Critical Year-End Considerations for Opportunity Zone Participants

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Overview

- Background and Tax Incentives of the Program
- Change in Administration and Potential Impact on the OZ Program
- COVID Relief – Notice 2020-39 – Open Issues
- Year-end Considerations for Investors
- Year-end Considerations for Qualified Opportunity Funds (QOFs)
- Year-end Considerations for Qualified Opportunity Zone Businesses (QOZBs)
- OH QOZ Tax Credit and other State considerations
- Tax Reporting Requirements

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Background

- Created as part of the Tax Cuts and Jobs Act that was signed into law December 22, 2017
- Is available to a wide range of taxpayers - individuals, C corps (including RICs and REITs), S corps, partnerships, trusts and estates
- This provision is 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 (QOFs) which in turn invest in qualified opportunity zone property (QOZP)

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Tax Incentives

- The 1st tax incentive for taxpayers is the temporary deferral of inclusion of capital gain into taxable income.
  - Gains deferred under the program will be subject to tax at the earlier of an inclusion event or December 31, 2026.
- The 2nd tax incentive for taxpayers is a potential reduction in the original deferred gain to be picked up into income.
- The 3rd tax incentive is the permanent exclusion of post-acquisition appreciation on the original investment in the QOF.

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Election Impact on OZ Program

Biden Tax Plan

- Increase in corporate rate from 21% to 28%.
- Minimum tax (15%) on corporations with book profits of $100M or greater.
- Increases top individual rates for taxable income above $400K to 39.6%.
- Taxes long-term capital gains and qualified dividends at the ordinary income tax rate of 39.6% on income above $1 million.
- Elimination of step up in basis at death on capital gains.

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Opportunity Zone Bills

- S 2994 IMPACT Act
  - Lead sponsor Tim Scott (R – SC)
  - Would help determine the impact of OZs by reinstating and expanding upon reporting requirements.
- HR 5011 Opportunity Zone Accountability and Transparency Act
  - Lead sponsor Ron Kind (D – WI)
  - Would require QOFs to annually report assets, aggregate amounts of QOZ stock and partnership interests and QOZBP along with details about the types of businesses the QOF holds business property in.

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Opportunity Zone Bills Cont.

- S 2787 Opportunity Zone Reporting and Reform Act
  - Would require information reporting from both QOFs and investors
    - There would be assessment of penalties for failure to report
  - Re-designation of certain OZ census tracts
  - GAO report of effectiveness of OZ incentive

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COVID-19 Relief - Notice 2020-39

- 180-day Investment Period: if the last day of the 180-day investment period begins on or after April 1, 2020, and before December 31, 2020, the *last day of that 180-day investment period is postponed to December 31, 2020*
- QOF Penalty relief: if the last day of the first six-month period of the taxable year, or last day of the taxable year, is within the period beginning on or after April 1, 2020, and before December 31, 2020, any failure to satisfy the 90% investment standard for that taxable year is presumed to be due to reasonable cause and *not subject to the penalty*.

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COVID-19 Relief - Notice 2020-39 (Cont.)

- QOF Penalty relief: relief is automatic and does not require notifying the IRS. However, an affected QOF still must accurately complete Form 8996, placing a “0” in Part IV, Line 8 (the penalty line).
- 30-Month Substantial Improvement Period: suspended during the period beginning on April 1, 2020 and ending on December 31, 2020.
- 31-Month Working Capital Safe Harbor: automatic 24-month extension to the 31-month safe harbor period.
- 12-Month Reinvestment Period: 12-month extension to the end of the 12-month reinvestment period for QOF’s whose reinvestment period began before January 20, 2020 and ends after January 20, 2020.

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COVID-19 Relief - Open Issues

- QOZB gross income safe harbor: How does work from home impact this calculation?
  - -50% of the hours spent by employees an independent contractors are within the QOZ.
  - -50% of the amount paid to employees and independent contractors are for services performed within a QOZ.
  - -Management or operational functions performed in a QOZ are necessary for the generation of at least 50% of the gross income of the business.
- How are government delays under the working capital safe harbor handled during extension period?
- Are structural changes that cause the QOF to fail the 90% investment standard covered under the reasonable cause provision?

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Year-end Considerations for *Investors*

- 180 Day Investment Period
  - In general, the taxpayer must re-invest the capital gains proceeds into a *QOF* within 180 days of the sale/exchange.
  - IRS Notice 2020-39 provides that if a taxpayer's 180th day investment requirement falls between April 1, 2020 – December 31, 2020, a taxpayer will now have until 12/31/20 to invest the gain dollars into a QOF.
  - The relief is automatic if Forms 8949 and Form 8997 are included with their timely filed Federal income tax return.

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Year-end Considerations for *Investors Cont.*

- 5 Year Basis Step-Up
  - Taxpayers who have held their QOF interest for 5 years prior to an inclusion event or 12/31/26 are eligible for a 10% basis step-up.
  - Investments must be made by 12/31/21 in order to take advantage of this benefit.

- Tax Rate Risk
  - Capital gains tax rate at the time of deferral vs. tax rate in effect at the time of gain recognition.
  - There are ways to structure an inclusion event to mitigate this risk.

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Year-end Considerations for *Investors Cont.*

- Estate Planning
  - Gifts of a QOF interest are considered an inclusion event.
  - Transfer of a QOF interest to a grantor trust are not considered an inclusion event.

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Year-end Considerations for *Qualified Opportunity Funds (QOFs)*

- 90% Investment Standard
  - IRS Notice 2020-39 provides automatic relief to a QOF that fails to meet the 90% investment standard whose testing dates fall between April 1, 2020 and December 31, 2020.
  - The failure will be considered due to reasonable cause and will be disregarded for purposes of determining whether the QOF or any otherwise qualifying investments in that QOF satisfy the requirements under Sec. 1400Z-2 and the related regulations.

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Year-end Considerations for *Qualified Opportunity Funds (QOFs) Cont.*

- 12-Month Reinvestment Period
  - The general rule is that a QOF has 12 months to reinvest proceeds it receives from either the sale of QOZP or a return of capital into other QOZP without impacting the 90% investment standard.
  - IRS Notice 2020-39 provides that if any of a QOF's 12-month reinvestment period includes January 20, 2020, the QOF will receive up to an additional 12 months for reinvestment.
    - January 20, 2020 is the date the COVID-19 disaster was identified in the Major Disaster Declarations as a Federally Declared Disaster.

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Year-end Considerations for *Qualified Opportunity Funds (QOFs) Cont.*

- Restructuring single asset QOFs
  - The final regulations provided flexibility for avoiding gain upon exit.
  - Consolidating QOFs is not an inclusion event.
  - Partnership divisions may cause issues.
  - Retroactive operating agreement changes.
  - Multi-phased projects may create challenges in QOZB testing.

- Investor pressure due to Tax Rate Risk.

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Year-end Considerations for *Qualified Opportunity Zone Businesses (QOZBs)*

- 30-Month Substantial Improvement
  - General rule is that a QOF or QOZB has 30 months to substantially improve property
    - Substantial improvement requires additions to the basis of the property in an amount greater than the original purchase price (purchase price + $1)
  - IRS Notice 2020-39 provides that the 30-month substantial improvement period is tolled during the period beginning on April 1, 2020 and ending on December 31, 2020.

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Year-end Considerations for *Qualified Opportunity Zone Businesses (QOZBs) Cont.*

- Working Capital Safe Harbor
  - Provides for a period of up to 31 months before cash being held by the QOZB will be considered nonqualified financial property as long as there is a written plan to expend the funds with 31 months and the working capital assets are used in a manner consistent with the written schedule.
  - IRS Notice 2020-39 provides QOZBs that are currently utilizing a working capital safe harbor an additional 24 months to expend the funds.

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Year-end Considerations for *Qualified Opportunity Zone Businesses (QOZBs) Cont.*

- COVID-19 Impact
  - Construction delays lead to increased carrying costs
  - First floor retail tenants – Significantly impacted – Restaurants, Gyms, Spa's
  - Cap Rate compression – Will it impact your refinance or perm loan?
  - Construction loan – Tighter underwriting?
  - Construction Costs – Still high
  - Interest rates – Offsetting some costs above
    - Some banks setting higher Libor floors
  - Decreasing rents in urban core

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OHIO Qualified Opportunity Zone Tax Credit

- The OH QOZ program is separate and distinct from the Federal QOZ program.
- The OH QOZ tax credit is a nonrefundable income tax credit.
- The amount of the tax credit is equal to 10% of the amount of the taxpayer's investment in the Fund that the Fund invested in projects located in OH QOZs in the calendar year preceding the application.
- Eligible taxpayers to receive the credit under the program are individuals, estate, trusts or pass-through entities.
  - Both OH residents and non-residents may claim the credit.
  - The taxpayer may claim the tax credit for the taxpayer's qualifying taxable year or the next ensuing tax year.

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OHIO Qualified Opportunity Zone Tax Credit Cont.

- An unused credit amount may be carried forward for the following 5 tax years.
- A taxpayer may transfer the right to claim the tax credit 1 time. However, it is important to note that the taxpayer CANNOT claim any portion of the credit prior to transferring it.
- A taxpayer may not be issued and may not claim tax credit certificates in excess of $1M.
- Applications for investments that were (or still will be) made in 2020 will be due January of 2021.
  - Applications will be processed on a 1st come 1st serve basis.

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State Considerations

- Reminder that some states do not allow the deferral of capital gain under this program.
  - Nonconformity - CA, MA, MS, NC
  - Limited Conformity – AL, AR, HI
- Some states have created enhanced economic development incentives or bonus points in certain programs for investing in QOZ’s.
  - AL, CT, LA, MD, NJ, NM, OH, WI
  - These programs vary by state but include income tax credits, enhanced economic incentives, abatements and increased state deferred gain step-up.

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Tax Reporting Requirements

- Form 8949
  - This form is used for the initial gain deferral election.
  - It is required to be included with the Federal income tax return for the taxable year the gain would be recognized if it had not been for the deferral.
- Form 8997
  - New for tax year 2019, this form requires an eligible taxpayer holding a QOF investment at any point during the tax year to report their deferred ST and LT gain along with any changes to their QOF holdings during the current tax year.

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Tax Reporting Requirements Cont.

- Form 8996
  - QOFs use this form for several different things:
    - Initial self-certification of the fund a qualified opportunity zone fund
    - Annual compliance reporting with the 90% investment standard
  - This form requires the QOF to report additional information on its investments including:
    - QOZ tract numbers
    - EINs of QOZBs
    - Cost of tangible property both owned and leased

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Key Takeaways

- The QOZ program provides 3 tax benefits to investors:
  - Deferral
  - Reduction
  - Exclusion
- IRS Notice 2020-39
  - Provided additional time for investors, QOFs and QOZBs
- OH QOZ Tax Credit
  - Application period begins 1/8/21 and ends 1/31/21 for 2020 investments
  - Allocated on a 1st come, 1st serve basis

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Questions?

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