

New Opportunity Zone Rules

- Gail R. Runnels of
- Holliman, Langholz & Runnels, PC

- Presentation to TCOSCPA
- February 14, 2019

New Opportunity Zone Rules--TCOSCPA Presentation
February 14, 2019
Holliman, Langholz & Runnels, PC

New Opportunity Zone Rules

Capital Gain Tax Savings

Introduction to New IRC §§1400Z-1 and 2

- The new IRC §§1400Z-1 and -2 establish an entirely novel and completely different regimen for deferring and excluding capital gains.
- New vocabulary and acronyms require definition and explanation
- Unique concepts describe actions, limitations, results and options
- With working knowledge of terms, we can describe how they work to defer any capital gain and free from taxation ultimate values that may be achieved with Opportunity Zone investments

Deferral period and technique

- Eligible Taxpayers may elect to invest capital gain (short or long) in a QOF, with such election and investment occurring within 180 days after realization of the gain;
 - Only the gain portion of the prior transaction is eligible for deferral.
 - Since the gain has not been taxed, taxpayer's basis for his investment of the gain in the QOF is zero.
- Upon sale of the taxpayer's investment, the deferred gain is then recognized, or, if no sale has occurred, the gain is recognized 12/31/26.
- If the investment is held for five years, taxpayer is granted (given) basis equal to 10 percent of the deferred gain;
- if the investment is held for two more years (7 in all) an additional 5 percent is given as additional basis. Therefore, if the investment is held 12/31/26 only 85 percent of the deferred gain is recognized.

New Opportunity Zone Rules--TCOSCPA Presentation

February 14, 2019

Holliman, Langholz & Runnels, PC

Ultimate maximum exclusion of gain recognition

- If the investment is held for ten years or more, any further gain in the investment (beyond the prior recognition of up to 85 percent of the originally deferred gain) is forever tax free.
- Any sale or exchange of the investment after the ten years will not trigger recognition of any gain; i.e., basis equal to FMV of investment as sold is granted.

1. Qualified Opportunity Zone (QOZ).

- Qualified Opportunity Zones are specially designated areas that are eligible for specific federal tax benefits for investors.
- The first set of QOZs were designated on April 9, 2018. They were nominated by the state governors, generally from low income census tracts.
- A QOZ retains its designation for 10 years. There are almost 9,000 of them now identified.
- There are numerous QOZs in and around Tulsa and Oklahoma City—many of which are prime areas for current redevelopment or new projects.

QOZ—continued

- There is a map on which all QOZs can be seen:
https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml.
- See IRS Notice 2018-48, 2018–28 Internal Revenue Bulletin 9, July 9, 2018, for the official list of all population census tracts designated as QOZs for purposes of Internal Revenue Code §§ 1400Z-1 and 1400Z-2.
- Differentiating QOZs from similar sounding prior programs (New Markets, Enterprise Zones, etc.): there is no limit on the number of QOFs or individual investments that may be made in QOZs;
- There are no dollar limits on the amounts that can be invested; there are no government funds awarded for investment or other purposes.

2. Qualified Opportunity Fund (QOF).

- A Qualified Opportunity Fund is an investment vehicle/entity that is set up as a partnership or a corporation to invest in eligible property located in a QOZ;
- It utilizes capital gains from a prior investment for funding an investment in a QOZ.
- A QOF must hold at least 90 percent of its assets in “Qualified Opportunity Zone Property” which includes: QOZS, QOZPI and QOZBP (see below)

QOF cont'd

- Qualification of an entity is by "self-certification" and may be a fund that includes multiple investors and millions of dollars of capital gain or it may be an entity with very few members investing in a single QOZ—either QOZS (stock), QOZPI (partnership interest) or directly in QOZBP Zone business property itself—such as a building in a QOZ that was a part of a QOZB.
- One QOF cannot invest in another QOF. (Limitation in tiered plans.)
- IRS Draft version of Form 8996 "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."
- The form asks for the FYE of the entity and the first month of the entity's year; investments prior to the designated first month will not support valid elections for deferral. A paper election pre-fund formation notice may be helpful since Form 8996 is not to be filed until the time for the tax return for the entity.

QOF cont'd

- A pre-existing eligible entity can qualify as a QOF, but the entity must comply with the 90-percent requirement regarding QOZP
- In particular, its qualifying property must be acquired after 12/31/17 for cash and meet other requirements.
- The primary element in the self-certification filing is the requirement that 90 percent of the assets of the QOF must be invested in qualified opportunity zone business property (“QOZBP”).
- Either the QOF’s “applicable financial statement” or cost of the company’s assets will be the basis for 90-percent analysis every six months during the life of the QOF.

3. Qualified Opportunity Zone Business (QOZB)

- A QOZB is an entity where:
- substantially all (70 percent) of the tangible property owned or leased by the entity is QOZBP (as in “owned by a QOF directly”),
- at least 50% of the total gross income of such entity is derived from the active conduct of such trade or business,
- a substantial portion of the intangible portion of the intangible property of such entity is used in the active conduct of such trade or business, and
- such entity does not operate or lease to any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling or any liquor store

QOZB cont'd

- Less than 5% of the property of such entity is nonqualified financial property, as defined in §1397C(e), (e.g., stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts and annuities).
- However, funds on hand in excess of 5 percent may be set aside for future use (such as for a construction project) pursuant to:
 - a designation in writing,
 - proposing a reasonable schedule for spending (within 31 months) and
 - the working capital must actually be used in a manner substantially consistent with the plan.

4. Qualified Opportunity Zone Business Property (QOZBP)

- QOZBP is tangible property acquired after Dec. 31, 2017 for cash that is used in a QOZ trade or business and, either
 - the use of the property in the QOZ originates with the fund, or
 - the fund "substantially improves the property";so long as "during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a QOZ."
- Property is considered "substantially improved" if "during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the QOF exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the QOF."
- When land and buildings are purchased as in-use assets, "substantial improvement" is measured by the QOF's additions to basis of the building—with no requirement to double the basis of the land on which the building is located.

5. Qualified Opportunity Zone Stock (QOZS)

- Any newly issued equity interest in an entity classified as a corporation for US tax purposes
- whose only trade or business is a QOZB,
- where such stock is acquired by a QOF after 12/31/2017 directly or through an underwriter,
- solely in exchange for cash.
- For the QOZS to retain this designation, the issuing corporation needs to be an entity, the only trade or business of which is a QOZB for “substantially all” of the QOF’s holding period for such stock.
- (“Substantially all” has been defined as 85% with NMTC’s but may be lower depending on regulations to be promulgated.)

6. Qualified Opportunity Zone Partnership Interest (QOZPI)

- A QOZPI is any capital or profits interest in a domestic partnership that was acquired after Dec. 31, 2017 by the fund in exchange for cash.
- The partnership must be a QOZB when the interest is purchased or, if a new partnership, it must be organized for the purpose of being a QOZB.
- The partnership must qualify as a QOZB for a substantial duration of the Fund's holding period.
- The IRS has acknowledged that LLCs will be treated as a partnership and may qualify as a QOF
- For partnerships investing in a QOF that elect to defer recognition of eligible gains, that gain is not included in the distributive shares of the partners; when the gain is subsequently recognized by the partnership, it is then reported by the partners.

QOZPI cont'd

- However, if the partnership does not elect to defer recognition of eligible gains, and, therefore, the gains are included in the partners' distributive shares, an individual partner may elect to defer some/all of its eligible gains.
- And, the electing partner may choose either
 - the 180-day period beginning on the last day of the partnership year or
 - it may elect to treat its 180-day period as being the same as the partnership's 180-day period.
- Note that an electing partner (when partnership does not elect deferral) must make the cash investment of the amount of gain it elects to defer.
- S corporations, trusts and estates will be treated under rules analogous to the partnership rules.

7. Eligible Taxpayers; 8. Eligible Gain

- **Eligible Taxpayers** (to invest in QOFs) are persons that may recognize gains for Federal tax purposes, including C corporations, RICs, REITs; partnerships; S corporations; trusts and estates.
- No capital gain; can't "play" to receive deferral benefits, 15% donated basis or 10-year step up in basis for ultimate sale.
- **Eligible Gain** is any capital gain for Federal income tax purposes, otherwise recognizable before 1/1/27, that does not arise from a sale or exchange with a related person. (Special limitations apply with reference to 1256 mark-to-market Contracts and gains from straddles creating offsetting-positions.)
- Gain required to be recognized will have the same attributes as it would have had if tax had not been deferred—e.g., short term vs. long term. Special rules for identifying which interest is recognized—FIFO or pro-rata.

9. Eligible Interest

- An Eligible Interest in a QOF is an equity interest, including preferred stock or a partnership interest with special allocations; it excludes any debt instrument within the meaning of sections 1275(a) and 1.1275-1(d).
- Two Classes of Investments. Rules on deferral of gains and the benefits of a ten-year holding period are only applicable to the investment in a QOF of the gains being deferred when a proper election was made at purchase;
- No deferral or non-recognition of gain is applicable to investment of amounts other than capital gains—such as total proceeds from the transaction also yielding the capital gain (as in the case of a 1031 exchange).

10. Taxpayer's election and payment.

- The 180-day period for investment in the QOF begins on the day on which the gain would be recognized for Federal income tax purposes:
 - Stock sales—trade date;
 - Capital gain dividends by RIC and REIT shareholders —day on which the dividend is paid;
 - Undistributed CG allocated to RIC and REIT shareholders—last day of the RIC or REIT taxable year;
- Gains triggered by a prior investment in a QOF may be deferred by reinvestment of the gain in another QOF (and perhaps in the same QOF) within 180 days beginning on the date of the transaction that triggered the gain.

11. Deferral period and technique

- Eligible Taxpayers may elect to invest capital gain (short or long) in a QOF, with such election and investment occurring within 180 days after realization of the gain;
 - Only the gain portion of the prior transaction is eligible for deferral.
 - Since the gain has not been taxed, taxpayer's basis for his investment of the gain in the QOF is zero.
- Upon sale of the taxpayer's investment, the deferred gain is then recognized, or, if no sale has occurred, the gain is recognized 12/31/26.
- If the investment is held for five years, taxpayer is granted (given) basis equal to 10 percent of the deferred gain;
- if the investment is held for two more years (7 in all) an additional 5 percent is given as additional basis. Therefore, if the investment is held 12/31/26 only 85 percent of the deferred gain is recognized.

12. Ultimate maximum exclusion of gain recognition

- If the investment is held for ten years or more, any further gain in the investment (beyond the prior recognition of up to 85 percent of the originally deferred gain) is forever tax free.
- Any sale or exchange of the investment after the ten years will not trigger recognition of any gain; i.e., basis equal to FMV of investment as sold is granted.

Bonus Material—

Applications, Dangers, Open Questions

- 1. All other programs, incentives, grants remain available.
 - Federal and State funding, tax waivers, rehab credits, program grants untouched by Opportunity Zones legislation
- 2. Excellent exit from long term section 1031 program of sale and reinvestment
 - Provision of years' long deferral on ultimate gain recognition and opportunity for reinvestment in advance of recognition and further exclusion of future gains

Unique Uses of OZF

- 3. Leverage available both within OZFund and outside (for equity owners and creditors)
 - OZF can be funded with minimum qualified equity capital and maximum debt or non-qualified equity
 - Maximum leverage may produce minimum exclusion of OZF qualified equity investment but very great exclusion following ten-year ownership of debt-enlarged investment. (Caveat what additional Regs may limit.)
 - Qualified equity investment may be collateral for loan for funds for investment by taxpayer as well as OZF may borrow for investment in OZ. (Code and Regs only limit assets, not debt—as to source and/or use.)

More Uses

- 4. *B. N.* Time for investment is “180 days” after trigger date, not “six months.”
 - Additional latitude on start date for some passthrough entities—partnerships, REIT’s, mutual funds, etc.
 - Again, no tracing or sequestering of funds post trigger date and investment date.
 - For large public funds expect serial commitments because of size of funds and limited time for investment.
 - May pose challenge to time installment payments with newly created capital gains. Unknown whether Regs will consider “commitment” in year one to be “investment” in year three, four and five.

And More Still

- 5 *B.N.* Triple Net Lease (N3) of property may not count as OZBusiness.
 - *Section 199A* Regs reject N3 leases as a qualifying business for the purpose of the QBI 20% deduction.
 - Recent IRS Notice 2019-7 spells out a “safe harbor” circumstance for questionable arrangements—250 hours/year of described services in support of ownership/leasing transactions required to avoid N3 rule
 - Services can be by almost anyone—not limited to owner—but timesheets and records supporting claim must be documented and preserved; taxpayer must sign a perjury style oath on return regarding services provided.
 - IRS has refused to speak on N3 leases for OZF so far; but similarity of needing to show an actual “business”—not just an investment in OZ invites a similar rule.

On We Go

- 6. Many ways “to play” in OZF and related transactions—even if no capital gains are available for equity investment and special tax treatments.
 - Management fees
 - Sale, exchange out of prior ownership
 - Preferred partnership status with participation in all that evolves
 - Investment of non-qualified equity or debt
 - Services required by entity and business
 - Caveat no sale of qualified property between related parties, for other than cash or prior to 1/1/18.

Rounding the turn

- 7. Great flexibility in designing powers, rights, preferences in partnership status.
 - Only issue off limits is one OZF investing in another OZF—no tiering of partnerships, but side-side and subsidiary relationships not forbidden.
 - Larger funds may well limit themselves to one investment per fund and have multiple funds, side-by-side, all serviced by a different “Operator” entity that oversees them all.
 - Possible unique combinations of equity and debt with multiple layers and distinctions among them. Not like Subchapter S corporations where all shares must have similar rights and privileges in many areas.

Down the Backstretch

- 8. One's available capital gains from a single transaction may be invested in multiple OZFs
 - All investments must occur within 180 days of trigger date, but no requirement regarding timing of separate purchases.
 - Spreading risk of future success of various ventures may suggest multiple investments, particularly if large gains are involved.
- 9. Many options on triggering recognition of deferred gain by sale or exchange instead of waiting for 12/31/26 mandatory date.
 - Since "deferred gain" is (85%) required to be recognized by 2026, what is result if value is lower? One transaction or two? Regs may clarify.

Final Corner

- 10. Clarifying distinctions between Section 1031 Exchanges and OZone rules
 - OZ –Only reinvest capital gain; not all cash received.
 - OZ—No sequestering of cash received; no tracing required; no limit on use of funds or proceeds of gains
 - OZ—No requirement of “like kind” property: old into new. “Any capital gain will do.” Recaptured depreciation on sale creating capital gain is ordinary and does not count as qualified capital gain. Investment can be in business—not specific property.
 - OZ-->85% of capital gain excluded for 8 years; ultimate deferral of further gain in same investment—10-year+ hold required.
 - 1031: perpetual deferral of all gain

Finish Line

- 11 Watch out for the Ooops.
 - State income tax treatment of various aspects of OZF may not track IRS rules.
 - States will vary in several of the stages of recognition, investment, basis, exit.
 - Check each one, every year.
 - Question: What basis passes to heirs on death of owner of an OZF investment? Step up or 1400Z rules?
 - How are earnings of OZF taxed to holders of qualified equity during operating years prior to sale or exchange or 2026 recognition? Basis denied for partnership debt, but no mention of treatment of regular operating results.
- 12 Look for more Regs—there will be many issued over several years to more fully instruct in use of this new program.

Q&A and for structuring advice:

- Gail R. Runnels (918-584-1471) GRunnels@SelectVentures.com