

NEXT CHALLENGE. NEXT LEVEL.

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OPPORTUNITY ZONES: UPDATE ON STATUS

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OPPORTUNITY ZONES

- ▶ The Tax Cuts and Jobs Act of 2017 (the “Act”) provides for the designation of certain low-income community population census tracts as qualified opportunity zones and creates some tax incentives for those that have capital gains they would like to roll over into another investment on a tax-deferred basis to encourage investment in such qualified opportunity zones.

QUALIFIED OPPORTUNITY FUND

- ▶ The Act allows a taxpayer 180 days in which to reinvest capital gains in a “Qualified Opportunity Fund”, which is a corporation or partnership organized for the purpose of investing in qualified opportunity zone property.

QUALIFIED OPPORTUNITY ZONE PROPERTY

- ▶ “Qualified Opportunity Zone Property” includes any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property.

DEFERRAL

- ▶ Reinvesting the capital gains in a Qualified Opportunity Fund will allow taxpayers to defer recognition of the capital gains until the “Recognition Date”, which is the earlier of the date the “Qualified Opportunity Zone Property” is disposed of, or December 31, 2026.

BASIS STEP UP ON THE RECOGNITION DATE

- ▶ The taxpayer's income tax basis in the Opportunity Zone Fund is initially zero. If on the Recognition Date the taxpayer has held the Opportunity Zone Fund investment for 5 years, the taxpayer will get a 10% step up in the taxpayer's income tax basis in the Opportunity Zone Fund investment. If on the date the taxpayer recognizes the gain, the taxpayer has held the Opportunity Zone Fund investment for 7 years, the taxpayer will get an additional 5% basis step up for a total 15% step up in the taxpayer's income tax basis in the Opportunity Zone Fund investment. There is no capital gains tax if held more than ten years.

BASIS STEP UP AFTER TEN YEARS

- ▶ On the Recognition Date, the deferred capital gain is recognized, except for the basis step up. If the tax payer holds the Qualified Opportunity Fund investment for at least ten years, then the taxpayer may elect to step up the income tax basis in the Qualified Opportunity Fund investment to fair market value and not pay any income tax on the gains that result after the Recognition Date.

ADDITIONAL TAX ADVANTAGE

- ▶ In addition to deferral and reduction in the ORIGINAL capital gain.
- ▶ The SECOND capital gain (if any) from the subsequent sale of the sale of the investment in the Opportunity Zone or Fund is elimination.

EXAMPLE #1

- ▶ On July 1, 2018, Taxpayer sells a capital asset for \$30,000,000. Taxpayer's income tax basis is \$20,000,000, so the capital gain is \$10,000,000.
- ▶ Taxpayer rolls the \$10,000,000 capital gain into a Qualified Opportunity Fund ("QOF") on August 1, 2018.
- ▶ On December 31, 2026, Taxpayer still owns the QOF investment, valued now at \$40,00,000. Taxpayer's income tax basis is stepped up 15% from \$0 to \$1,500,000, and Taxpayer recognizes \$8,500,000 in capital gain, which is reported on their 2026 income tax return filed in 2027. Taxpayer's income tax basis in the QOF investment is \$10,000,000.

EXAMPLE #2

- ▶ Same as Example #1 with the further fact that on September 1, 2030, 12 years after rollover, Taxpayer sells its interest in the QOF investment for \$40,000,000.
- ▶ Taxpayer's income tax basis in the QOF investment is \$10,000,000, but Taxpayer can elect to step up its income tax basis by \$30,000,000 to \$40,000,000.
- ▶ Taxpayer has no gain upon the sale of the QOF investment.

LIKE-KIND EXCHANGES

- ▶ Before the Act, Internal Revenue Code § 1031 was the main vehicle for rolling over capital gains.
- ▶ § 1031 allows taxpayers to defer gains from the sale of investment property into other like-kind property, subject to certain rules regarding timing, identification of properties, character of properties and so on.

COMPARING 1031 EXCHANGES AND OPPORTUNITY ZONES

Comparison	1031	Opportunity Zones
Use of property	Must be like-kind property	Do not have to be like-kind
Nature of property	Only real property, no personal property	Tangible property used in a trade or business, can be real or personal
Identification of replacement property	Replacement property must be identified in 45 days, with limit on number of properties	No requirement, but must be in an Opportunity Zone

COMPARING 1031 EXCHANGES AND OPPORTUNITY ZONES

Comparison	1031	Opportunity Zones
Closing on replacement	180 days	180 days
Proceeds that must be invested	Entire proceeds from sale	Only the gain from the sale
Partnership interests	Not allowed	Allowed

COMPARING 1031 EXCHANGES AND OPPORTUNITY ZONES

Comparison	1031	Opportunity Zones
Stock in corporations	Not allowed	Allowed
Personal property	Not allowed	Allowed
Time of recognition of deferred gain	Upon sale of replacement property (unless further deferred in another like-kind exchange)	Earlier of sale of opportunity zone fund or 12/31/26

COMPARING 1031 EXCHANGES AND OPPORTUNITY ZONES

Comparison	1031	Opportunity Zones
Time of recognition of gain over and above deferred gain	Upon sale of replacement property (unless further deferred in another like-kind exchange)	Upon sale of opportunity zone fund unless held for more than 10 years, in which case there would be no gain
Income tax basis step up for holding property five or seven years	None	10% if 5 years before December 31, 2026, 15% if 7 years before 12/31/26
Related parties	Not prohibited, but 2 year holding period after exchange required	Sale to related party cannot be deferred

OPPORTUNITY ZONES

- ▶ On Friday, October 19, 2018, the U.S. Treasury Department issued its first set of guidelines for opportunity zones. That guidance included 74 pages of proposed regulations, a five page revenue ruling, an updated Q&A document and a draft of Form 8996 for qualified opportunity funds.
- ▶ While the regulations are proposed, taxpayers and opportunity funds may rely on the proposed regulations, presuming they apply the rules in their entirety and do so in a consistent matter.
- ▶ The IRS has indicated they will issue a second or third set of Regulations.

QUALIFIED OPPORTUNITY FUNDS

- ▶ The Proposed Regulations provide that any entity classified as a domestic corporation or a domestic partnership for U.S. federal income tax purposes, which should presumably include a limited liability company (LLC) or business trust, is eligible to be an Opportunity Fund. Opportunity Funds may be organized as REITs and “S” corporations.
- ▶ The Proposed Regulations clarify that an eligible interest in an Opportunity Fund includes preferred stock and a partnership interest with special allocations, but not a debt instrument.
- ▶ The eligible interest can be used as collateral for a loan, whether purchase money borrowing or otherwise.

QUALIFIED OPPORTUNITY FUNDS SELF CERTIFICATION

The IRS recently issued a FAQ which states in part:

- Q. How does a taxpayer become certified as a Qualified Opportunity Fund?
- A. To become a Qualified Opportunity Fund, an eligible taxpayer self certifies. (Thus, no approval or action by the IRS is required.) To self-certify, a taxpayer merely completes a form (Form 8996) and attaches that form to the taxpayer's federal income tax return for the taxable year. (The return must be filed timely, taking extensions into account.)

The proposed Regs confirmed the self-certification.

QUALIFIED OPPORTUNITY FUNDS SELF CERTIFICATION

- ▶ On October 19, 2018, the IRS issued a Draft IRS Form 8996 for qualifying as an Opportunity Fund. The draft form implies that the Opportunity Fund must own the Opportunity Zone Business Property directly. The draft Regs say that it is expected that taxpayers will use Form 8996, Qualified Opportunity Fund, both for initial self-certification and for annual reporting of compliance with the 90-Percent Asset Test. It is expected that the Form 8996 would be attached to the taxpayer's Federal income tax return for the relevant tax years.

QUALIFIED OPPORTUNITY FUNDS

- ▶ The statute outlines two requirements:
 - ▶ (1) The entity must be organized as a corporation or partnership; and (2) must maintain at least 90 percent of assets in “Qualified Opportunity zone property,” including investments in “Qualified Opportunity zone stock,” “Qualified Opportunity zone partnership interest,” and “Qualified Opportunity business property.”
 - ▶ Business Property is covered below.

QUALIFIED OPPORTUNITY FUNDS QUALIFYING OPPORTUNITY ZONE BUSINESS PROPERTY

- ▶ The qualifications as “Qualified Opportunity zone stock,” “Qualified Opportunity zone partnership interest,” and “Qualified Opportunity zone business property” encompass investments in (1) new or (2) substantially improved tangible property, including commercial buildings, equipment, and multi-family complexes.

QUALIFIED OPPORTUNITY ZONE BUSINESS

A qualified opportunity zone business is a trade or business:

- ▶ In which *substantially* all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property;
- ▶ At least 50 percent of the business' total gross income is derived from the active conduct of the trade or business;
- ▶ A substantial portion of the business' intangible property is used in the active conduct of the trade or business;
- ▶ In which less than five percent of the average of the aggregate unadjusted bases of its property is attributable to nonqualified financial property; and
- ▶ Which is not 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.

QUALIFIED OPPORTUNITY ZONE BUSINESS SUBSTANTIALLY ALL REQUIREMENT

- ▶ In order for an entity to be treated as an Opportunity Zone Business (and therefore count towards an Opportunity Fund's 90% Asset Test), "substantially all" of the tangible personal property owned or leased by the entity must be Opportunity Zone Business Property. The Proposed Regulations provide a bright-line rule that, if at least 70% of the entity's tangible property is Opportunity Zone Business Property, the entity satisfies this "substantially all" test (the "70% Safe Harbor").

QUALIFIED OPPORTUNITY ZONE BUSINESS

- ▶ Qualified opportunity zone business property means any tangible property used in a trade or business if:
 - ▶ The property was acquired by the qualified opportunity fund by purchase after 2017;
 - ▶ The original use in the qualified opportunity zone commenced with the qualified opportunity fund or the qualified opportunity fund substantially improves the property; and
 - ▶ During substantially all of the qualified opportunity fund's holding period, substantially all of the use of the property was in a qualified opportunity zone.

90% QUALIFIED PROPERTY ALLOCATION TEST

- ▶ The law states that an Opportunity Fund must hold at least 90 percent of its assets in Qualified Opportunity Zone Property “Qualified Property,” which is measured as the average holding over two periods: (A) “on the last day of the first 6-month period of the taxable year of the fund, and” (B) “on the last day of the taxable year of the fund.”
- ▶ The proposed Regs say, “For example, if a calendar-year entity that was created in February chooses April as its first month as a QOF, then the 90-Percent-Asset-Test testing dates for the QOF are the end of September and the end of December. Moreover, if the calendar-year QOF chooses a month after June as its first month as a QOF, then the only testing date for the taxable year is the last day of the QOF’s taxable year. Regardless of when an entity becomes a QOF, the last day of the taxable year is a testing date.”

ADDITIONAL PROPOSED REGULATIONS

- ▶ The Treasury Department and the IRS are working on additional published guidance, including additional proposed regulations expected to be published in the near future. The Treasury Department and the IRS expect the forthcoming proposed regulations to incorporate the guidance contained in the revenue ruling to facilitate additional public comment. The forthcoming proposed regulations are expected to address other issues under section 1400Z-2 that are not addressed in these proposed regulations. Issues expected to be addressed include: the meaning of “substantially all” in each of the various places where it appears in section 1400Z-2; the transactions that may trigger the inclusion of gain that has been deferred under a section 1400Z-2(a) election; the “reasonable period” (see section 1400Z-2(e)(4)(B)) for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty; administrative rules applicable under section 1400Z-2(f) when a QOF fails to maintain the required 90 percent investment standard; and information-reporting requirements under section 1400Z-2.

MAIN TAKEAWAYS

- ▶ Not many companies will have all of the stars line up right to realize a benefit from an opportunity zone
- ▶ May see companies being formed for people/companies that need the benefit of an opportunity zone to invest into, which will in turn invest in projects in opportunity zones.

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