Cohen & Co

Qualified Opportunity Zones

PRESENTED BY:

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July 24, 2018

Welcome & Introductions

Tracy Monroe, CPA, MT
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CPE Credit Guidelines

- To receive CPE you must:
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A copy of the slides will be available following the presentation

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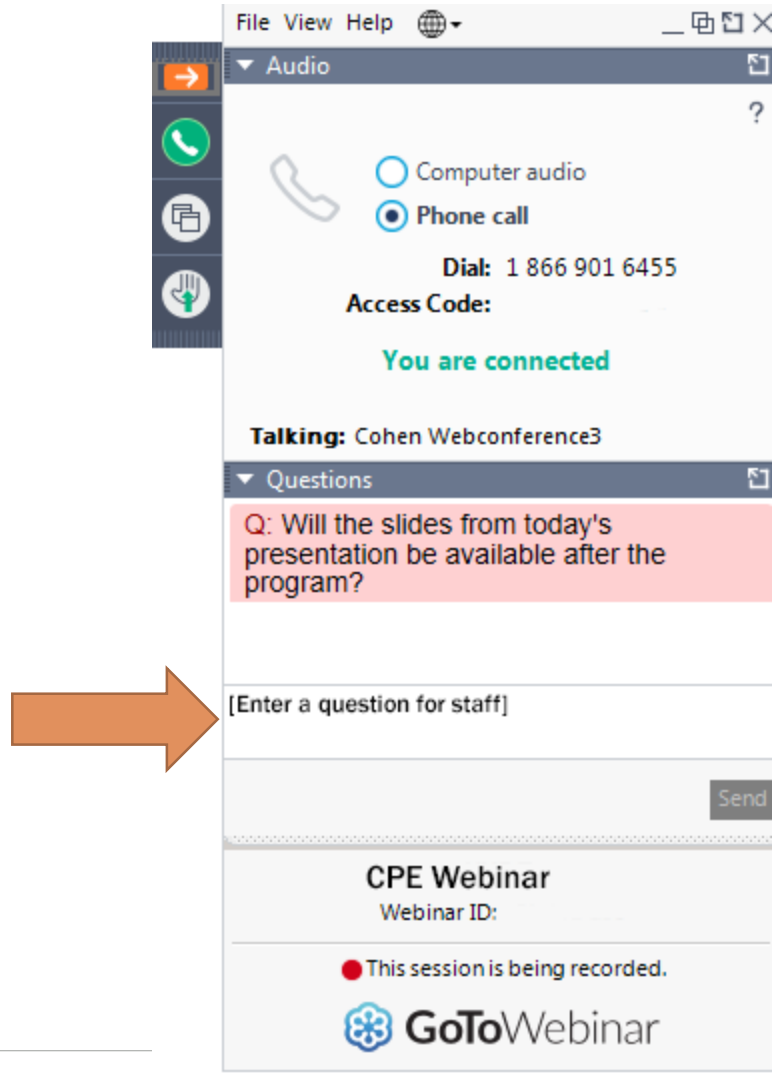
- If you have questions during the webinar:
  - Use the “Questions” feature to “Enter a question for staff” then click send
  - We will address during the program if there is time or will follow up after the program



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Overview

- Background of the Program
- Tax Incentives
- Qualified Opportunity Fund
- Qualified Opportunity Zone Property
- Set-up Considerations
- State Tax Implications
- Other Considerations
- Key Takeaways

Background

- Created as part of the Tax Cuts and Jobs Act that was signed into law December 22, 2017
- Established two new code sections: 1400Z-1 and 1400Z-2
- Designed to incentivize long-term investment in low-income and economically distressed communities
- Taxpayers have the ability to defer paying tax on capital gains by investing those capital gains into qualified opportunity funds, which in turn invest in qualified opportunity zone property
- Will be available to a wide range of taxpayers

Tax Incentives

- The first main tax incentive is the temporary deferral of inclusion of gain into taxable income
  - A taxpayer experiences an event that triggers the realization of capital gains
  - The capital gains could be derived from a variety of sources
  - The gain must be derived from a sale/exchange with an unrelated party (20% test)
- The taxpayer then must re-invest the capital gains proceeds into a qualified opportunity fund (QO Fund) within 180 days of the sale/exchange

Tax Incentives

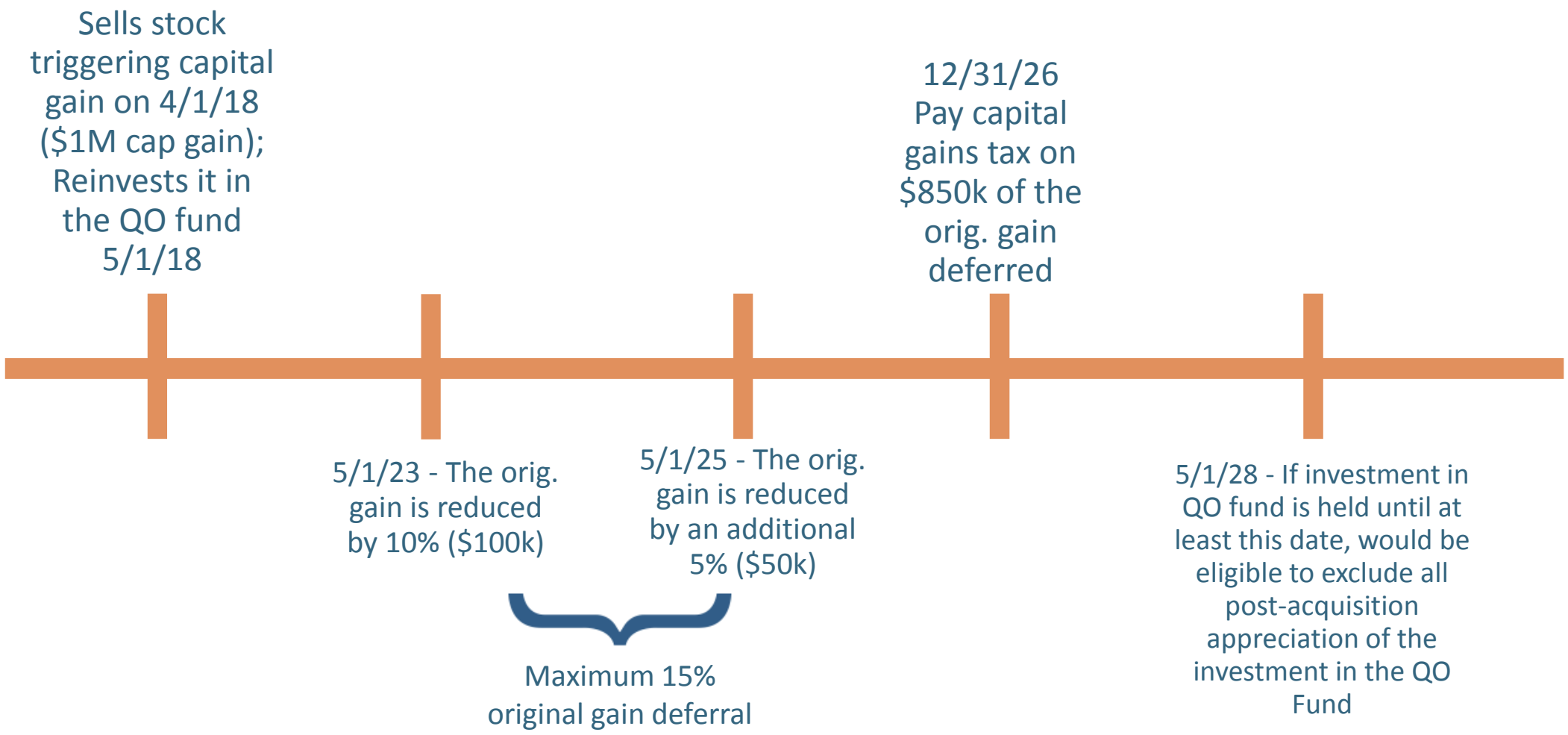
- By investing the capital gains proceeds into a QO Fund, the taxpayer is deferring the tax due on those gains until the earlier of two events (gain deferral recognition event):
  - Sale of his or her interest in the QO Fund
  - December 31, 2026
- At the time the taxpayer is required to recognize the originally deferred gain, it will be important to determine how long the taxpayer has held his or her investment in the QO Fund:
  - If the taxpayer held his investment for 5 or more years, the capital gain that was originally deferred will be reduced by 10%
  - If the taxpayer held his investment for 7 or more years, the capital gain that was originally deferred will be reduced by 15%

Polling Question #1

Tax Incentives

- The second main tax incentive is the permanent exclusion of post-acquisition appreciation on the original investment in the QO Fund
  - This incentive is only available to those taxpayers who have held their investment in the QO Fund for 10 years or longer

Example of Tax Incentives



Example of Tax Incentives (cont'd)

- Sara holds Apple stock and she decides that she wants to sell the stock on April 1, 2018. This sale generates a capital gain of $1 million. Under this provision, Sara has the opportunity to defer the inclusion of that $1 million of capital gain into her taxable income by reinvesting all of the gain proceeds into a QO Fund within 180 days of the sale. On May 1, 2018, she finds a QO Fund to roll the proceeds into. The taxes on her original $1 million of gain will be due either on the date she sells her investment in the QO Fund or on December 31, 2026, whichever is earlier.
- May 1, 2023 rolls around and she continues to hold her investment in the QO Fund. At that point she has now held her QO Fund interest for 5 years so that 10% ($100K) of the original gain that was deferred will be forgiven.
- May 1, 2025 rolls around and she continues to hold her investment in the QO Fund. At that point she has now held her QO Fund investment for 7 years, so an additional 5% ($50K) of her original gain that was deferred will be forgiven. She has now hit the maximum amount of the original deferred gain that can be excluded which is 15%.
- December 31, 2026 has now arrived and she will be required to pick up a total of $850,000 of her original gain that was deferred into her taxable income. We arrived at the $850K by taking her $1M of original gain that was deferred and excluding 15% of that amount or $150K (which she was qualified to do for holding her investment in the QO Fund for at least 7 years).
- Sara continues to hold her investment in the QO Fund and we have now reached May 1, 2028. At that point she has held her investment in the QO Fund for at least 10 years, and as a result, she has the ability now to qualify for that 2nd tax incentive which is the ability to exclude any post-acquisition appreciation of her investment in the QO Fund. If at the time of selling the investment in the QO Fund it sells for $1.2 million, Sara will have only have paid tax on $850,000 of the original $1 million of deferred gain and the $200,000 of appreciation ($1.2 million less $1 million), will not be included in her taxable income.
- If we use our same example as above, but instead the QO Fund decides that regardless of the tax effects, it wants to sell the underlying property it holds in year 4 and shut down, Sara will not only be required to pick up all of the original gain she deferred of $1M, she will also have to pick up any appreciation of the QO Fund investment at that point.

Polling Question #2

Qualified Opportunity Fund

- A qualified opportunity fund is an investment vehicle organized as a corporation or partnership whose purpose is to deploy funds into qualified opportunity zone property
  - Funds will undergo a self-certification process
  - The form has not been released yet (expected timeline is summer 2018), but will need to be attached to the timely filed federal income tax return for the fund, including extensions
  - Must hold 90% of its assets in qualified opportunity zone property
    - To determine if this threshold is met, look to the average percentage of assets held on both 6-month and year-end dates for the fund

Qualified Opportunity Fund

- Looking for additional guidance on a number of issues:
  - Legal classification vs. federal income tax classification when determining which entities qualify
  - 90% test
    - Timing issues
    - Will there be safe harbors for cash and working capital, etc.
    - How to measure the assets – cost, FMV, any reasonable method, etc.

Qualified Opportunity Zone Property

- There are two different categories of eligible property
- The first category is opportunity zone business property
  - This includes tangible property, such as machinery and equipment, furniture and fixtures, buildings, tenant improvements, and land
  - The use of the property must be in the QO Zone for substantially all of the Fund's holding period
  - The original use must commence with the taxpayer
  - Alternatively, the fund can substantially improve the property
    - Substantial improvement requirement is met if during a 30 month window following acquisition, the basis of the property increases by an amount that exceeds the amount of the adjusted basis at the beginning of the period

Qualified Opportunity Zone Property

- The second category of property is a direct investment in a qualified opportunity zone stock or partnership interest
  - Must qualify as a qualified opportunity zone business
  - Must be original issue if acquiring qualified opportunity zone stock
  - At least 50% of the business's total gross receipts are derived from the active conduct of a trade or business
  - A substantial portion of the business's intangible property is used in the active conduct of a trade or business
  - Less than 5% of the average of the aggregate unadjusted bases of the business property is attributed to nonqualified financial property.
  - Business cannot be a "sin" business

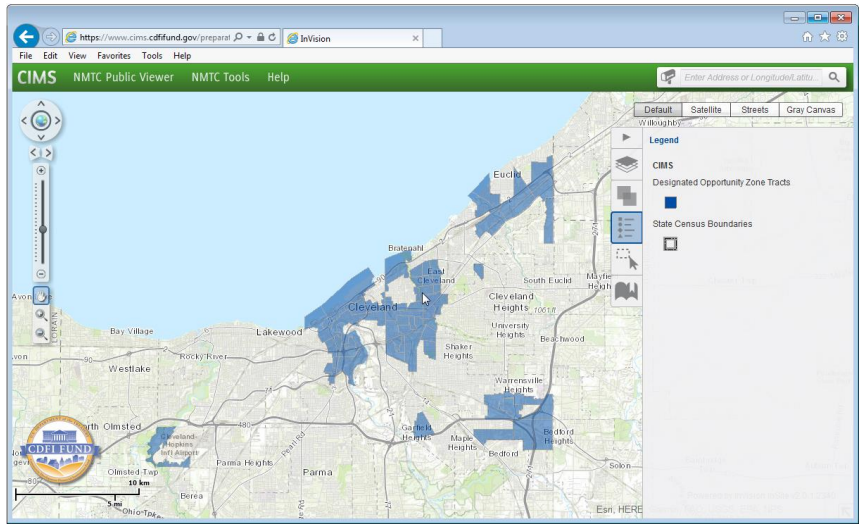
Polling Question #3

Census Tracts Designated as Opportunity Zones

- There were criteria around which census tracts that could be nominated by the Governors of each state and subsequently approved by the IRS
  - Leveraged definitions under Sec. 45D(e) for what was considered a low-income community
- The designation and approval process is now complete
  - 31,848 Eligible Low-Income Community census tracts
  - 10,312 Eligible Non-Low-Income Community Contiguous tracts
  - **8,762 Designated Low-Income Community census tracts**
  - A complete list of the designated Qualified Opportunity Zones can be found in IRS Notice 2018-48

Census Tracts Designated as Opportunity Zones

- QO Zones have been designated in all 50 states and U.S. territories (Guam, Puerto Rico and the Virgin Islands)
- The Community Development Financial Institutions Fund has created a mapping tool that will identify the opportunity zones in each state: https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml



Set-up Considerations

- Formation/structuring of funds
  - Partnerships
  - Setting up one fund per investment
  - Mixed fund investments
  - Joint venture partnerships
- The statute does not require the fund to be a brand new entity – could use an existing entity
  - Consider tracking/maintenance requirements
  - Existing property would have to be “substantially improved”

Polling Question #4

State Tax Considerations

- Generally speaking most states use federal taxable income as a starting point for determining state taxable income
  - As a result, a change in how federal taxable income is determined may cause a change in how state taxable income is calculated
- Not all states conform to the Internal Revenue Code the same way
  - Fixed conformity
  - Rolling conformity
  - Selective conformity
- This will most likely require a state-by-state analysis to determine the impact on a taxpayer-by-taxpayer basis

Other Considerations

- Despite not all states recognizing the tax benefits of the Qualified Opportunity Zone program, this is not the only tax incentive program available
- State and local governments have numerous cash, tax and other incentives available including but not limited to:
  - R&D credits
  - Hiring and payroll credits
  - Training and other discretionary grants
  - Real and personal property tax abatements
  - Infrastructure assistance
  - TIF financing
  - New Markets Tax Credits, Historic Rehabilitation Credits, Low-Income Housing Credits
  - Investment Tax Credits for investments in sustainable/renewable energy sources

Other Considerations

- Investments in QO Funds are not eligible for a step-up in basis at death; instead these investments are treated as IRD assets
  - Section 1400Z-2(e)(3)
- The loss limitations under Section 465 (at-risk limitations) and Section 469 (passive activity limitations) still play a role in determining the extent to which an investor may be able to benefit from any losses flowing through from the QO Zone fund investment
  - Also will need to consider basis limitations
    - Differences in outside basis of investment of QO Fund vs. inside basis of assets owned by the QO Fund
- Evaluate IRC Section 1031 (Like-Kind Exchange) treatment versus the QO Fund when you are dealing with gain from real estate

Key Takeaways

- This is a broad program available to a wide variety of taxpayers
- Taxpayers must invest in a QO Fund in order to receive the tax benefits of the program – they cannot invest in QO Zone property directly; we recommend a new entity be set up and used that can self certify
- Qualified Opportunity Zones provide two main tax incentives:
  - Temporary deferral of inclusion of the capital gains into income
    - Invest capital gains proceeds into a QO fund within 180 days of a sale/exchange with an unrelated party
    - A maximum of up to 15% of the original deferred gain may be forgiven if certain holding period requirements are met
  - Permanent exclusion of post-acquisition gain on the investment in the QO Fund.
- Still waiting for a lot of guidance from the IRS and Treasury
  - https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

Questions for our Presenters?

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Upcoming Webinar

Inbound and Outbound International Tax Rules

Tues., July 31 @ 10 a.m.

FEATURING **CYNTHIA PEDERSEN**, JD, LLM
RAY POLANTZ, CPA, MT

LEARNING OBJECTIVES

> Discover the new provisions to capture foreign income

> Recognize how the rules impact different entity types

Thank you.

July 24, 2018