



## THE QUALIFIED OPPORTUNITY ZONE TAX INCENTIVE

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## > Part of the Tax Cuts & Jobs Act

- Enacted December 22, 2017
- Bipartisan effort that was originally initiated in Feb. 2017 by Tim Scott (R-SC) and Cory Booker (D-NJ)
  - Intended to allow “trillions of dollars in private capital to be used to encourage small business, support entrepreneurs, and to develop dilapidated properties in zip codes most in need of resurgence.”
- Builds on/improves upon incentives provided under existing programs
  - E.g., NMTC program, which is subject to annual allocation limit
    - No limit to OZ Investments



## > Opportunity Zones (OZs)

- Nominations were made by the chief executive officer of each state by March 2018
  - Population census tracts designated as “low-income communities” per the NMTC program
  - Limited to 25% of the eligible low-income communities within the state
- Treasury certified those nominations and designated opportunity zones in each state in April – June 2018
- Designations expire December 31, 2028
- Virginia has 212 designated OZs



## > Proposed Regulations

- First tranche of proposed Treasury Regulations issued October 2018
- Second tranche of proposed Treasury Regulations expected in late March or early April
  - Draft regulations sent to Office of Information and Regulatory Affairs on march 12<sup>th</sup>

## > Technical Corrections

- On January 2, 2019, the Joint Committee on Taxation issued a draft of its “Tax Technical and Clerical Corrections Act” that included changes to the OZ statute

# WHAT IS THE INCENTIVE?



## > Three Potential Tax Benefits

- Deferral of tax on the initial capital gain from the sale or exchange of property (“Initial Gain”)
  - Any gain treated as capital gain for federal income tax purposes qualifies as eligible gain
  - Attributes of capital gain preserved throughout deferral period
- Reduction of tax on Initial Gain
- Avoidance of tax on future capital gain from sale or exchange of OZ Investment (“Future Gain”)

# WHAT IS THE INCENTIVE?



## > **The Deferral Election**

- Permits taxpayer to defer recognition of Initial Gain on sale or exchange of property to unrelated person
  - Taxpayer must invest Initial Gain in an OZ Fund within 180 days following sale or exchange
    - Partners in a partnership have 180 days after the end of the partnership's taxable year to make deferral election, provided partnership does not make deferral election
- Recognition of Initial Gain deferred until earlier of:
  - Disposition of OZ Investment, or
  - December 31, 2026

## > **Election Mechanics – Form 8949**

- Filed with tax return for the year of deferral

# WHAT IS THE INCENTIVE?



## > Amount Recognized

- No later than **December 31, 2026**, Taxpayer recognizes:
  - The lesser of:
    - The Initial Gain, or
    - The FMV of the OZ Investment, over
  - The Taxpayer's Basis in the OZ Investment
- If the value of an OZ Investment depreciates –
  - Taxpayer should obtain valuation as of 12/31/26

# WHAT IS THE INCENTIVE?



## > Permanent Tax Reduction

- Initial Basis in OZ Investment
  - Taxpayer takes a \$0 basis in OZ Investment
- Basis Increases
  - OZ Investment held for **5 years**:
    - Basis increased by **10%** of Initial Gain
  - OZ Investment held for **7 years**:
    - Basis increased by an additional **5%** of Initial Gain
  - Total possible basis increase = **15%**

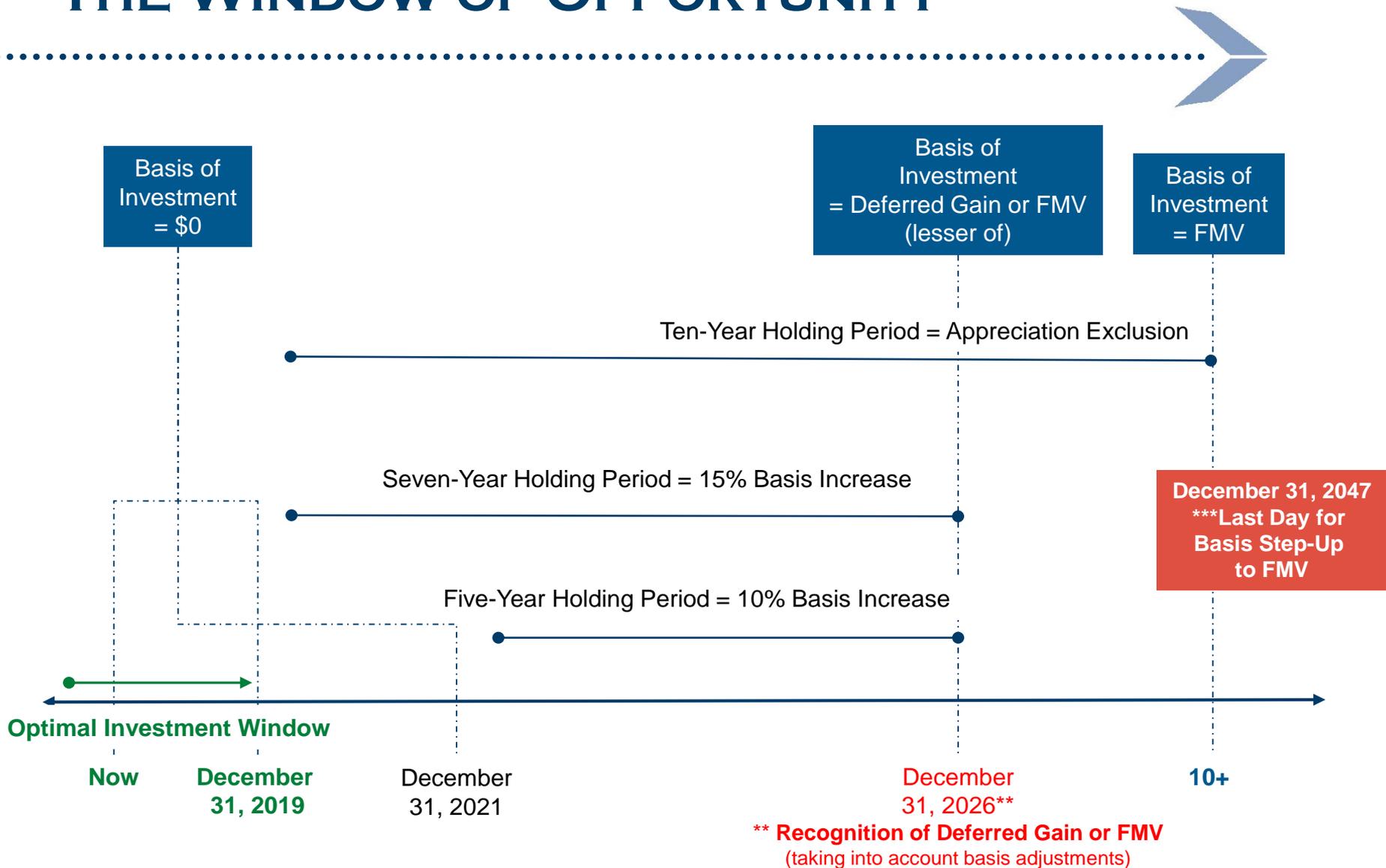
# WHAT IS THE INCENTIVE?



## > Permanent Tax Avoidance

- Gain Exclusion Election
  - If OZ Investment is held **at least 10 years** prior to **December 31, 2047**, and
  - Taxpayer makes a valid election...
    - Basis of OZ Investment is increased to its **FMV** as of the date it is sold or exchanged
- Election mechanics
  - Requires further guidance

# THE WINDOW OF OPPORTUNITY



# EXAMPLE



## > Example:

- Taxpayer sells stock with a basis of **\$500,000** for **\$1,000,000** on 10/31/19
- Taxpayer invests the **\$500,000** of gain into a OZ Fund on 12/31/19
- Assume Taxpayer sold the OZ Fund investment after year four, five, seven or ten for **\$1,000,000**
- Assume a tax rate of **20%** in each potential year of sale/recognition

# EXAMPLE



Holding Period	Basis	FMV	Gain Recognized	Effective Rate
Four Years	\$0	\$1,000,000	\$1,000,000	20%
Five Years	\$50,000	\$1,000,000	\$950,000	19%
Seven Years	\$75,000	\$1,000,000	\$925,000	18.5%
12/31/26 (Temporary Deferral Ends)	\$75,000	\$1,000,000	\$425,000	
Post-12/31/26	\$500,000	\$1,000,000		
Ten Years +	\$1,000,000	\$1,000,000	\$0	8.5%

Taxpayer's \$0 basis preserves unrecognized \$500,000 eligible gain investment in OZ Fund

Regardless of sale or exchange, taxpayer recognizes deferred \$500,000 gain (less basis increases)

Taxpayer's basis increases to FMV, and no additional tax is paid on appreciation in OZ Fund investment

# How Do I Use The Incentive?



## > Investment in OZ Fund

- What is a OZ Fund?
  - Investment vehicle that:
    - Is a corporation or tax partnership
    - Must have at least 2 partners to be a tax partnership
    - Holds at least 90% of its assets in OZ Property

# How Do I Use The Incentive?



## > The 90% Asset Test

- Based on the average percentage of OZ Property held on:
  - The last day of the first 6-month period of the taxable year of the OZ Fund, and
  - The last day of the taxable year of the OZ Fund
    - Ex. calendar-year taxpayer: June 30th and December 31<sup>st</sup>
  - If formed after 1<sup>st</sup> of year, based on first 6-month period of taxable year
  - If taxable year less than 6 months, only tested on last day of taxable year
- OZ Funds measure assets using financial statement values or, if none, cost

# How Do I Use The Incentive?



## > How to become a OZ Fund

- OZ Funds self-certify by filing IRS Form 8996
  - Filed with timely federal income tax return for the year of OZ Fund certification
    - OZ Fund selects month when OZ Fund status commences
      - » If not, defaults to first month of taxable year
      - » If OZ Investment made before OZ Fund commencement date, it is not an eligible OZ Investment

# How Do I Use The Incentive?



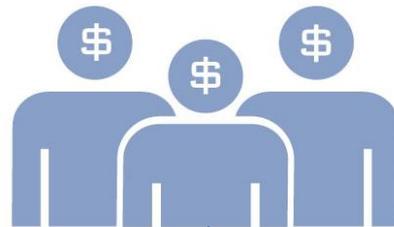
## > What is OZ Property?

- OZ Business Property
- OZ Stock
- OZ Partnership Interests

# How Do I Use The Incentive?



## Direct Structure



### **10% of Assets:**

- Cash and other nonqualified financial property
- Intangibles
- Nonqualifying tangible property

**OZ Business Property**

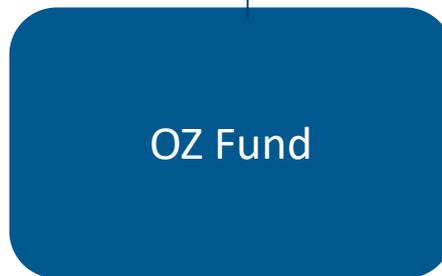
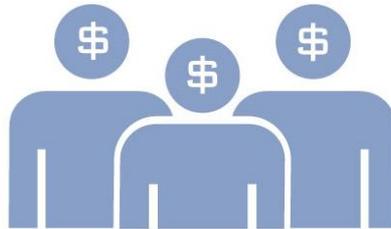
### **90% of Assets:**

- Tangible property used in trade or business
- Acquired by purchase after 12/31/17
- Original use in OZ or substantially improved
- Substantially all located in OZ during substantially all of holding period

# How Do I Use The Incentive?

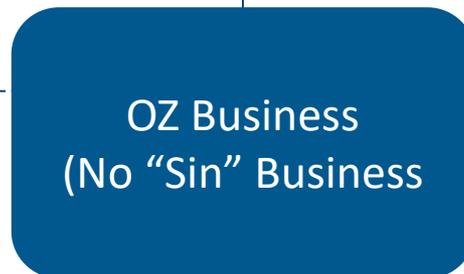


## Indirect Structure



**90% of Assets** in OZ Partnership Interests (acquired after 12/31/17 for cash)

Max **5% of assets** Nonqualified financial property (excluding reasonable working capital)



**50% gross income** attributable to the "active conduct" of trade or business in OZ

**Unlimited intangibles** if substantial portion used in active conduct of business in OZ

At least **70% of tangible assets** must be **OZ Business Property**

# How Do I Use The Incentive?



## > Key Provisions

- Purchase
  - Excludes acquisitions of property from “related” parties
- Substantial Improvement
  - Occurs when, over a 30-month period, beginning after the date of acquisition, additions to basis by QO Fund exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period.
    - In the case of real estate, cost of land excluded from this calculation, lowering threshold

# How Do I Use The Incentive?



## > Key Provisions

- “Active Conduct”
  - Term yet to be defined
  - Presumably, higher threshold for indirect structure businesses
- “Sin” Business
  - Country club, massage parlor, hot tub facility, racetrack, health club or store the principal purpose of which is to sell alcoholic beverages for consumption off premises
    - No prohibition against these businesses in direct structure

# How Do I Use The Incentive?



## > Key Provisions

- Reasonable Working Capital
  - Safe Harbor
    - Available for OZ Businesses (Indirect Structure)
      - » Permits OZ Businesses to hold reasonable amounts of working capital for a period of up to 31 months
    - To satisfy safe harbor, must develop a written plan that:
      - » Identifies the financial property
      - » Provides a plan for the financial property
      - » Includes a written schedule for the deployment of financial property consistent with ordinary course of business operations

# How Do I Use The Incentive?



## > **Mixed Use Funds**

- OZ Investment and non-OZ Investment in OZ Fund treated as two separate investments
  - Tax deferral and exclusion only apply to qualifying OZ Investment
  - Requires tracking of eligible and non-eligible OZ Investments
- Deemed contributions to a partnership under Code Section 752 do not constitute non-OZ Investments giving rise to mixed-use OZ Fund

# WHEN CAN I USE THIS INCENTIVE?



## > Important Dates

- Optimize deferral and potential exclusion/avoidance benefits
- Deferral period ends 12/31/26
- OZ Investment made by 12/31/19 may meet seven-year hold
- OZ Investment made by 12/31/21 may meet five-year hold
- Basis step-up election available until 12/31/47

# WHERE CAN I USE THE INCENTIVE?



Click [HERE](#) for Virginia Opportunities!

Link to:

Virginia Department of Housing and Community Development

# QUESTIONS



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