Opportunity Zones
Presentation to Kansas CCIM Chapter

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OPPORTUNITY ZONES - A Capital Gains Tax Deferral Investment Opportunity

- Equity investment enhancement for taxpayers with capital gains from any source.
- Requires an investment in an Opportunity Zone ("OZ") Fund — the OZ Fund may be privately owned, by the Taxpayer ("TP"), with a single or only a few members.
- The tax benefit for a qualified investment:
  - Deferral of realized capital gains which are reinvested in an OZ Fund until 2026 or earlier withdrawal;
  - 10% of gain is eliminated after holding the OZ Fund investment for 5 years;
  - An additional 5% is eliminated after holding the OZ Fund investment for 7 years;
  - All capital gains on the investment itself are eliminated after holding the OZ Fund investment for 10 years (ends 2047).
OZ Tax Math

Assumptions:

- TP realizes a capital gain of $1,000,000.
- TP has a combined effective tax rate of 25% and would otherwise owe $250,000 in taxes.
- TP timely contributes $1,000,000 to an OZ Fund.
- At all times the OZ Fund is operated in accordance with IRS regulations.
- The OZ Fund makes a timely investment in an OZ business.
- In 2026 the tax rate remains unchanged.
- Investment is made in 2018.
OZ Tax Math

Example 1:

• In 2026 investment in the OZ Fund has a fair market value (FMV) of $1,000,000 or greater.
• Tax calculation:
  • Deferred gain $1,000,000, less basis $150,000 benefit of 7-year ownership (10% for 5 years + 5% for 7 years = 15% of $1,000,000 ) = $850,000 gain x 25% = $212,500 tax due in 4/15/2027 (appreciation in excess of the original cost does not impact the tax amount).
  • If asset is held less than 5 years, no basis increase. The gain remains $1,000,000, and the tax is $250,000.
  • If the asset is held 5 or more years but less than 7, the gain is $900,000 (10% basis increase) and the tax is $225,000.
OZ Tax Math
Example 2:

• In 2026 investment in OZ Fund has a FMV of $600,000.
• Tax calculation:
  • Gain recognized is the lesser of FMV or deferred gain, in excess of basis.
  • In 2026, after 7 years the gain amount is $600,000 (FMV) less ($1,000,000 x .15 basis increase) = $450,000 gain x .25 tax rate = $112,500 tax.
  • If asset is held less than 5 years the gain is $600,000 and the tax is $150,000.
  • If the asset is held 5 or more years but less than 7, the gain is $500,000 and the tax is $125,000.
• If the asset value later appreciates no additional tax and 10-year benefit remains.
## OZ Incremental Benefit

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>4 Year</th>
<th>5 Year</th>
<th>7 Year</th>
<th>12/31/2026</th>
<th>10 Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard After Tax IRR</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
<td>6.00%</td>
</tr>
<tr>
<td>Incremental OZ Benefit</td>
<td>1.44%</td>
<td>2.08%</td>
<td>1.95%</td>
<td>1.71%</td>
<td>3.08%</td>
</tr>
<tr>
<td>OZ Investment IRR</td>
<td>7.44%</td>
<td>8.08%</td>
<td>7.95%</td>
<td>7.71%</td>
<td>9.08%</td>
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<tr>
<td>Percentage Increase</td>
<td>24%</td>
<td>35%</td>
<td>32%</td>
<td>29%</td>
<td>51%</td>
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</tbody>
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*Table Source: Novogradac & Company [www.novoco.com/resource-centers/opportunity-zones-resource-center]*
*Table
Source-Novogradac & Company (www.novogradac.com/resource-centers/oppportunity-zones-resource-center)
OPPORTUNITY ZONES

• An OZ is a geographic area designated by the governor and approved by the Department of Commerce:
  • Low income census tract;
  • Each state designated OZs;
  • Approximately half of the qualifying census tracts were permitted to be designated.

• Investors may invest in OZs in all states and territories.

• Investment must be in an OZ Fund.
OPPORTUNITY ZONES

• OZ Fund must invest in qualified OZ investments:
  • Active trade or business;
  • Conducted by partnership, corporation or the Fund directly;
  • Cannot be certain “sin businesses”;
  • Located within a geographic zone;
  • Acquired by purchaser after 1/1/18.
OPPORTUNITY ZONES

• Fund must either: (1) substantially improve existing property (i.e., an additional 100% of acquisition cost investment) or (2) original use of property begins with Fund.

• Gains must be rolled into Fund within 180 days of realizing the gain. (For partners in partnerships, a second rollover period commences at fiscal year end.)

• Funds have 31 months to reinvest Fund in a qualified OZ business.

• Technical rules and penalties for excess working capital, early withdrawals.
OPPORTUNITY ZONES

• Potential disqualification for doing business not in the OZ.

• Status: law enacted effective 12/31/17. First IRS rules issued October 2018, more regulations to come.

• Cost of initial investment in private OZ Fund is low. Must act within 180 days of realizing gain. So no harm in creating a personal OZ Fund and then deciding what to do. Unclear what happens if you change your mind but anticipate that no penalty if money is withdrawn within the same tax year.
Is There Money in it for Me?

I am a landowner, I don’t want to sell, is there money in it for me?
Yes

I am a landowner, I want to participate, is there money in it for me?
Yes

I am a landowner, I want to sell, is there money in it for me?
Yes

I am a capital gains investor, is there money in it for me?
Yes

I am a cash investor without capital gains, is there money in it for me?
Yes

I am a Fund manager, is there money in it for me?
Yes

I am a developer without land or money, is there money in it for me?
Yes
Takeaway 1:
All about deferring and reducing income tax

- Not a jobs or investment act, no tax credits, no specific role for state or local government approving OZ or monitoring compliance.

- **Primary benefits**: up-front cash can be taken out; no like kind requirements; partial gain reduction; no tax on appreciation.
Takeaway 2: Flexible

- No minimum investment.
- No third-party compliance monitoring.
- Model allows for preferred returns, promote structures, “private label” Funds.
Takeaway 3: Limited in Scope

- Need recent capital gains.
- Need active trade or business in specific geographic areas.
- Deferral benefit ends on 1/1/2027.
- Need long-term hold (5-10 years) to get other benefits.
- Designed for sound equity business investment in areas which have traditionally not supported sound equity investments.
Comparison with 1031:
Type of Property That Can Be Sold With Deferred Gain

• 1031: Only real property. If sold to related party, two-year holding requirement (purchased and replaced property). Sales of mixed assets (such as a multi-family residential project with personal property) can no longer be exchanged for similar projects and will result in some gain recognition.

• OZ: Any real or personal property generating a capital gain, e.g., stock/real estate/passthrough capital gains from investment, goodwill. Cannot sell to related party (20% test).

Advantage: OZ, unless related-party sale.
Comparison with 1031:
Type of Replacement Property

- 1031: Must be “like-kind” real property (not any personal property); can be located anywhere in US. Can reinvest in passive real estate (triple net). Designed for single asset exchanges/replacements. No pooled or shared investments. (May do TIC if IRS compliant–complex.)

- OZ: Any, but must be used in an active trade or business located in an OZ, acquired by purchase after 2017, original use begins with OZ Fund or OZ Fund substantially improves the property. No like-kind requirement. Can use multiple asset replacements and pooled funds.
  - No triple net.

Advantage: Mixed. 1031 offers geographic flexibility; need not improve existing property. OZ offers replacement flexibility: real or personal property, stock, partnership interests in Fund. But no passive investment.
Comparison with 1031:
Timelines

- **1031**: 45 days to identify replacement property; generally limited to three potential sites. Close within 180 days of sale

- **OZ**: No replacement identification deadline. No limit on number of Fund investments. Close within 180 days of gain. If gain is in a passthrough entity, then entity has 180 days and owner has an additional 180 days from year end or entity termination, whichever is first.

**Advantage**: OZ.
Comparison with 1031:
Reinvestment Requirements

• **1031:** *Entire proceeds* (principal and gain) from sale must be reinvested or can recognize gain. Gain recognized if cash out some equity. “Proceeds” includes repayment of debt.
  Ex: Sell property for $100 with $40 basis, subject to $30 debt, and debt is paid out of $100 proceeds. Even though net cash is only $70, must reinvest $100 to avoid recognizing $60 of gain on sale.

• **OZ:** *Only some or all of the gain* from the sale need be reinvested.
  Ex: Same example, need invest $60 (gain); can pocket the $10 without gain recognition. But only defer some of what is reinvested.

**Advantage:** OZ.
Comparison with 1031:
Formalities

• **1031:** Proceeds usually must be held by qualified intermediary until reinvested. Can do reverse 1031 (buy before sell)

• **OZ:** No intermediary needed, even for deferred investment; no tracing of OZ investment cash back to original sale. But cannot do reverse OZ (invest before gain).

**Advantage:** OZ, unless reverse transaction critical.
Comparison with 1031:
When Taxed

- **1031**: Upon sale of replacement property (unless rollover that sale into another 1031 or OZ). Indefinite time to resell. No tax if die (basis step-up).

- **OZ**: Original gain: Earlier of sale of investment or year ended **12/31/2026**. 10% of original gain is reduced if held for 5 years, and additional 5% is reduced if held for 7 years. But original gain is taxed if investor dies before 2026.
  - **Appreciation**: Upon sale of Fund unless held for 10 or more years, no post-investment appreciation is taxed.

**Advantage**: Mixed. 1031 control taxation event (long-term deferral; death step-up). But OZ offers some permanent tax exclusions if hold long enough, potentially raising the return on investment significantly.
Comparison with 1031:

Other

• 1031: Is carryover basis transaction, meaning no bonus or accelerated depreciation for FMV of replacement property, and eventual recognition of depreciation recapture when 1031 property is sold

• OZ: It appears OZ Fund may take advantage of bonus and accelerated depreciation, with no depreciation recapture if investment held for the full 10-year period.

Advantage: OZ.
Comfort zone

Opportunity zone
Questions?

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