Opportunity Zone Investing

2017 Tax Cuts & Jobs Act

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INTEGRATED TAX CREDIT SOLUTIONS

MOXIE INVESTMENT FUNDS

FRAMEWORK ARCHITECTURE

TMS

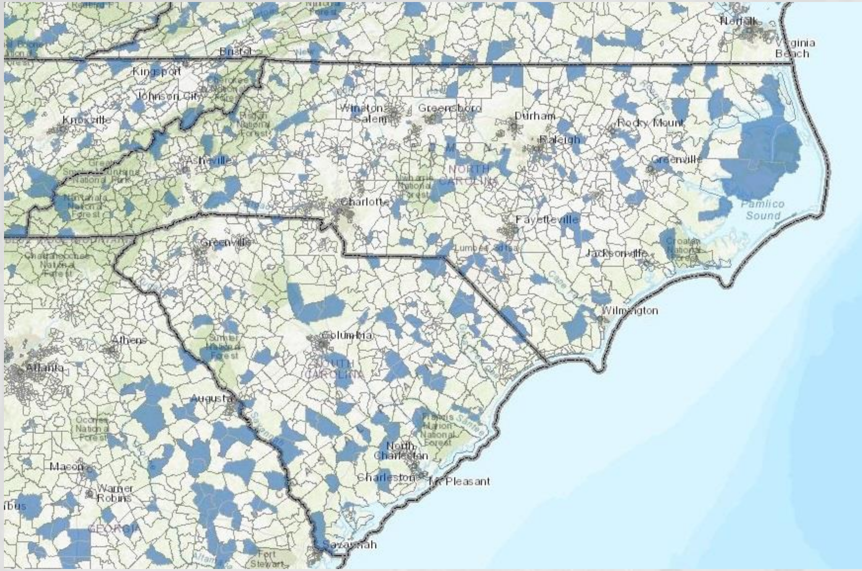
SHERBERT CPA, PC

The Sherbert Group is a unique integration of companies that provide valuable tax, accounting, investment and consulting services to clients in the tax credit industry.

- Serving clients in 16 states
- Combined portfolio of $4 billion
- Member of the American Institute of CPAs Government Audit Quality Center
- Expertise & experience in a variety of state & federal tax incentives
- Specializing in real estate tax credits

Introduction

- Opportunity Zones were added to the Internal Revenue Code by the 2017 Tax Cuts and Jobs Act by Code sections:
  - 1400Z-1 discusses designation of Opportunity Zones



  - 1400Z-2 discusses how to invest capital gains into opportunity zones and receive significant tax benefits

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Who Can Benefit?

- Literally any US taxpayer with capital gains (net 1231 capital gains) can potentially benefit from this new tax incentive. This Includes:
  - Individuals or corporations looking to reinvest gains from sales of property in order to defer and reduce taxes;
  - Real estate developers and start-up companies located in an Opportunity Zone who are looking for equity investment; and
  - Real estate sponsors, syndicators and/or private equity funds looking to create Qualified Opportunity Funds and then make investments in Qualified Opportunity Zone Property, including investments in corporations, partnerships or direct investments in property.

3 Major Buckets of “Opportunity”

- A taxpayer who timely reinvests gain from a sale of property into a “Qualified Opportunity Fund” (“Fund”) can enjoy the following tax benefits:
  - Bucket 1 - Deferral: Gain on a property sale that is invested in a Fund is deferred until the earlier of the date that the taxpayer sells its interest in the Fund or December 31, 2026.
  - Bucket 2 - Capital Gain Reduction: If the taxpayer invests in the Fund for at least 5 years, 10% of the original gain is excluded; if the investment lasts for at least 7 years, an additional 5% (for a total of 15%) of the original gain is excluded.
  - Bucket 3 - Appreciation Exclusion: If the taxpayer invests in the Qualified Opportunity Fund for at least 10 years, all appreciation in the new investment will be tax-free.

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Bucket 1 – Deferral of Capital Gain

- Investor Sells an Investment or Property for a Capital Gain of $100
  - Reinvests the Capital Gain in a Qualified Opportunity Fund
- Capital Gain of $100 is deferred until the earlier of:
  - Date when NEW investment is sold or exchanged, or
  - December 31, 2026
- How much Gain is Recognized?
  - Lesser of the amount of gain excluded originally <u>or</u> the sales proceeds <u>or</u> the fair market value of the investment on 12/31/2026
- What does this mean?
  - Original Gain $100
  - Reinvestment $100
  - Sale in 2020 for $90
  - In 2020 your deferred gain of $100 is recognized as $90 gain

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Bucket 2 – Reduction of Gain

- If New Investment is held for 5 years, the basis in the Investment is increased by 10%
- If New Investment is held for 7 years, the basis in the Investment is increased by 15%

This can result in the reduction of the original deferred gain.

Examples:

1. Original reinvested gain of $100 (12/31/2019)
   Sell in 2022 for $90
   Gain recognized $90 (no reduction of gain since not held for 5 or 7 years)

2. Original reinvested gain of $100 (12/31/2019)

   Sell on 1/1/2025 for $90 (5 years plus 1 day)

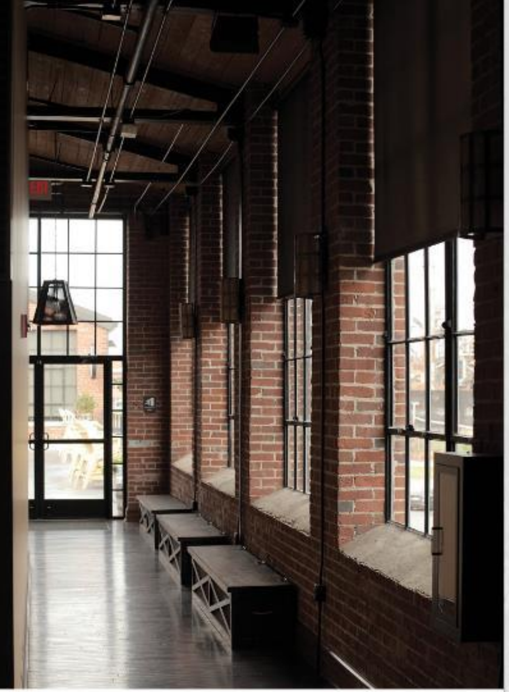
   Basis = $0

   Increase in Basis 10% x $100 = $10

   Sales Proceeds $90 (A)

   Adjusted Basis = $10 (B)

   Resulting Gain $80 (A) – (B)



Bucket 3 – Permanent Exclusion of New Investment Acquisition Appreciation

- For Investments held by taxpayer for at least 10 years, the basis of such property = FMV at the time the investment is sold or exchanged for Qualifying Investments made between now & December 31, 2028
- Following example – <u>Investment in Fund is Held for 10 Years and Sold in 2029</u>

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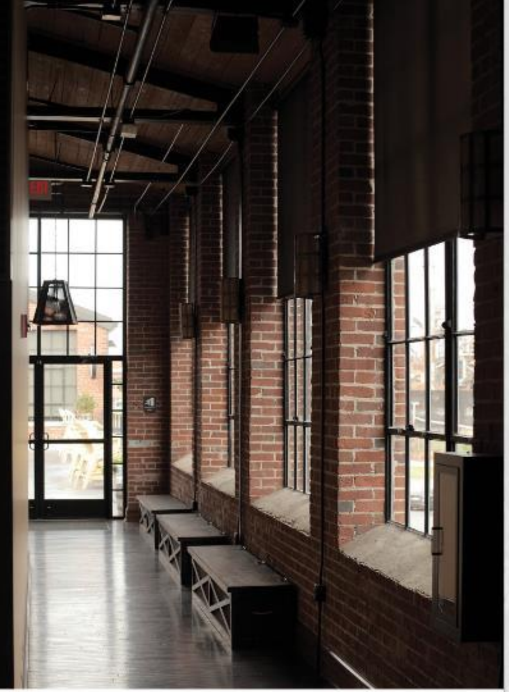

Example – Investment in Fund is Held for 10 Years and Sold in 2029

Opportunity Zone Investment Held for at least 10 Years		Ordinary Investment		Benefit
		Bucket 2 - Reduction of Gain		
Deferred Gain (taxed in 2026)	$100.00	Gain (taxed in 2018)	$100.00	
Basis Step-up	15.00	Basis Step-up	0.00	
Taxable Gain	85.00	Taxable Gain	100.00	
Tax (at 23.8%)	$20.23	Tax (at 23.8%)	$23.80	$3.57
		Bucket 1 - Present Value of Deferral of Gain		
Present value of tax @ 10% discount rate	$9.44		$20.23	$10.79
		Bucket 3 - Permanent Exclusion of New Investment Appreciation		
Gain on Disposition of Investment in Fund	$100.00	Gain on Investment	$100.00	
Basis Step-Up	100.00	Basis Step-Up	0.00	
Taxable Gain on Disposition	0.00	Taxable Gain on Disposition	100.00	
Tax (at 23.8%)	$0.00	Tax (at 23.8%)	$23.80	$23.80
TOTAL BENEFITS				$38.16
BENEFITS AS A PERCENT OF ORIGINAL GAIN				38.16%

What is a Qualified Opportunity Fund?

- A Corporation or Partnership organized for the purpose of investing in “Qualified Opportunity Zone Property” that holds at least 90% of its assets in QOZP
  - 90% determination is made at 6-month and year-end measurement periods (test can be performed without taking into account investments received in preceding six months for investments held in cash or debt instruments of 18 months or less)
  - If a Opportunity Zone does not have at least 90% of its assets in QOZP, then fund assets (not invested in QOZP) are penalized at the same interest rate for underpayments of Federal Taxes under IRC Section 6621 – 6% starting in January – no penalty if failure is due to “reasonable cause”, which has not been well defined.
  - Calculation = Shortfall amount x underpayment rate divided by 12
  - This is reported on Form 8996

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Qualified Opportunity Fund

- Capital gains via Cash or property at lower of tax basis or FMV
- No services allowed for contribution
- Net 1231 gains at 12/31

QOF

Qualified Opportunity Zone Property
90% - Valued by GAAP Audit or Cost Average, 2 testing periods per year

STOCK (QUALIFIED OPPORTUNITY ZONE BUSINESS)

PARTNERSHIP INTEREST (QUALIFIED OPPORTUNITY ZONE BUSINESS)

QUALIFIED OPPORTUNITY ZONE BUSINESS PROPERTY

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Qualified Opportunity Zone Business (Stock or Partnership Interest)

- Purchased after December 31, 2017, via cash & qualifies for 90% of holding period as QOZB
  1. Substantially all (70%) tangible property **owned or leased** is a QOZBP
  2. 50% gross income is derived from active conduct of the trade or business in the QOZ
     - A. 50% Gross Income Measured via
       1. At least 50% of hours worked were in a QOZ
       2. At least 50% of payroll dollars spent were for services performed in a QOZ
       3. Tangible property & Management Operations Functions are responsible for at least 50% of the gross income of the trade or business.
       4. If it can be demonstrated by Facts and Circumstances that at least 50% of gross income is derived from business in a QOZ.
  3. "**Substantial portion" 40% of intangible property is used** in active conduct of the trade or business in the OZ (ex. Franchise Fee)
  4. < 5% of the average of the aggregate unadjusted basis is attributable to Nonqualified Financial Property ("NQFP") – Debt, Stock, Non –Qualifying Partnership Interest, LESS reasonable Working Capital, ordinary accounts receivable.
  5. No Sin Businesses – Golf Course, Country Club, Massage, Hot Tub/Suntan Facility, Race Track/Gambling, off premises alcohol seller.

Qualified Opportunity Zone Business (Stock or Partnership Interest)

- Working Capital safe harbor – 3 requirements:
  1. Designated in writing for acquisition, construction and/or substantial improvement of tangible property.
  2. A written schedule for the expenditure of working capital assets to be spent within 31 months. Delays due to government actions or inactions does not cause a failure of the safe harbor.
  3. Actual use of the working capital that is consistent with 1 and 2.
- Delays attributable to waiting for governmental action, the application for which is completed during 31 month period do not violate 31 month period.
- Allows for multiple 31 month-working capital safe harbors
- The written designation for planned use of working capital now includes the development of a trade or business in the qualified opportunity zone as well as acquisition, construction, and/or substantial improvement of tangible property.

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QOZB Structure Diagram

Taxpayer

Investment ↓

Qualified Opportunity Fund

QOF must hold at least 90% of its assets in QOZP (i.e. QOZ stock, QOZ partnership interest or QOZBP)

Investment ↓

QOZB Partnership or Stock

Substantially all (at least 70%, per proposed regulations) of the tangible property owned or leased by the QOZB must be QOZBP.

Qualified Opportunity Zone Business Property

- Tangible property used in business
  1. Property acquired by QOF via non-related party purchase after December 31, 2017,
  2. Original use of such property in the QOZ commences with the QOF <u>or</u> the QOF Substantially Improves the property <u>AND</u>,
     a) <u>Original Use—Person or prior person first places the property in service in the QOZ for depreciation or amortization</u>
     b) <u>5 year vacancy requirement for abandoned/vacant buildings</u>
  3. During "substantially all" 90% of the QOF's holding period for such property, "substantially all" 70% of the use of such property is in a QOZ.
     - Inventory in transit does not break use test
  4. Leased property now qualified

Leased Property Rules

Leased property for QOZBP now qualifies when:

- Acquired under a lease entered into after 12/31/2017
- Substantially all (70%) of all the use of the leased tangible property must be in a QOZ during 90% of the lease term
- No original use requirement on improvements made by a lessee
- No substantial improvement requirement
- Can be leased from related party if:
  - Market rate lease terms exist
  - No prepayment for rent exists greater than 12 months of rent
  - Leased tangible personal property only qualifies if:
    - Lessee becomes the owner of the tangible property of which has value not less than the value of the leased personal property(within 30 months)
    - Substantial overlap in zones

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Valuation of Leased Property for 90% Test

- Financial statement method(GAAP)
- Alternative valuation method
    - Net present value of lease payments
    - Discount rate under 1274(d)(1) prescribed
        - Calculated once at the time lease is entered into

Proposed Regulations Issued October 19, 2018

- Provide a safe harbor that allows an O Zone Business to hold funds for up to 31 months for the acquisition, construction, or improvement of real and other tangible property
- Calculate the substantial improvement test by reference to the basis of the building, excluding the basis of the land
- Require that an O Zone Business have only 70% of its assets invested in O Zone Business Property
- Allow gains recognized by a partnership to be invested in an O Fund by either the partnership or its partners
- Allow all of the benefits of the program to be claimed by taxpayers through December 31, 2047, despite the earlier expiration of the O Zone designations
- Allow an O Fund to specify the first year and month in which it will be classified as an O Fund
- Limit the eligible gains that can be deferred under the program to capital gains, arguably contrary to the statute

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Guidance Provided in Additional Regulations

- Triggering events for income inclusion
- Distributions from a QOF
    - Are inclusion events if the investor has no basis
    - Results in acceleration of the original deferred capital gain to the extent there is no basis
- Reasonable period defined for re-investment or proceeds (12 months)
- No substantial improvement requirement for land, but the land must be used in active conduct of a trade or business (speculative land purchased to hold does not qualify) to be considered QOZBP
- Investor that holds its QOF interest for 10 years can elect to exclude QOF K-1 capital gain (from a QOZB’s sale of QOZBP) from gross income

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Proposed Reporting

116TH CONGRESS
1ST SESSION

S. 1344

To require the Secretary of the Treasury to collect data and issue a report on the opportunity zone tax incentives enacted by the 2017 tax reform legislation, and for other purposes.

IN THE SENATE OF THE UNITED STATES

MAY 7, 2019

Mr. BOOKER (for himself, Mr. SCOTT of South Carolina, Mr. YOUNG, and Ms. HASSAN) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To require the Secretary of the Treasury to collect data and issue a report on the opportunity zone tax incentives enacted by the 2017 tax reform legislation, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. COLLECTION OF DATA ON OPPORTUNITY ZONE TAX INCENTIVES.

(a) IN GENERAL.—The Secretary of the Treasury, or the Secretary's delegate (referred to in this Act as the "Secretary"), shall collect information on investments held by qualified opportunity funds (as defined in section 1400Z–2(d) of the Internal Revenue Code of 1986) nationally and at the State level, which shall include—

(1) the number of such qualified opportunity funds,

(2) the amount of assets held in qualified opportunity funds,

(3) the composition of qualified opportunity fund investments by asset class,

(4) the percentage of qualified opportunity zone census tracts designated under subchapter Z of the Internal Revenue Code of 1986 (as added by section 13823 of Public Law 115–97) that have received qualified opportunity fund investments, and

(5) the impacts and outcomes of zone designation in those areas on economic indicators, including job creation, poverty reduction, new business starts, and other metrics as determined by the Secretary.

(b) INVESTMENTS.—For any investment described in subsection (a), the Secretary shall collect relevant information regarding each such investment, including—

(1) the total amount of the investment and the date on which such investment was made,

(2) the type of investment, such as whether the investment is in an existing business, new business, or real property, and the location of such business or property,

(3) the type of activity being supported by such investment, such as single-family or multi-family residential properties, commercial properties, or the economic sectors in which the business operates,

(4) in the case of a business, the approximate number of full-time employees at the time the investment in such business was made, and

(5) in the case of real property, the approximate total square footage and the approximate number of residential units, as applicable.

(c) COLLECTION OF INFORMATION.—For purposes of any information described in this section, the Secretary shall establish appropriate procedures and measures to ensure that—

(1) collection of such information is performed in a manner so as to prevent duplicative or redundant reporting, and

(2) any personally identifiable data included in such information is properly protected and withheld from disclosure to the public.

SEC. 2. REPORT TO CONGRESS.

The Secretary shall submit a report to Congress on the opportunity zone incentives enacted by section 13823 of Public Law 115–97, beginning 5 years after the date of enactment of this Act and annually thereafter, which shall include the information described in section 1(a).

SEC. 3. INFORMATION REGARDING INVESTMENTS.

Subject to subsection (c) of section 1, the Secretary shall make the information submitted pursuant to subsection (b) of such section publicly available, with such information to be made available not later than the date which is 1 year after the date of enactment of this Act and annually thereafter, following the initial reporting of such information by any qualified opportunity fund.

Some Timing Considerations

- If a partnership with an eligible gain does not elect to defer the gain, then the partners may make the deferral. In this case:
  - The 180-day period for investment begins on last day of partnership's tax year;
  - OR the partner may elect to use the partnership's 180-day period (i.e. beginning during the tax year, when the gain would normally be recognized).
- Section 1231 gains must be net of Section 1231 losses as of the end of the tax year; 180-day period begins on last day of tax year

OZ Critical Dates

12/31/2017
QOZBP AND QOZB must be acquired after this date

12/31/2019
Investment in QOF must be made by this date in order to get 15% reduction in deferred gain if held until 12/31/2026

12/31/2021
Investment in QOF must be made by this date in order to get 10% reduction in deferred gain if held until 12/31/2026

12/31/2026
Deferred gain must be recognized no later than this date

12/31/2028
Qualified Opp. Zones expire on this date, no more qualified investments can be made after this

12/31/2047
Sale of investment in QOF must be made by this date

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