



Qualified Opportunity Zones

OSCPA – Tulsa Chapter

November 6, 2019

Agenda

Qualified Opportunity Zones

Overview	4
Definitions	8
Proposed Regulations	13
Exit Strategy, Reinvestment, Other Issues	26

Qualified Opportunity Zone Overview

Qualified Opportunity Zones

Sections 1400Z-1 & 1400Z-2

Three types of potential QOZ benefits



Deferral of gain from a sale or exchange of prior investments:

Taxpayers may elect to temporarily defer from inclusion in gross income certain gains from the sale or exchange of an asset to the extent of the aggregate amount invested in a QOF during the 180-day period beginning on the date of the sale or exchange. The deferral lasts until the earlier of the sale or exchange of the QOF investment or December 31, 2026.



Reduction of deferred gain from the sale or exchange of prior investments:

After holding investments in QOFs for a specified period of time, taxpayers may receive a permanent reduction of the deferred gain originally realized equal to 10% (if QOF is held at least five years), or 15% (if QOF is held at least seven years) through a partial basis step-up.



Exclusion of gain from the sale or exchange of investments in QOFs:

After holding investments in QOFs for a period of at least ten years, taxpayers may elect to receive a permanent exclusion of the appreciation of the QOF investment through a full step-up in basis to the fair market value of the QOF investment on the date such investment is sold or exchanged.

Qualified Opportunity Zones

Benefits Timeline

Front-end benefits for deferred gains

2019	2024	2026	12/31/2026	2029 to 2047
Defer paying tax of \$238,000 (\$1,000,000 x 23.8%; 20% capital gain rate + 3.8% NII)	\$23,800 (10%) of tax forgiven at 5-year holding period by virtue of \$100,000 basis step-up	\$11,900 (5%) of tax forgiven at 7-year holding period by virtue of \$50,000 basis step-up	Regardless of holding period must pay tax of \$202,300 on deferred gain (effectively 17% capital gain rate + 3.23% NII, or 20.23%)	

Back-end benefits for deferred gains

2019	2024	2026	12/31/2026	2029 to 2047
\$1,000,000 investment in QOF made within 180-days; zero outside basis	\$100,000 QOF outside tax basis increase	\$50,000 QOF outside tax basis increase	\$850,000 QOF outside tax basis increase	QOF outside basis increased to FMV at time of sale or exchange of QOF investment

Qualified Opportunity Zones Considerations

Important dates

- **December 31, 2017** - must acquire QOZ stock, QOZ partnership interest, or QOZ business property after this date
 - This is probably the biggest restriction when determining whether property “counts” as QOZ property
- **December 31, 2019** - latest date to invest for 7-year, 15% gain exclusion
- **December 31, 2021** – latest date to invest for 5-year, 10% gain exclusion
- **December 31, 2026** - required recognition of capital gains on original investment
- **December 31, 2047** – last date for electing to avoid gain recognition on QOF investment

Penalties

- If a QOF fails to meet the requirement to hold 90% QOZ property, the QOF must pay a penalty for each month it fails this requirement, unless the taxpayer can show reasonable cause.

Qualified Opportunity Zone

Important Definitions

Qualified Opportunity Zones

Important definitions

Eligible gains – Only gains that satisfy the following requirements:

- Characterized as capital gains for federal income tax purposes
 - would otherwise be recognized in gross income by the taxpayer before January 1, 2027; and
 - not arising from a sale or exchange with a related party (20% or more common ownership/control).

Actual and deemed sales or exchanges of property, including:

- Sale of a section 1221 capital assets (e.g., stock, bonds, art, land, other investment property);
- Section 1231 gain (sale of property used in a trade or business including real estate and held for more than 1 year), if § 1231 gains exceed § 1231 losses for taxable year
- Unrecaptured Section 1250 gain (capital gain taxed at 25% rate)
- Note: Special rules apply to Section 1256 contracts and straddles
 - No deferral for offsetting-positions transactions (where one position with respect to personal property substantially diminishes risk of loss with respect to another position in personal property, whether or not the positions concern the same type of property)

Qualified Opportunity Zones

Important definitions

Qualified Opportunity Fund – any investment vehicle which is organized as a domestic corporation or partnership for the purpose of investing in QOZ property and holds at least 90% of its assets in QOZ property. *Must be a regarded entity.*

- Any domestic corporation, S-corporation, or partnership that self-certifies as a QOF by filing Form 8996 with its income tax return.

QOZ property - includes QOZ business property (QOZBP), QOZ partnership interests (QOZPI), or QOZ Stock.

QOZ business property – means tangible property used in a trade or business of the qualified opportunity fund if:

- Such property was acquired by the qualified opportunity fund by purchase (as defined in section 179(d)(2)) after December 31, 2017;
- The original use of such property in the qualified opportunity zone commences with the qualified opportunity fund or the qualified opportunity fund substantially improves the property (* see definition of “substantially improved property” below); and
- During substantially all (90%) of the qualified opportunity fund's holding period for such property, substantially all (70%) of the use of such property was in a qualified opportunity zone.

Qualified Opportunity Zones

Important definitions

Substantially improved property - is tangible property (other than land) that 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 qualified opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the qualified opportunity fund(i.e., the double-the-basis rule).

QOZ partnership interest

- Any capital or profits interest in a domestic partnership, if:
 - Such interest is acquired by QOF after December 31, 2017 from the partnership solely in exchange for cash,
 - As of the time such interest was acquired, such partnership was a QOZ business or, in the case of a new partnership, such partnership was being organized for the purposes of being a QOZ business, and
 - During substantially all (90%) of the QOF's holding period for such interest, such partnership qualified as a QOZ business.

QOZ business determination - When a QOF acquires a partnership interest (any capital or profits interest in a partnership) rather than directly engaging in a trade or business, the 90% asset holding test shifts from measuring the assets held by the QOF to the assets and operations held by the partnership to determine whether the partnership interest will be respected as QOZ property and is reduced to a 70% assets test for the QOZ business.

Qualified Opportunity Zones

Important definitions

QOZ business

- A trade or business in which substantially all (at least 70%) of the tangible property owned or leased by the taxpayer (partnership or corporation) is QOZ business property, and each of the following requirements are satisfied:
 - At least 50% of the total gross income of such entity is derived from the active conduct of any such business in the QOZ,
 - The second round of regulations created three safe harbors to allow businesses to be deemed to meet this requirement
 - A substantial portion (at least 40%) of the intangible property of such entity is used in the active conduct of any such business in the QOZ,
 - Less than 5% of the average of the aggregate unadjusted bases of the property held by such entity is attributable to nonqualified financial property, and
 - The trade or business is NOT engaged in certain “sin” businesses, including:
 - Golf courses; Country clubs; Massage Parlors; Hot tub facilities; Suntan facilities; Racetracks or other facilities used for gambling; or any store that primarily sells alcohol for consumption off premises

Qualified Opportunity Zone Proposed Regulations

Qualified Opportunity Zones – Second Set of Prop. Regs

Highlights from 120186-18

- Provide three safe-harbors for purposes of determining whether 50% or more of gross income is derived in QOZ;
- Permit certain debt-financed distributions to QOF partnership investors;
- Allow tangible property to be leased by a QOF or QOZB and counted as “good” property in certain situations;
- Clarify the application of a “rolling” 31-month working capital safe-harbor for QOZBs;
- Treat land as “good” property provided it is used in a trade or business;
- Provide a 12-month rollover period for the QOF to reinvest gain during the 10-year investor hold period provided the investor is not “cash-out” (note: the gain is taxable);
- Clarify that certain investors in a QOF (after the 10-year hold period) are permitted to exclude capital gains realized by the fund on the disposition of underlying assets, without required the sale of the investor’s entire interest in the QOF;
- Clarify that the election to step-up basis upon the sale or other disposition of QOZP by the QOF is treated as occurring immediately before the sale or disposition, meaning inside basis is stepped up in addition to outside basis;
- Define “original use” as essentially being the first use to which property is put and becomes depreciable in the QOZ;
- Allow vacant buildings to be treated as placed in service as new after a 5-year vacancy period;
- Define “substantial portion” as 40% for purposes of determining whether QOZB meets the test for using a substantial portion of its intangible property in a QOZ trade or business;
- Describe “inclusion events” which cause some amount of the QOF investor’s deferred gain to be recognized for federal income tax purposes; and
- Define “substantially all” as 70% in all cases with the exception of when it is defined as 90% for purposes of the required holding period of QOZBP.

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

- IRS and Treasury issued the second set of proposed regulations providing guidance on investing in Qualified Opportunity Funds
- These proposed regulations modify, clarify and amplify aspects of the companion set of proposed regulation first promulgated in October 2018.

Highlights:

Definition of Substantially All: The new regulations adopt the same **at least 70%** threshold requirement for purposes of determining the use of tangible property within a QOZ for purposes of satisfying the definition of QOZBP. However, in the context of the holding period of such property, the threshold requirement is increased to **90%** standard.

- Therefore, the statutory definition of QOZBP in IRC 1400Z-2(d)(2)(D)(i)(III) should be read as follows:
 - The term qualified opportunity zone business property means tangible property used in a trade or business of the QOF [or QOZB] if during **90-percent** of the QOF's [or QOZB's] holding period for such property, **at least 70-percent** of the use of such property was in a qualified opportunity zone.

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

Highlights:

– Operating Business Requirements

- **Three new safe-harbors for a QOZB to meet the 50% Gross Income Test:**
 - (1) If at least 50% or more of hours worked by its employees and independent contractors (and employees of independent contractors) in the QOZ, then the QOZB satisfies the 50% Gross Income requirement.
 - (2) If at least 50% or more of wages paid for services performed by its employees and independent contractors (and employees of independent contractors) in the QOZ, then the QOZB meets the 50% Gross Income requirement.
 - (3) If the tangible property used in the QOZ and the management or operational functions performed in the QOZ are each necessary to generate 50% of the gross income, then the QOZB may satisfy the 50% Gross Income requirement.
 - Note that if a QOZB is unable to meet any of the three safe harbors, then a QOZB may meet the 50% Gross Income requirement if, based on all the facts and circumstances, at least 50% of the gross income of a QOZB is derived from the active conduct of a trade or business in the QOZ.
- **Intangible Property Test**
 - The proposed regulation defines a substantial portion of intangible property of a QOZB that must be used in the active conduct of a trade or business in the QOZ as 40%.

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

Highlights:

– Original Use Property and Land Issues

- **Tangible Property Acquired by Purchase and Owned by QOF or QOZB:** In the case of tangible property owned by the QOF or QOZB, the original use of such property must commence in the QOZ with the QOF or QOZB. If the original use does not commence in the QOZ, then the QOF or QOZB must substantially improve the tangible property.
 - The original use of tangible property in a QOZ commences on the date that any person first places the property in service in the QOZ for purposes of depreciation or amortization (or first uses it in a manner that would allow depreciation or amortization if that person were the property's owner). Therefore, used property can satisfy the original use requirement if the property has not yet been previously placed in service in the QOZ. If the tangible property has been placed in service in the QOZ by another taxpayer before it was acquired by the QOF or QOZB, then it must be substantially improved by the QOF or QOZB to satisfy the definition of QOZBP.
- **Vacant Structures or Other Tangible Property:** The regulation provides a special rule for tangible property that has been unused or vacant for an uninterrupted period of at least 5 years. The original use of such property is treated as commencing in the QOZ on the date any person first so uses or places the property in service in the QOZ. Since the tangible property is treated as original use property under these circumstances, a QOF or QOZB does not have to substantially improve the property for it to be QOZBP.

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

Highlights:

– Original Use Property and Land Issues (cont.)

- **Lessee Improvements to Leased Property:** The proposed regulations provide a special rule for lessee improvements to leased property where the lessee owns the improvements. Under this special rule, improvements made by a lessee to leased property in a QOZ are treated as satisfying both the original use requirement and the acquired by purchase requirement for the amount of the unadjusted costs basis under IRC 1012 of such improvements. In other words, any tenant improvements made by the lessee made pursuant to a lease qualify as QOZBP even if such improvements are not substantial in cost.
- **Land:** The proposed regulations clarify that original use and substantial improvement requirements are not applicable to land whether the land is improved or unimproved after the QOF or QOZB purchase the land after December 31, 2017 from an unrelated party. The proposed regulations clarify that land can be treated as QOZBP only if it is used in a trade or business as defined under IRC 162. The proposed regulations note that the simple holding or banking land for investment does not give rise to a trade or business, and therefore, in this instance, the land would not qualify as QOZBP.
- **Real Property (Other than Land):** Real property that was acquired by purchase in accordance with the QOZBP rules but previously placed in service in the QOZ by a person other than the QOF or QOZB must be substantially improved by the QOF or QOZB to qualify as QOZBP using the same “double the basis” substantial improvement rules as tangible property.

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

Highlights:

– Original Use Property and Land Issues (cont.)

- **Real Property Straddling a Qualified Opportunity Zone** : The regulations incorporate the rules of IRC 1397C(f) for when real property straddles a QOZ and the QOZB needs to determine the location of services, tangible property, or business functions.
- The rules state if the amount of real property based on square footage located within the QOZ is substantial as compared to the amount of real property based on square footage outside of the zone, and the real property outside of the zone is contiguous to part or all of the real property located inside the zone, then all of the property would be deemed to be located within a QOZ.
- The guidance states that real property located within the QOZ should be considered substantial if the unadjusted cost of the real property inside a QOZ is greater than the unadjusted cost of real property outside of the QOZ.

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

Highlights:

– **Leased Property:** The regulations have provided an elaborate set of rules that allow for ground leases and leases of tangible personal property to a QOF or QOZB without requiring substantial improvements to be made to such property or the satisfaction of the original use requirements described above. These rules even permit leasing between related parties. However, the leased tangible property must meet the following conditions:

- **1. The property must be acquired by the QOF or QOZB under a lease entered into after December 31, 2017; and**
- **2. The terms of the lease must be market rate at the time that the lease was entered into.**

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

Highlights:

- **Leased Property (cont.):** If the lessee and lessor are related parties (applying the same 20% affiliated ownership analysis as used for other IRC 1400Z-2 purposes), then the following additional conditions must also be satisfied:
 - **3. Pre-Payment Restriction:** The lessee is prohibited from making any prepayment in connection with the lease relating to the period of use of the property that exceeds 12 months;
 - **4. Purchase of Other QOZBP:** Assuming the original use of leased tangible personal property does not commence with the lessee, the lessee must become the owner of other tangible property that is QOZBP having a value not less than the value of that leased tangible personal property during the relevant testing period (generally the earlier of 30 months after the date the lessee receives possession of the leased tangible personal property or the last day of the lease term);
 - **5. Original Use Rules for Purchase of Other QOZBP:** The same rules as described above must be applied for purposes of determining whether original use has been satisfied with respect to Other QOZBP acquired by purchase by the QOF or QOZB; and
 - **6. Valuation Methodologies:** For purposes of determining whether #4 has been satisfied with respect to evaluating the value of leased tangible personal property in relation to other QOZBP held on the applicable testing dates during the relevant testing period, the QOF or QOZB is generally permitted to utilize either U.S. GAAP net book value or IRC 1012 unadjusted cost basis.

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

Highlights:

- **Asset Valuation:** The proposed regulations provide QOFs the flexibility to reset their valuation methodologies annually and for QOFs with AFS to use the unadjusted cost basis under IRC 1012 for purposes of the 90% QOZP assets threshold under section 1400Z-2(d) (including for purposes of applying the 70% QOZBP requirement at the QOZB level).
- **Financial Statement Valuation Method**
 - Pursuant to the applicable financial statement valuation method, the value of each asset that is owned or leased by the QOF is the value of that asset as reported on the applicable financial statement for the respective reporting period. QOFs and QOZBs that have an applicable financial statement, filed with the SEC or another federal agency other than the IRS or a certified audited financial statement may select the applicable financial statement valuation of leased property only if their financial statement was prepared in accordance with U.S. GAAP and requires recognition of the lease of the tangible property.
- **Alternative Valuation Method**
 - Under the alternative valuation method, the value of purchased property is its unadjusted cost basis under IRC 1012. The value of leased tangible property is determined under the alternative valuation method based on the discounted present value of cash flows determined at the time the lease is entered into of all lease payments over the term of the lease using a discount rate equal to the applicable federal rate (AFR) under IRC 1274(d)(1) which would apply to a debt instrument of the same term as the lease.

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

Highlights:

- **31-month Working Capital Safe Harbor:** The proposed regulation incorporates two important modifications to the 31-month Working Capital Safe Harbor.
 - First, the written designation for planned use of the working capital now includes the development of a trade or business in the QOZ as well as acquisition, construction, and/or substantial improvement of tangible property.
 - Second, if a QOZB exceeds the 31-month period due to delays attributable to waiting for government action on an application completed and submitted by a QOZB during the 31-month period, then the QOZB will not violate the safe harbor.
 - The regulations make explicit that a business may benefit from multiple overlapping or sequential applications of the working capital safe harbor, provided each application independently satisfies all requirements. In addition, the regulation provides an example illustrating the application of 31-month working capital safe-harbor applying the provision and confirming that it is to be applied on a “rolling” basis. As a result, each tranche of capital raised by the QOZB is subject to its own 31-month working capital safe-harbor.

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

Highlights:

- **Active Conduct of a Trade or Business:** The term “trade or business” is defined to mean a trade or business within the meaning of IRC 162.
 - In addition, the regulation specifically provides that solely for purposes of IRC 1400Z-2(d)(3)(A) the ownership and operation (including leasing) of real property is the active conduct of a trade or business.
 - However, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer. Despite addressing the use of the term active conduct of a trade or business in the context of operating real property, the regulation nonetheless reserves more generally on the definition of an active conduct of a trade or business.
- **Section 1231 Gain:** The new guidance clarifies that eligible capital gains now include net 1231 gains. This capital gain net income amount requires the taxpayer to take into account all section 1231 gains and section 1231 losses for a taxable year (including applicable carryovers) with respect to all of the taxpayer’s section 1231 property, and to the extent 1231 gains exceed 1231 losses, the taxpayer is eligible to defer this capital gain net income amount. The 180-day tolling period for investing capital gain income from the sale or exchange of section 1231 property into a QOF begins on the last day of the taxpayer’s taxable year.

Qualified Opportunity Zones

Proposed Regulation 120186-18 (cont.)

Other Issues:

- Six month rule providing relief from the 90% Test**
- Contributions of property other than cash to a QOF**
- Other Partnership and S-Corp Considerations**
- Consolidated Return Considerations**
- Tribal Lands**
- Inclusion Events and Exceptions**
- QOF REIT Capital Gains Dividends Permitted on Tax-Advantaged Basis**
- Holding Period and Other Tacking Rules in Certain Nonrecognition Transfers**
- Carried interest by QOF Sponsor Not Eligible for QOZ Tax Benefits**

Qualified Opportunity Zone

Exit Strategy, Reinvestment, and Other Issues

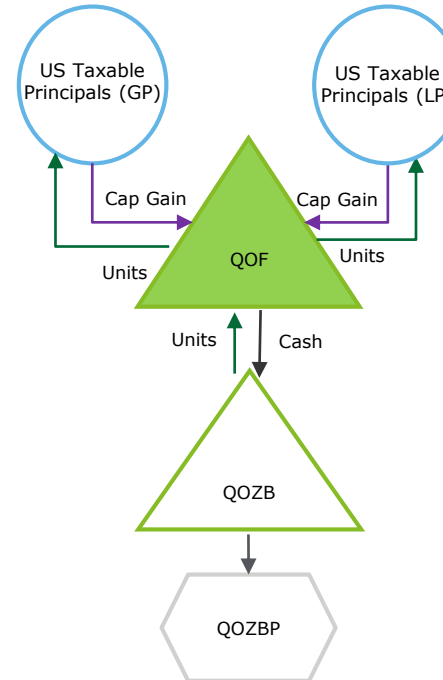
Qualified Opportunity Zones

Other Issues - Exit

- Sale or exchange of QOF Interest

- On the day of the sale or exchange, immediately before the sale or exchange, the taxpayer's interest in the QOF is stepped up to FMV, which includes a step-up at every level of assets or equity interest held by the QOF (e.g. QOZB and QOZBP).
- Proposed regulations provide for a deemed section 743(b) adjustment.
- In this scenario, there is no §751, §1250 and §1245 recapture.
- **Sale at this level allows investors to exclude capital gains and ordinary income.**

Simple Structure Example

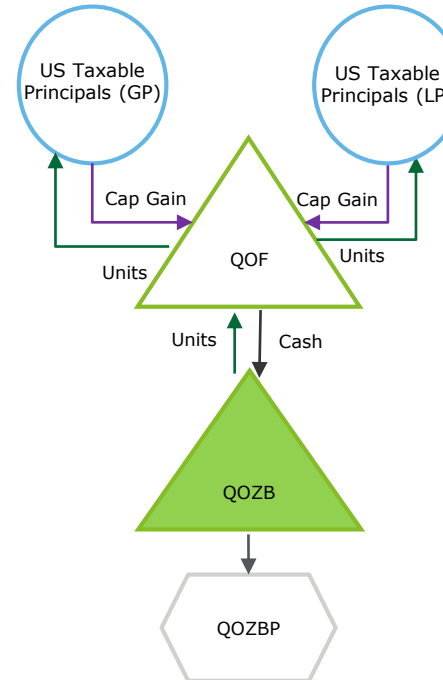


Qualified Opportunity Zones

Other Issues - Exit

- **Sale or exchange of QOZB interest**
 - **The investors in the QOF who have held their interest for 10 years or more can step-up their portion of the capital gain to FMV.** Therefore, the step-up includes § 1250, but excludes §1245 and §751 ordinary recapture.
 - **Sale at this level allows investors to exclude capital gains but not ordinary income.**

Simple Structure Example

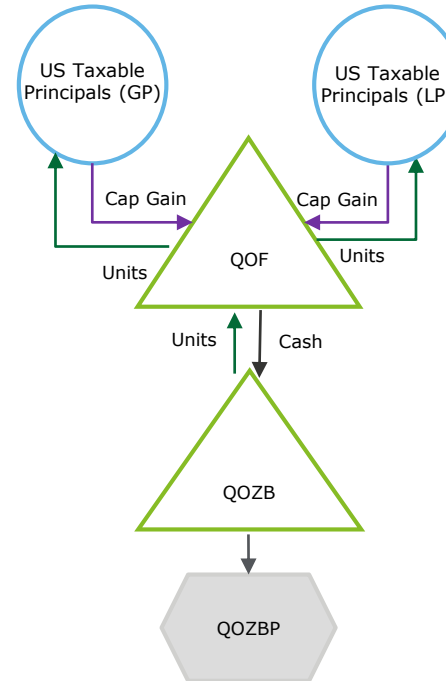


Qualified Opportunity Zones

Other Issues - Exit

- **Sale or exchange of QOZBP**
- if the QOZB sold or exchanged the QOZBP, there is no provision that permits a step-up to FMV.
- Instead, the QOZB would allocate the gain to the QOF, which provides outside basis. When a QOF investor sells its interest, then the QOF interest is stepped up to FMV creating a whipsaw effect because the outside basis exceeds FMV, creating ordinary income offset by a capital loss.
- **No step-up in basis to FMV if sold at this level.**

Simple Structure Example



Technical Contact information



Jeremy DeMuth

Senior Manager
Deloitte Tax LLP
jdemuth@deloitte.com



Marty Karamon

Principal
Deloitte Tax LLP
mkaramon@deloitte.com

Technical Contact information



Jeremy Morales

Tax Senior Manager
Deloitte Tax LLP
jermorales@deloitte.com



Ashlee Crouch

Tax Senior Manager
Deloitte Tax LLP
ascrouch@deloitte.com

Technical Contact information



Doug Puckett

Deputy National Tax Leader – Private
Equity
Deloitte Tax LLP
dpuckett@deloitte.com



Nick Sapp

Tax Senior Manager
Deloitte Tax LLP
nsapp@deloitte.com

About this presentation

This presentation contains general information only and Deloitte is not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this presentation.



Official Professional Services Sponsor

Professional Services means audit, tax, consulting, and advisory.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. In the United States, Deloitte refers to one or more of the US member firms of DTTL, their related entities that operate using the "Deloitte" name in the United States and their respective affiliates. Certain services may not be available to attest clients under the rules and regulations of public accounting. Please see www.deloitte.com/about to learn more about our global network of member firms.