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Opportunity Zones

Tax incentives for investing in low-income communities

Overview

- Established by Tax Cut and Jobs Act of 2017
- 8,700 zones in the US (11% of the country)
- Only capital gains can be invested
- Capital gains must be invested within 180 days
- Fund has 30 months to develop/redevelop property with the funds
- Expenditures must at least equal the acquisition cost + $1 (does not include land)
- 90% of a fund’s assets must be in qualifying property
- Funds “self certify”
- The “original” capital gain will be recognized on 12/31/26
- Investors have until 12/31/47 to make the permanent gain elimination election

Benefits of the Opportunity Zone

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> **Defer** capital gain for up to 7 years

> **Eliminates** up to 15% of original capital gains

> **Tax-free appreciation** from capital gain investment if held 10 years

Highlights from the Regs

- Land is <u>not</u> taken into account in determining whether property has been substantially improved
- The step-up in basis after 10-years appears to be inclusive of accelerated depreciation
- 90% of a fund's assets must be in qualified opportunity zone property or business within 6 months from the date received
- With a fund investing indirectly in an OZ business, it is required that 70% of the business be qualified opportunity zone business property
- 50% of the gross income of a qualified opportunity zone business must be derived from the active conduct of a trade or business in the qualified opportunity zone
- Partnerships and corporations (as well as the owners) can make the election to defer/eliminate gain
- Cash held for construction or rehabilitation may be held for a period of up to 31 months, if there is a written plan
- Opportunity Zone investments may be liquidated in total before 12/31/2028 and re-invested into another QOZ project within 180 days to maintain all benefits
- Taxpayers can make the basis step-up election until December 31, 2047

Opportunity Zone Time Line

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Investor

1	2	3	4	5	6	7	8	9	10
2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Sale and Invest within 180 days				10% Gain Eliminated		15% Gain Eliminated	Original Gain Recognized (less % eliminated)		All Gain Eliminated

Developer

1	2	3	4	5	6	7	8	9	10
2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Receive Funds and acquire property in 6 months		Build or rehab project (30/31 month rule)					Consider cash distribution so investors can pay taxes		

Example

- On November 7, 2018, taxpayer sells stock for $150M with an adjusted basis of $50M, resulting capital gain of $100M
- Taxpayer invests all $150M in a QOF including the $100M capital gain
- Only the $100M is eligible for the tax benefits
- The taxpayer is treated as having two separate investments in the QOF, a $100M investment with a tax basis of zero initially and a $50M investment with a cost basis of $50M which is not eligible for any special tax benefits
- The taxpayer may receive two separate K-1s from the QOF

Example

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- If the taxpayer holds the investment until Nov. 7, 2023, (5 years) the taxpayer's investment will have a $10M tax basis and if held two more years, the investment will have a $15M tax basis
- On 12/31/26, the taxpayer will pay tax on $85M of the original deferred gain even if the investment in the QOF is not sold. Its tax basis in the QOF investment will be stepped-up to $100M on this date.
- On 11/7/2028, the taxpayer can make an election to step-up its tax basis in the asset on the sale or exchange of the investment in the QOF
- As a result of that sale or exchange, there is no tax on the appreciation on the investment

Example Impact on IRR

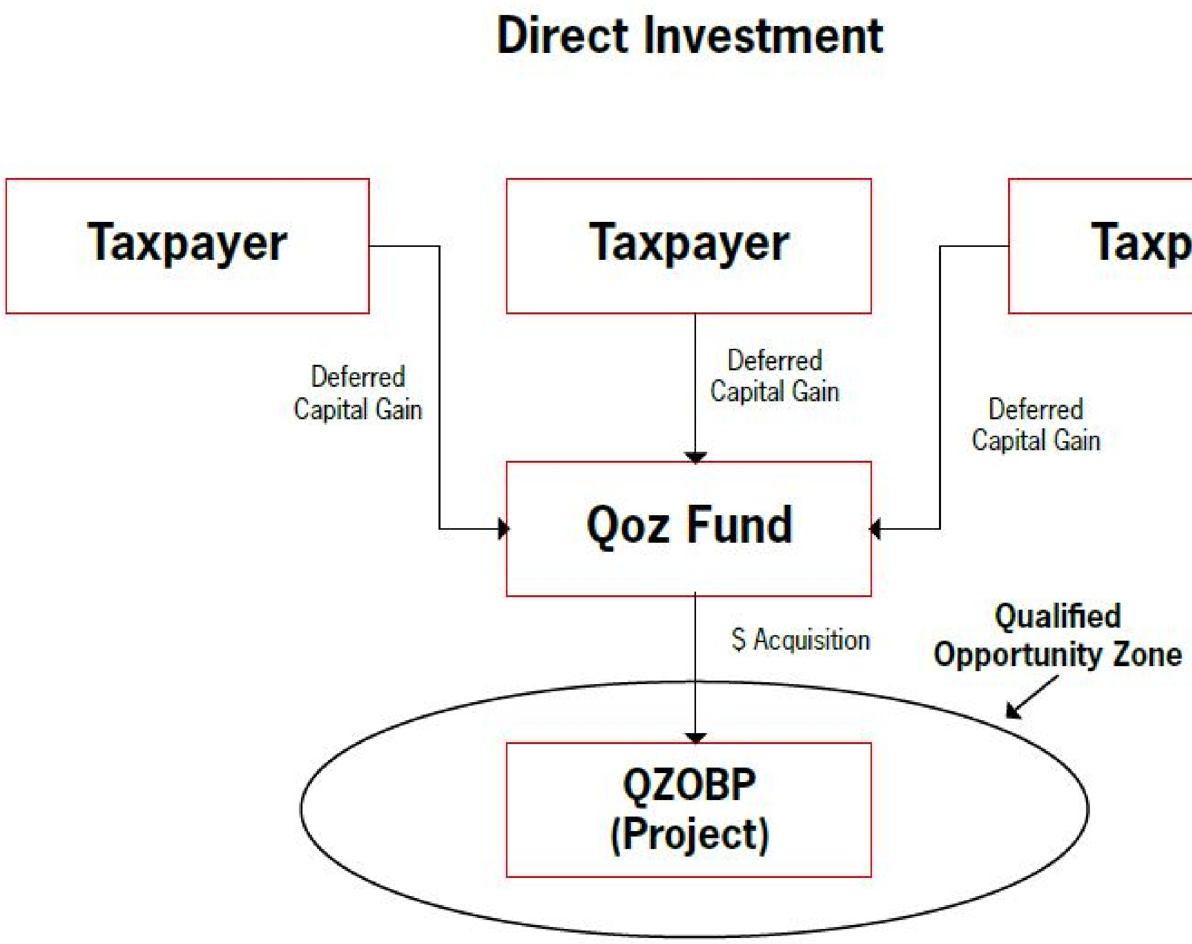
Assumptions

- Projects are economically identical (i.e., same cash and tax shelter attributes), but one is within an OZ and one is not
- OZ investors defer 23.8 percent in capital gain tax, while non-OZ investor pays 23.8 percent capital gains tax (both investors assumed to liquidate an investment with a gain to make this investment)
- NOI growth of 2 percent per year, 3 percent management fee, triple net tenants, 5 percent assumed vacancy, accelerated depreciation*
- Investment sold at 6 percent cap rate, net of 5 percent transaction expenses
- Annual income taxed at 29.6 percent and tax losses assumed to be used in current year

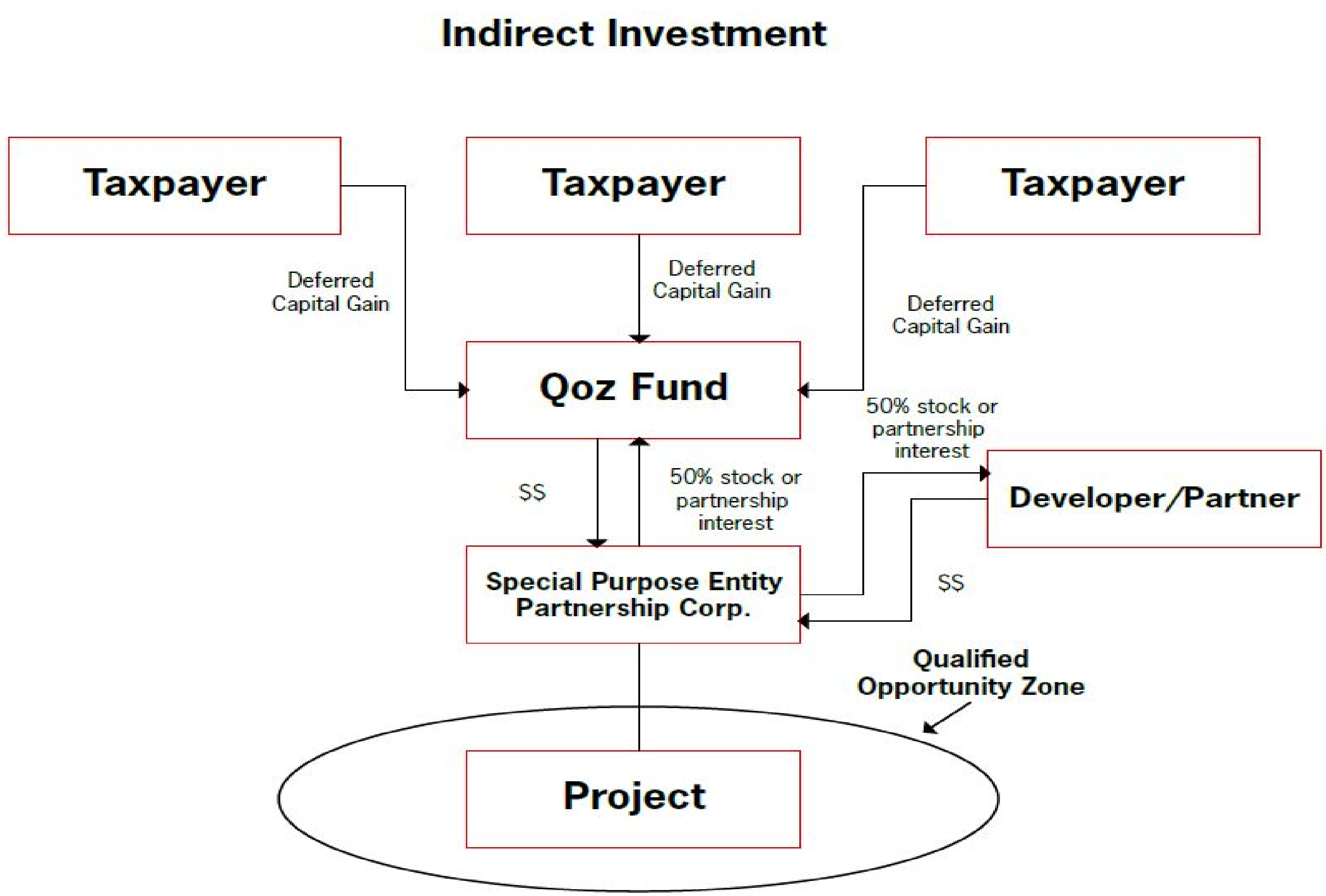
After-tax IRR	OZ	Non-OZ	Improvement
5 years	7.8%	5.9%	32%
7 years	8.9%	6.9%	29%
10 years	10.9%	7.5%	45%

**Awaiting IRS confirmation on negative capital account step-up*

Investment Structure - Direct



Investment Structure - Indirect



Comparison of QOF structures

Direct investment

- 90% of QOF assets must be in QOZ property
- The QOF is tested for qualifying assets at 6 mos and at the end of the taxable year- no grace period for deployment of cash
- Statute says that the QOF must acquire property by purchase; no mention of leased property by the QOF
- No “active” conduct of trade or business requirement
- No grace period if property removed from QOZ
- All IP would be considered non-QOZBP
- QOF can invest in “sin” business

Indirect investment

- 70% of the QOZB assets must be QOZ business property
- Working capital safe harbor-cash is qualifying asset for 31 months if entity complies with written plan of deployment
- “All property owned or leased…”, the QOZ business can lease property but treatment not specifically addressed
- QOZ business must be engaged in the “active” conduct of trade or business
- 5-year grace period if property removed from QOZ
- IP is qualifying property if it is used in active conduct of trade or business
- Prohibition on sin businesses

Exit Strategy

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- The tax free disposition after 10 years only applies to a disposition of a QOF interest, not the underlying business asset. A taxpayer needs to exit with equity to get step-up.

- The sale of the underlying asset held by the QOF is a taxable event, even if it occurs after the 10-year holding period.

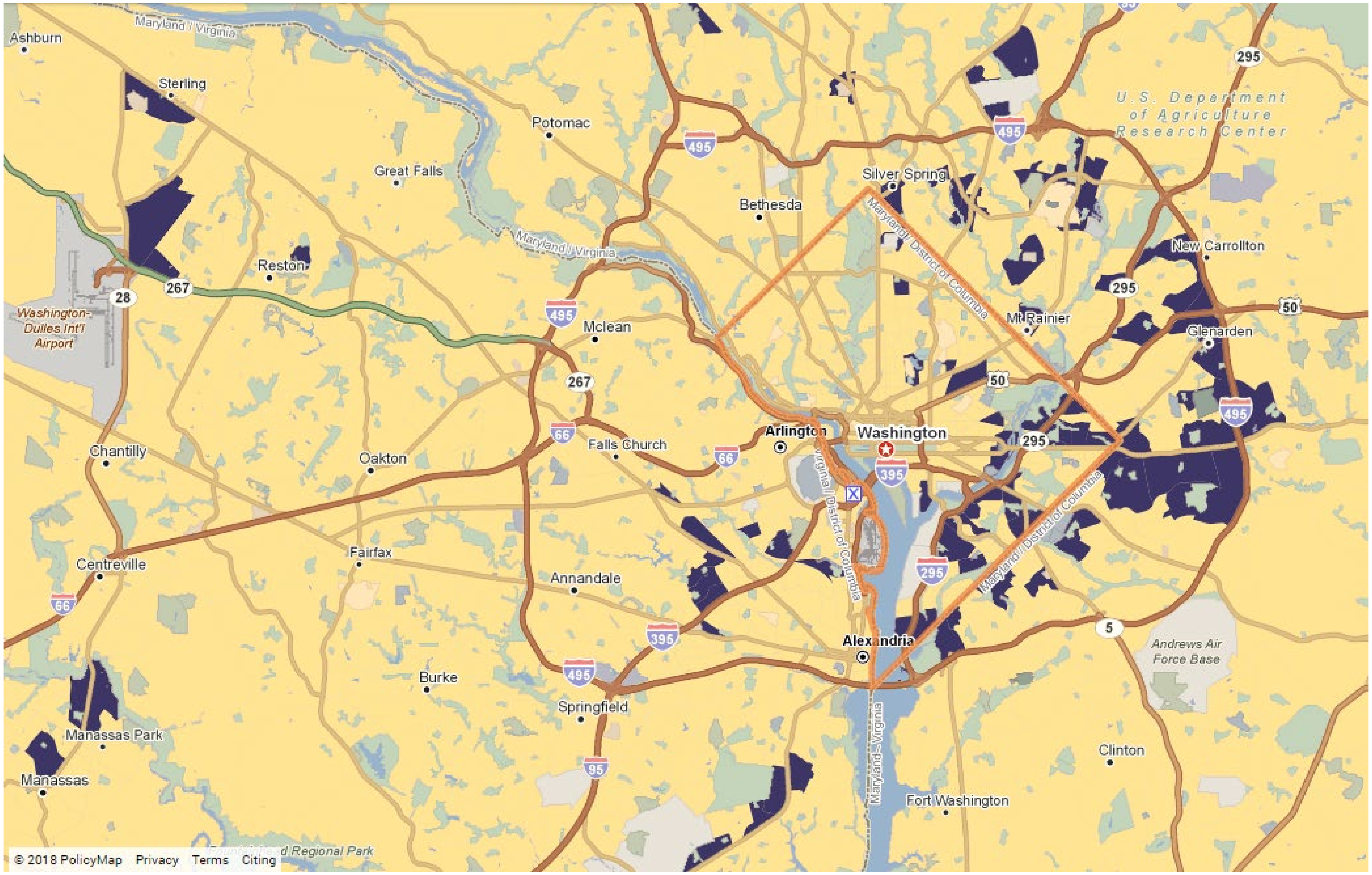
- Consequently, it is advisable to have a QOF for each project. The investor can set up multiple funds from a single deferred gain as long as there is no double counting.

FAQs

- Better to raise money or find your project first?
- If you own pre-2018 land in the zone is there a way to get the tax benefits?
- Will more zones be identified?
- Can developers receive the tax benefits through a profits interest?
- Can investors get the benefits through a debt investment?
- Are there other credits and incentives available to zone developers?
- Can a QOF be open-ended allowing new investors to come in and buy out old investors?
- Can investors re-invest their zone proceeds tax free?
- Is all cash from the QOF tax-free after 10 years?
- How will QOF investors pay their taxes in 2026?
- Are opportunity zones the same as IRC section 1031 exchanges?
- Do states follow the federal rules for opportunity zones?

Baker Tilly's Opportunity Zone mapping tool

Find eligible areas at bakertilly.com/opportunityzones



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