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OPPORTUNITY ZONES- UNDERSTANDING THE OPPORTUNITY

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CCIM-WA September Speaker Series Luncheon

DISCLAIMER

These materials, and the accompanying oral presentation, are for educational purposes only and are not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

This information is of a general nature and based on authorities that are subject to change.

The Basics

OPPORTUNITY ZONE BASICS

- Opportunity zone provisions created as part of the Tax Cuts and Jobs Act of 2017
- State and local governments, working with the Treasury Department, designated certain low income areas as qualified opportunity zones
- For a list of resources, including links to maps, see: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx
- Effective for the 2018 tax year
- Eligible capital gain income before 2027; new investments must be made within 180 days (as late as June 29, 2027)

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OPPORTUNITY ZONE BASICS

- Proposed regulations issued in 2018 and 2019 but still many open questions
- Taxpayers can elect to defer eligible capital gain from an exchange with an unrelated party by investing into a qualified opportunity fund (QOF)
- Eligible capital gains must be reinvested into a QOF within 180 days
- QOF- a partnership (for federal tax purposes) or corporation meeting certain eligibility and certification requirements

OZ MECHANICS- SETTING UP A QOF

- Can be a variety of state law entities, including a LLC
- No mandated structure- can track to traditional real estate deal structures involving limited investors and managers with promotional interests
- QOF self certifies with the IRS
- Can have Funds with mixed investments and can use leverage; however, only qualified capital gain is eligible for tax incentives
- Contrast to section 1031 exchanges

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TAX BENEFITS

2019: **Gain Deferral/Invest in QOF**

2024: **10% Basis Step-Up**

2026: **Additional 5% Basis Step-Up**

2026: **Gain Recognition**

Year 10 and later: **Gain Exclusion on Post Investment Appreciation**

Key Terms, Dates, and Timelines

KEY TERMS

- QOF= Qualified Opportunity Fund
  - Self certification
  - Can be state law LLC, very flexible
  - Holds at least 90% of its assets in “QOZ property”
- QOZ property= QOZ stock, QOZ partnership interest, or QOZ business property
- QOZ stock and QOZ partnership interest = acquired post 2017
  - During substantially all of the QOF’s holding period, the corporation/partnership qualifies as a QOZ business

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KEY TERMS

- QOZ business property= tangible property used in trade or business purchased from <u>unrelated party</u> (20 percent threshold) post 12/31/17
  - Need original use or substantial improvement
  - During substantially all of the QOF's holding period, substantially all of the use of the property in QOZ

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KEY TERMS

- QOZB
  - Substantially all (70 percent) of tangible property owned or leased by the business is QOZB property
  - 50 percent or more gross income from active conduct of business in QOZ
  - Substantial portion (40%) of intangible property used in trade or business
  - Can't hold 5% or more of assets as certain financial assets
  - Not a "sin business"= golf course, country club, massage, suntan, hot tub, racetrack/gambling, store with principal purpose of selling alcohol

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KEY DATES AND TIMELINES

- If sell capital asset directly, taxpayer has 180 days to reinvest the gain
- If a partnership or S corporation sells the assets
  - 180 days to roll gain over
  - If entity does not do so, the owner can elect to reinvest the gains within 180 days of the close of the entity's tax year (end of June for calendar year partnerships) or within 180 days of the entity's sale (assuming the partner has the requisite information)

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1231 GAINS

- Section 1231 gains- from the sale of property (including real estate) used in a trade or business
  - Net 1231 gains=capital
  - Net 1231 losses=ordinary
- New guidance- must wait until the end of the tax year to make a qualified investment (180 day reinvestment period starts then)
- Focus on 12/31/19 for maximum benefit

COMPLIANCE POINTS

- Individual
  - Form 8949- gain deferral election
- QOF self certifies with Form 8996
  - Testing dates on last day of the first 6 month period of the tax year and on the last day of the tax year
  - Can ignore certain recent capital contributions for the first test

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Acquiring Property

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ORIGINAL USE AND SUBSTANTIAL IMPROVEMENT

- For qualified property, need “original use” or substantial improvement

ORIGINAL USE

- Purchased tangible property- original use begins on placed in service date
- Used property never placed in service in OZ- original use begins when placed in service in OZ
  - Planning opportunity- move purchased used tangible property into a OZ
- Used property previously placed in service in OZ- need substantial improvement
- Also, if a building/structure has been vacant for at least 5 years, can satisfy original use requirement

SUBSTANTIAL IMPROVEMENT

- Substantial improvement= $1 of improvement for every $1 of cost (excluding land)
    - Important point for real estate
- Measured on an asset by asset basis, not in the aggregate- burden for businesses with lots of assets

LAND

- Land and real estate can qualify as good property, but beware of "land banking"
  - What about parking lots, or a single "hot dog stand" on a large piece of real estate- investment or trade or business?
- Don't need original use for land
- Leased real property can qualify as an active business
- Beware of a triple net lease

LEASES

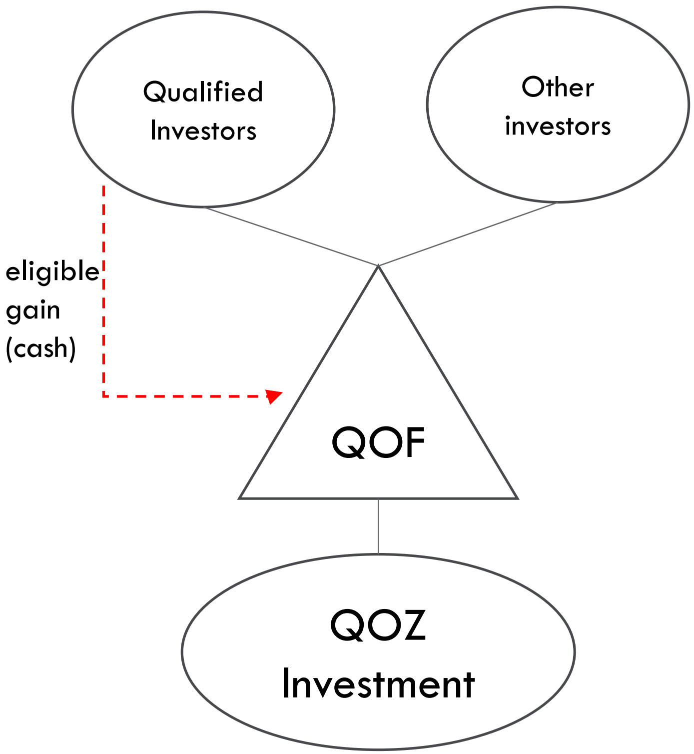
- Lessee improvements can work
- Leased property is QOZBP if:
  - Lease entered after December 31, 2017
  - 70% of the use of the leased property in OZ during 90% of the time period
  - Market rate lease
- Can lease between related parties, but no prepayment and, if is tangible property, need to acquire other tangible property at least equal to the value of the leased property

Working Capital Safe Harbor

WORKING CAPITAL SAFE HARBOR

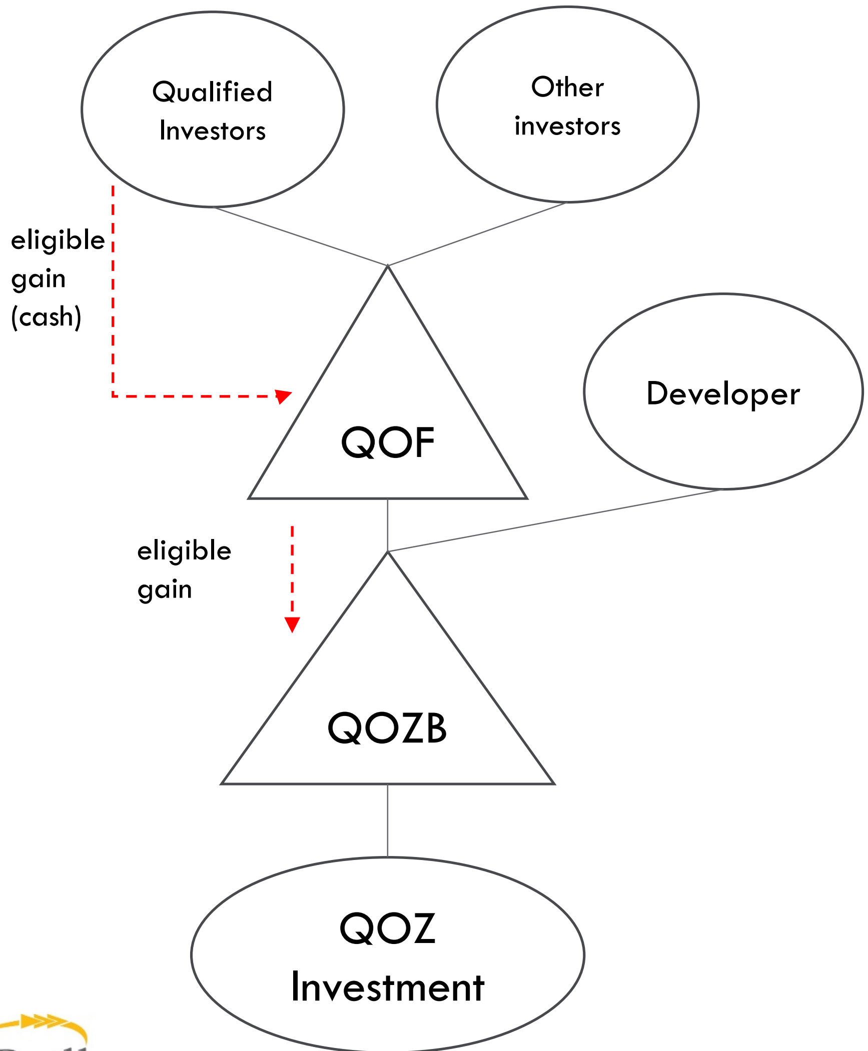
- Working capital safe harbor allows QOZB to treat “reasonable” working capital as a good asset for a period of up to 31 months if there is a:
  - Written plan to use capital
  - Written schedule consistent with ordinary start up of a business
  - Working capital used in a manner consistent with schedule
- Can exceed 31 months under certain circumstances

BASIC STRUCTURES- DIRECT INVESTMENT



- 90 percent of assets must be QOZB property
- May be hard to deploy cash within 6 months
- Led to focus on two tier structure (next slide)

BASIC STRUCTURES- INDIRECT INVESTMENT



- 70 percent of tangible property owned/leased by business is QOZB property
- 50% of gross income from trade or business <u>within</u> OZ
- Can use working capital safe harbor
- More flexible than direct investment structure (prior slide)

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Existing Land/Property Owners

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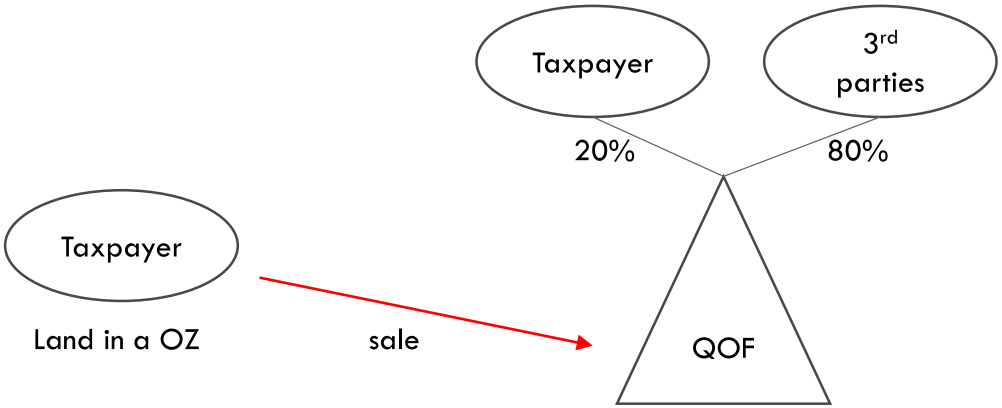
OWNING PROPERTY/BUSINESS IN A OZ

- Owning property and/or a business in a OZ may not provide any immediate tax benefits
- Just selling property and/or a business located in a OZ does not necessarily produce any tax benefits unless the owner decides to invest the qualifying capital gain into a QOF
- But the property and/or business may be an attractive investment for a QOF
    - Recent examples- large developments close to completion

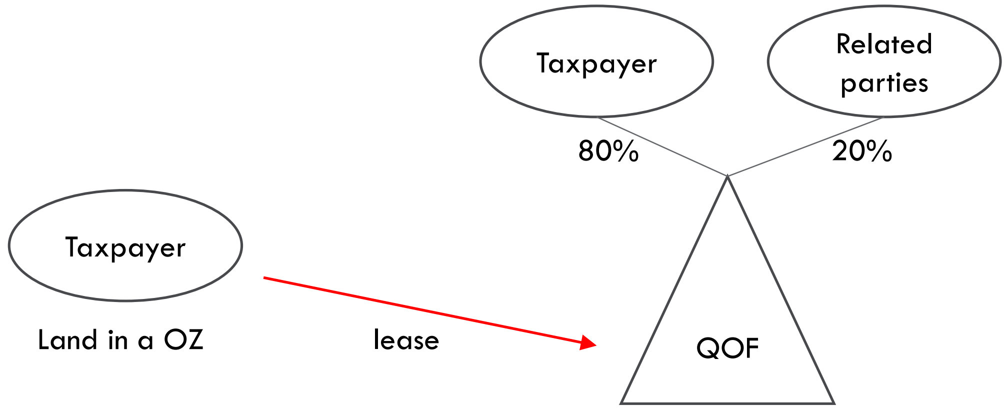
OWNING PROPERTY/BUSINESS IN A OZ

- Selling property to own fund and reinvest gain? Only if willing to give up control



OWNING PROPERTY/BUSINESS IN A OZ

- Can also consider leasing property to QOF



Operating an Active Business in an OZ

GROSS INCOME REQUIREMENT

- At least 50% of a business's gross income must come from the active conduct of a trade or business in an opportunity zone
- 3 new safe harbors
  - At least 50% of services performed by QOZB employees and contractors are in an OZ, measured by service hours
  - At least 50% of services performed by QOZB employees and contractors are in an OZ, measured by amounts paid for services
  - Both the tangible property of the QOZB in the OZ and the management/operational functions in the OZ are each necessary for generation of at least 50% of QOZB gross income

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Exiting the Investment

UPDATES- EXIT CONSIDERATIONS

- Capital gain from a QOF's (but not QOZB's, at least yet) sale of its assets can be excluded by an owner who has held their qualifying interest for at least 10 years
- Owner can sell their qualified equity interest (provided have held for 10 years) and avoid all tax, including, apparently, depreciation recapture
- Taxpayer can make a qualified investment by acquiring an interest from another equity owner- may help with liquidity considerations
- Debt financed distributions can work so long as the cash distributed does not exceed basis (including debt)- may provide cash for tax payment due in 2026

QOF SALE OF ASSETS

- If QOF sells an asset, has 12 months to reinvest the cash into other qualifying property (cash will count as qualified property during that period)
- But the gain is still subject to tax- Government has asked for comments
- QOFs may consider section 1031 exchanges

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UPDATES- INCLUSION EVENTS

- Triggers deferred gain
- Events include
  - Disposing of all or a portion of a QOF interest
  - Distributions in excess of basis
  - Certain transfers

State and Local Considerations

STATE AND LOCAL GOVERNMENTS

- Unclear what state and local governments may do to enhance the program, particularly in states with no income tax
- Possible Approaches
  - Tax incentives
    - Property tax abatements
    - Sales and use tax exemptions or refunds
- Non-tax incentives
  - Grants – cash / property
  - Discounts – utilities and other costs

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Simple Example

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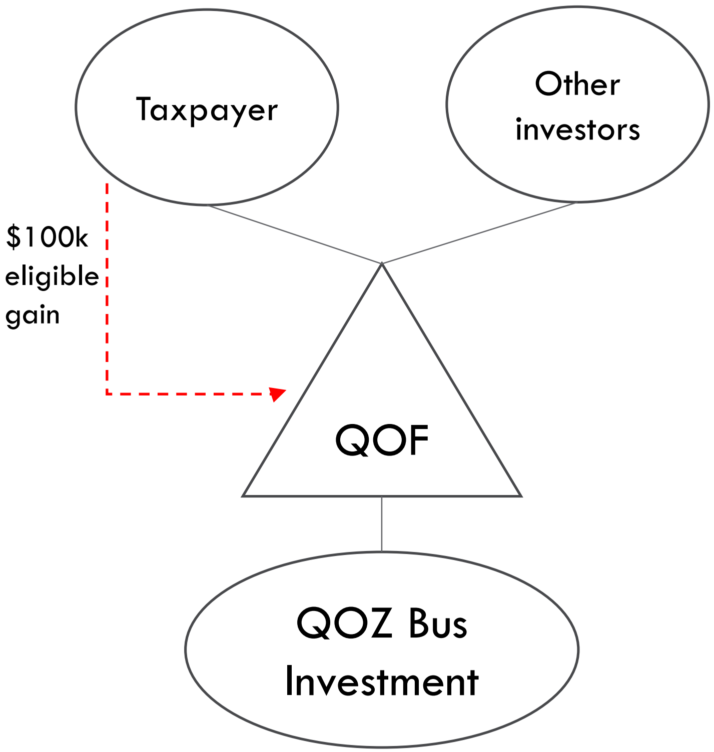
OPPORTUNITY ZONE EXAMPLE

- Taxpayer sells publicly traded stock for $200k in 2019 that was purchased for $100k, triggering **$100k of gain**
- Under new code section 1400Z-2, taxpayer elects to invest the **$100k of gain** into a QOF (an LLC treated as a partnership for federal tax purposes) within 180 days of the sale of the stock

Important note: This is a simplified example for illustrative purposes and this example assumes all statutory and regulatory requirements are met

OPPORTUNITY ZONE EXAMPLE 2019



- Taxpayer defers the $100k of gain in year 1 (meaning no tax recognized) by filing requisite **IRS Form 8949**
- QOF self-certifies with the IRS that it is initially qualified **(Form 8996)**
- QOF also files annual report certifying it meets all requirements
- Taxpayer takes a $0 tax basis in its QOF interest

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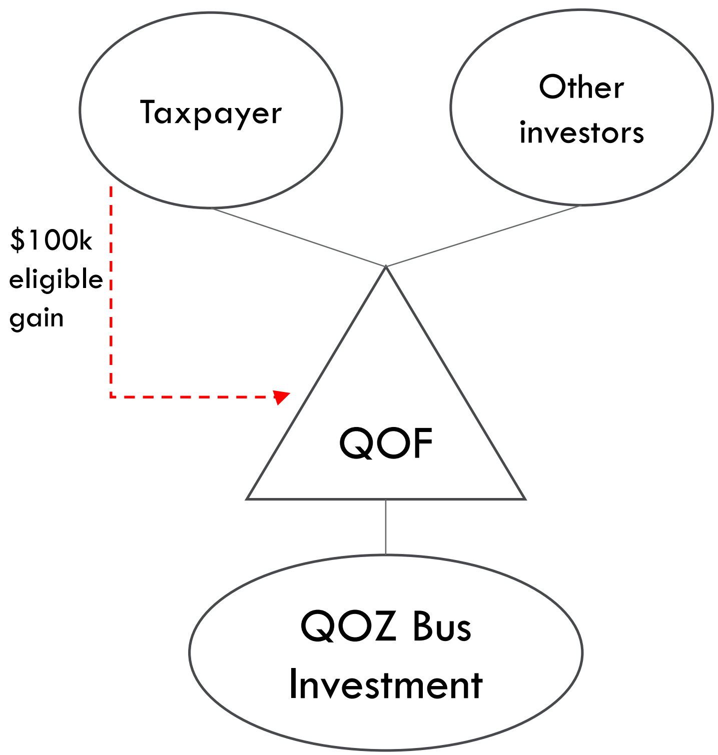
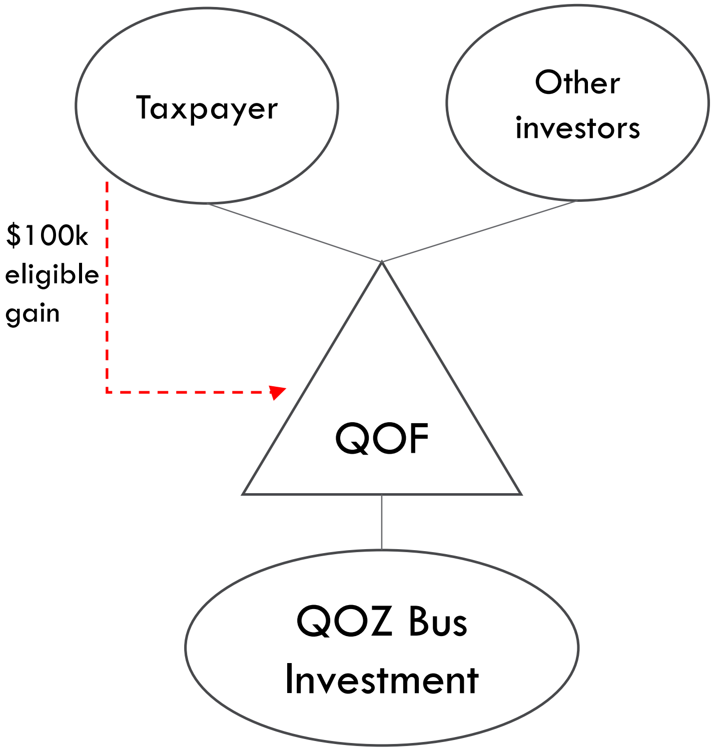
OPPORTUNITY ZONE EXAMPLE 2026



- Assume QOF interest now worth $150k ($50k appreciation)
- Taxpayer receives basis step-up of $15k ($10k at year 5 and additional $5k at year 7)
- Taxpayer's 2026 basis= $15k
- Deferred gain recognized in 2026= $85k of original $100k

OPPORTUNITY ZONE EXAMPLE 2029



- 2029- Assume QOF interest now worth $200k and taxpayer sells interest
- Taxpayer's basis= $100k ($15k basis step-up plus $85k of gain recognized in 2026)
- The $100k of gain ($200k proceeds minus $100k of basis) permanently excluded from income

QUESTIONS

Contact

Adam Sweet
Eide Bailly
asweet@eidebailly.com
509 252 4019

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