be published this summer
  - There is no limit on the number of Qualified Opportunity Funds that can be created

# Opportunity Zone Incremental Benefit



23.8% Tax Rate	5 Year	7 Year	12/31/2026	10 Year
Standard After Tax IRR	6.00%	6.00%	6.00%	6.00%
Incremental OZ Benefit	2.08%	1.95%	1.71%	3.08%
OZ Investment IRR	8.08%	7.95%	7.71%	9.08%
Percentage Increase	35%	32%	29%	51%

Table Source - Novogradac & Company LLP, [www.opportunityzoneresourcecenter.com](http://www.opportunityzoneresourcecenter.com), May 7, 2018

# Qualified Opportunity Funds

- Key Open Issues
  - Will states recognize OZ Funds for state tax purposes?
  - Clarify definition of qualified business property
  - Clarification of on-going compliance requirements
  - Clarification of exit requirements





# Qualified Opportunity Funds

- Practical challenges in raising and deploying gains within the parameters of the program:
  - Aggregating large amounts of capital gains while deploying funds so as to meet the Asset Test
  - Meeting the “substantial improvement” test for all but larger development projects

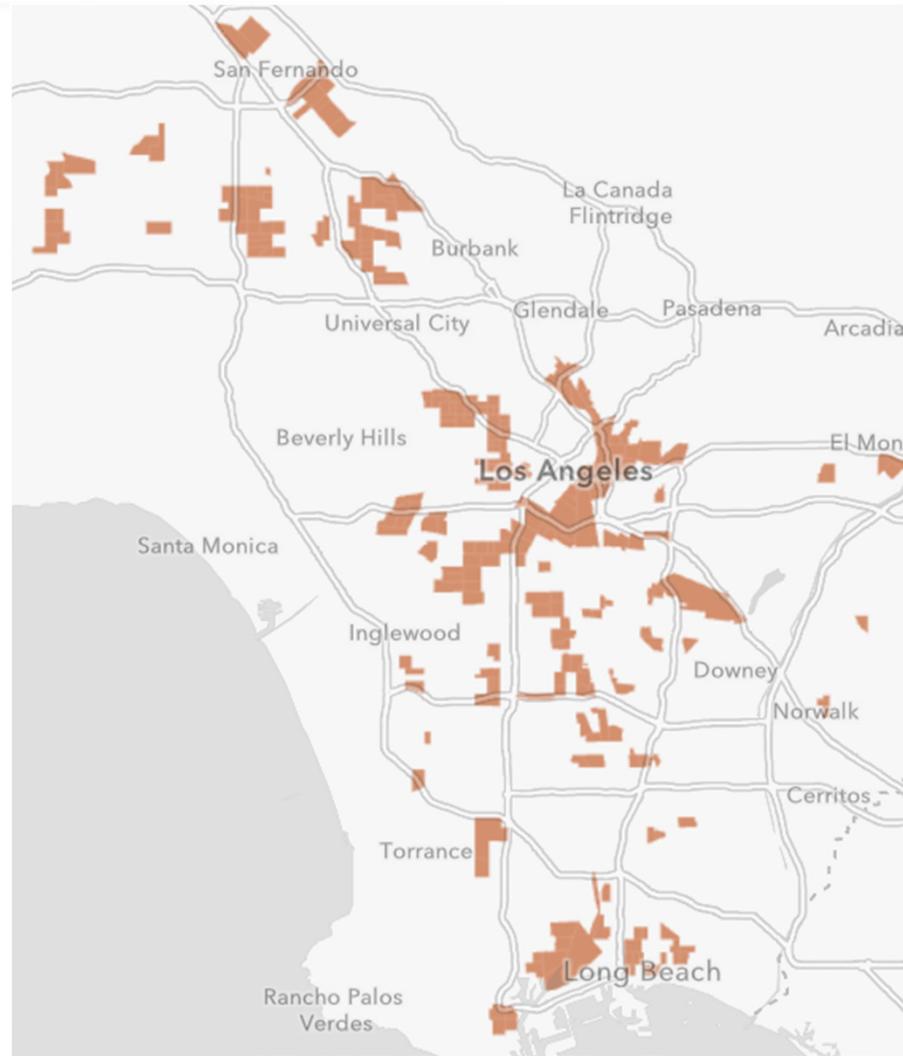
# Comparison to 1031 Exchange

	Opportunity Zone Fund	1031 Exchange
<b>“Like-Kind” Requirement</b>	<b>No</b>	<b>Yes</b>
<b>Use of all sale proceeds required?</b>	<b>No, only capital gains may be invested</b>	<b>Yes, to get full deferral</b>
<b>Intermediary Required</b>	<b>No</b>	<b>Yes</b>
<b>Investment Window</b>	<b>180 days</b>	<b>180 days</b>
<b>Tax Deferral</b>	<b>Yes, but ends 12/31/2026</b>	<b>Yes</b>
<b>Potential Capital Gains Avoidance</b>	<b>Partial on Initial Investment w 5-7 year hold; full for additional gains</b>	<b>Full if stepped-up basis upon death</b>

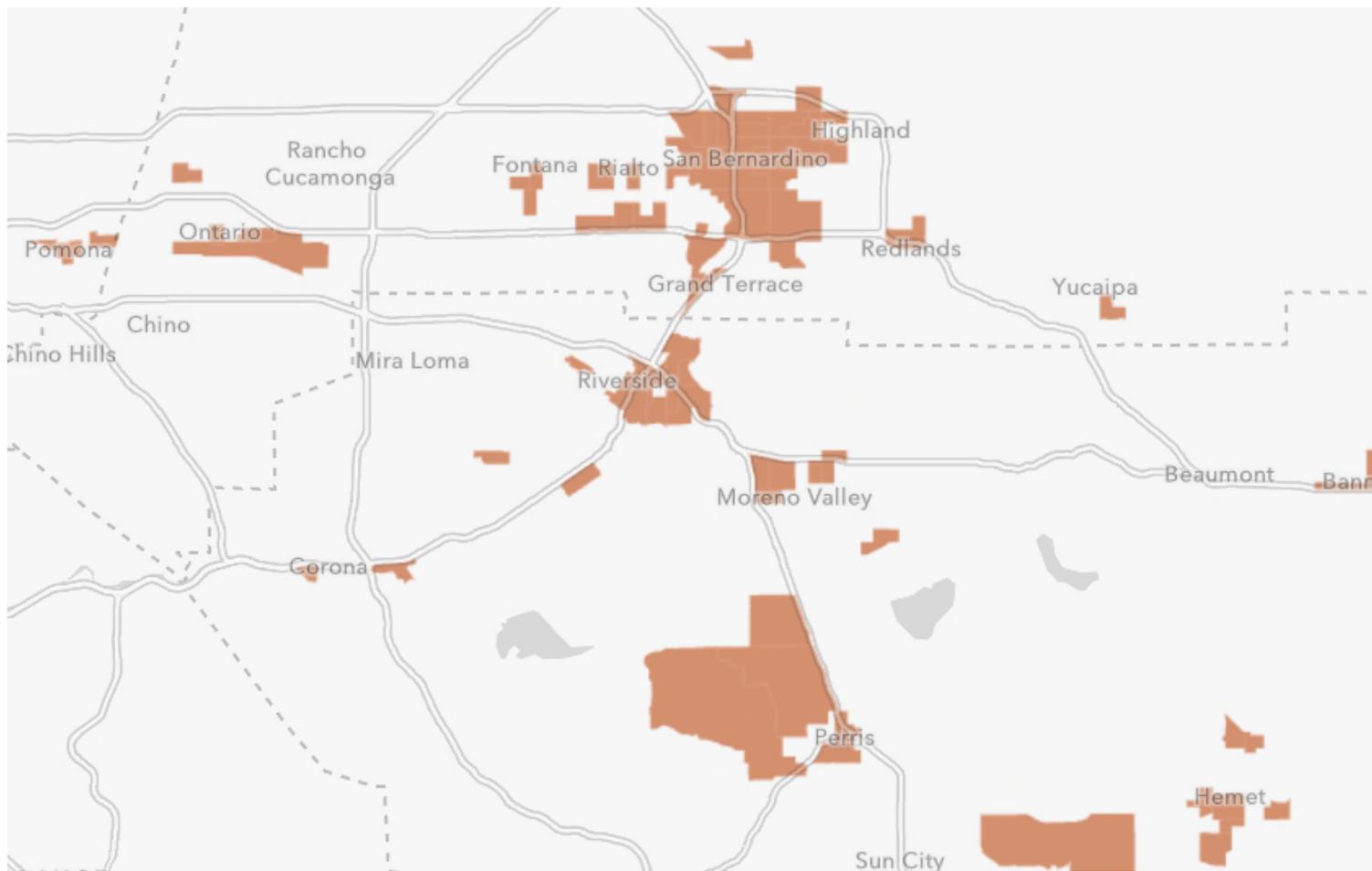
# Opportunity Zones – Final Status of Designations

- Geographic designation – Zone certification
  - As of June 14, 2018, Opportunity Zones have been designated in all 50 states, Washington, D.C., Guam, American Samoa, Puerto Rico, the U.S. Virgin Islands and the Northern Mariana Islands.
  - <https://home.treasury.gov/news/press-releases/sm0414>
- Submission analysis of 9 states (1/3 of national eligible tracts – CA, TX, WI, OH)
  - Poverty rate (average tract) – 32% vs. 28% of total
  - Median family income among nominations - \$39,941 is 58% vs. 64% average
  - Average tract – 28% of adults w/o a high school diploma (vs. 13%)
  - Average tract – 38% of prime age population is not working (vs. 28%)
  - 9 state OZ tract average distress score is 13 points higher than state average (according to <http://eig.org/dci>)

# Opportunity Zone Mapping Los Angeles Area



# Opportunity Zone Mapping Inland Empire





# Qualified Opportunity Zones

For a link to additional maps:

GO [HERE](#) to download maps:  
<http://eig.org/opportunityzones>

Questions?

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