
Opportunity Zones

A powerful new tax incentive for real estate investors, venture capital, private wealth, family offices and private equity



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Presenters



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Michael Ross, partner with Baker Tilly Virchow Krause, LLP and president of Baker Tilly Capital, LLC, the wholly owned private investment banking subsidiary of Baker Tilly, has been with the firm since 1987. He is based in the Austin office.

Mike is the transactions team leader and specializes in real estate and comprehensive project finance for development projects. Additionally, Mike is a licensed investment banker and CPA.

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Molly Bryson is Team Leader of Ballard Spahr's Tax Credits Team. She focuses her practice both on using federal and state tax credits to finance affordable housing, businesses in low-income communities, historic preservation, and solar energy, and on using the Qualified Opportunity Zone (QOZ) program to finance community economic development throughout the U.S. and its territories.

Molly is a frequent lecturer on tax credits and QOZs, and has spoken at a number of conferences, including those sponsored by the American Bar Association Forum on Affordable Housing & Community Development, Housing Alliance of Pennsylvania, the Pennsylvania Bar Institute, the National Housing & Rehabilitation Association, and CRE Financial Council.

OVERVIEW

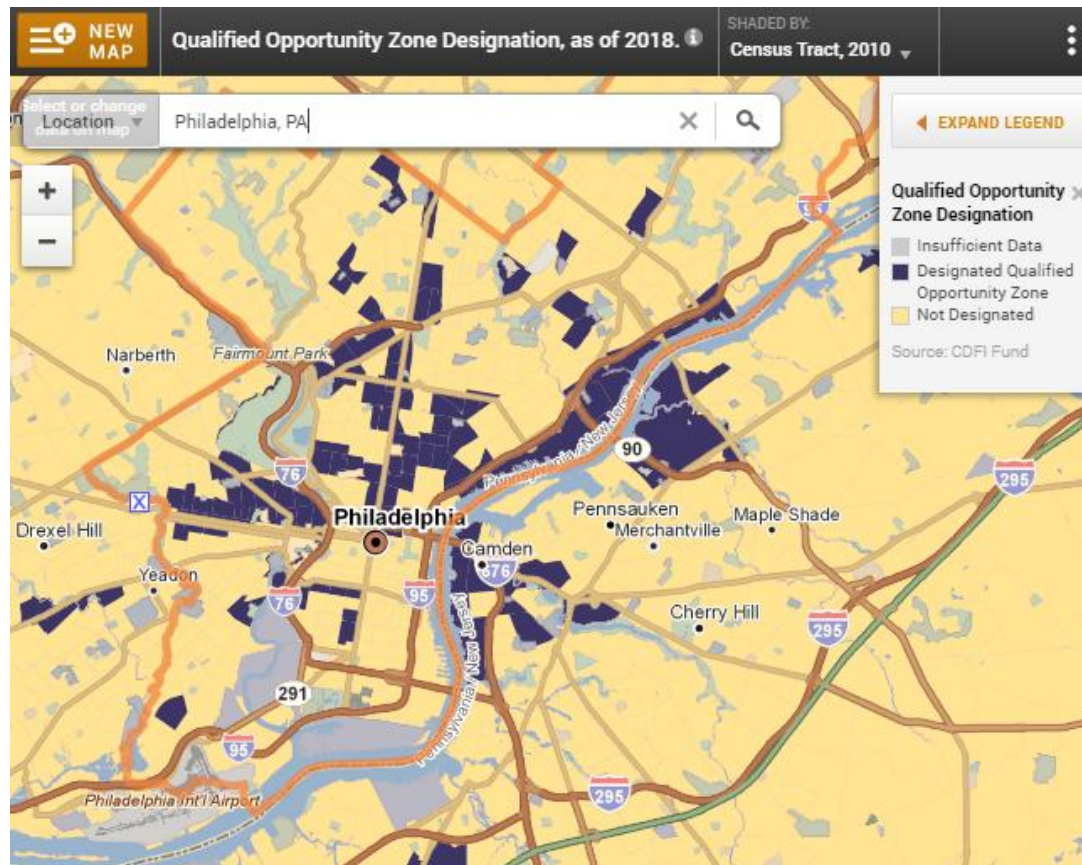
Opportunity Zones

What are Opportunity Zones and where are they?

- An Opportunity Zone (OZ) is a population census that meets the definition of a “low-income” community as that term is defined in the Internal Revenue Code in the context of the New Markets Tax Credit (NMTC)
 - Eligible areas are based on low-income census tracts and tracts contiguous to these low-income census tracts
- These census tracts have been specifically designated as Qualified Opportunity Zones (QOZs) under Section 1400Z
- IRS Notice 2018-48 includes an official list of all population census tracts designated as QOZs
- There are now more than 8,700 certified QOZs in all 50 states, D.C., Puerto Rico and the Virgin Islands
 - 11 percent of the country is designated as an OZ

OPPORTUNITY ZONES

Baker Tilly's mapping tool



Find eligible areas at bakertilly.com/opportunityzones

OPPORTUNITY ZONES

What are the tax incentives for investment in a QOZ?



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Benefits of the OZ

Deferral The original gain invested is generally taxable when the investment in the Opportunity Fund is sold or December 31, 2026, whichever occurs first. However, certain events can accelerate gain recognition.

Partial forgiveness If the OZ investment is held five years, the original gain is discounted 10 percent (15 percent if held more than seven years). Investment must be made by Dec. 31, 2019, in order to qualify for 15 percent discount.

Tax-free appreciation If the Opportunity Fund investment is held for more than 10 years, the tax basis of the OZ investment steps up to its fair market value upon sale.

This is upon an election made by the investor on their tax return covering the period of sale, if the investment's value appreciated. If the value decreased, the election would not be made.

In effect, appreciation on the investment, but not the original deferred gain, is eliminated permanently. Depreciation deductions are a permanent benefit if QOF interest with a 10-year hold is disposed.


OPPORTUNITY ZONES

What gain qualifies for tax benefits?

Participation in the OZ program begins with investing capital gain into an Opportunity Fund.

- It includes long- and short-term capital gain, collectables gain, net section 1231 gains, capital gain dividend distributions, but gains that would generate ordinary income are ineligible.
- The capital gain must originate from a sale or exchange with an unrelated party within the previous 180 days.
- Investing other money alongside capital gain is permissible, but only the capital gain portion of the investment qualifies for the tax benefits.
- When recognized, the deferred gain includes the same attributes in the year of inclusion that it would have had if tax on the gain had not been deferred.

OPPORTUNITY ZONES

How long is the designation?

- The designation of a census tract as a QOZ remains in effect until December 31, 2028
- Qualified gain must be invested in a QOZ before 12/31/2026 for the OZ benefits.
- Recent regulations clarified that if an investment is made, and during the holding period of the investment the QOZ designation expires, the investor will obtain tax-free appreciation on a sale of their investment until a hard date of 2047

OPPORTUNITY ZONES

Taxpayers eligible to elect gain deferral— special rule for pass-throughs

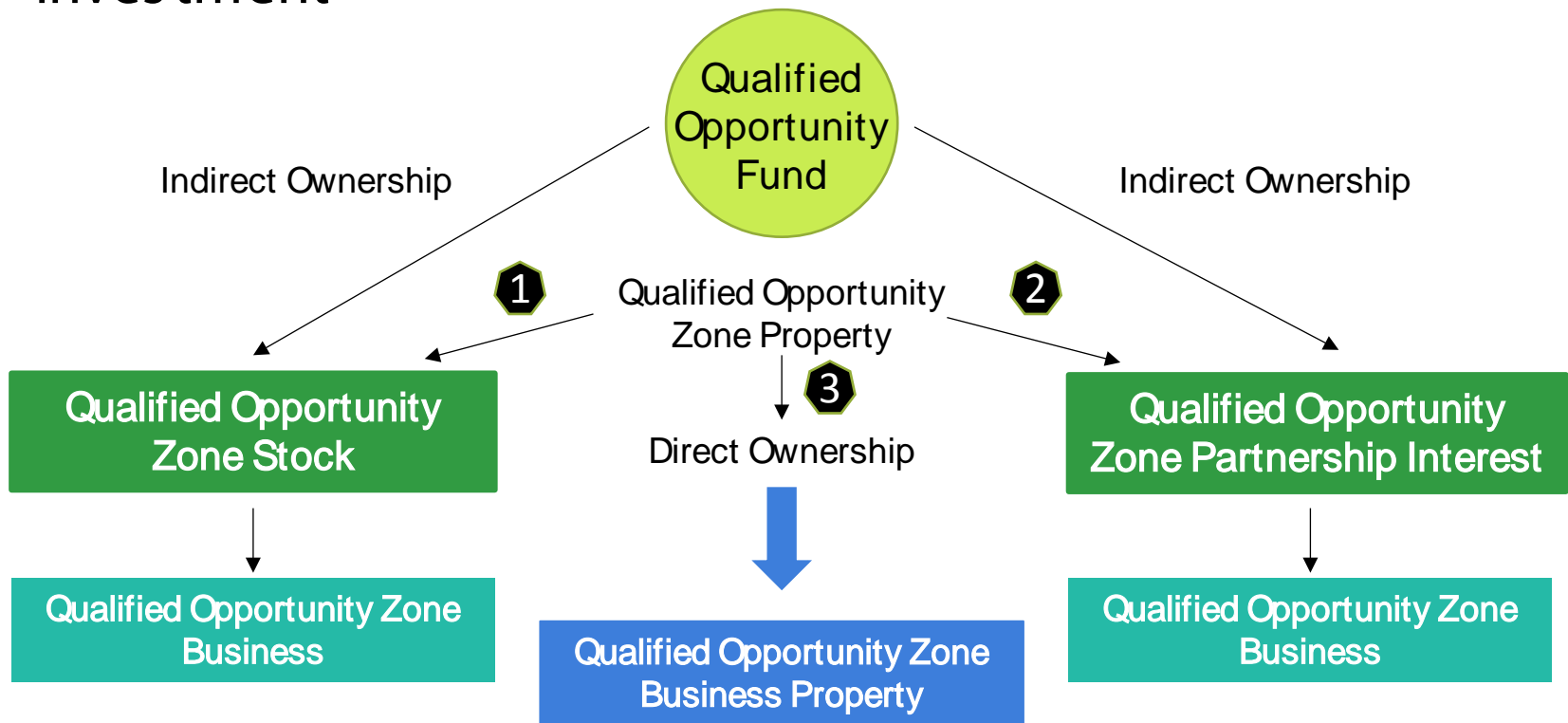
- If a partnership elects to defer the gain, the gain is not included in the distributive share of the partner
- All the tax benefits are applied at the partnership level, and the original gain is not taken into account by the partners
- If a partnership chooses not to defer the gain, then the partner has the ability to make the election with regard to its distributive share
 - The 180-day investment window generally begins at the close of the partnership's taxable year
 - Alternatively, if the partner has actual knowledge of the date the gain is recognized by the partnership, it can elect within the 180-day window beginning on the earlier date
 - Special rule also applies to other pass-through entities, such as S corporations



Partnerships as well as partners are eligible to defer the capital gain.

INVESTMENT STRUCTURE

Options for direct or indirect QOF investment



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What type of investment qualifies?

Qualified Opportunity Zone business property means:

- Tangible property used in a trade or business
 - Rental real estate is a qualifying trade or business
- Property acquired by purchase after Dec. 31, 2017
- The original use of such property in the QOZ commences with the qualified Opportunity Fund or the Opportunity Fund substantially improves the property
- Where the Opportunity Fund owns the property directly, substantially all of the use of such property occurs within a qualified OZ

OPPORTUNITY ZONES

Original use or substantial improvement

The original use of the Opportunity Zone property must commence with the fund or there must be “substantial improvement” to the property.



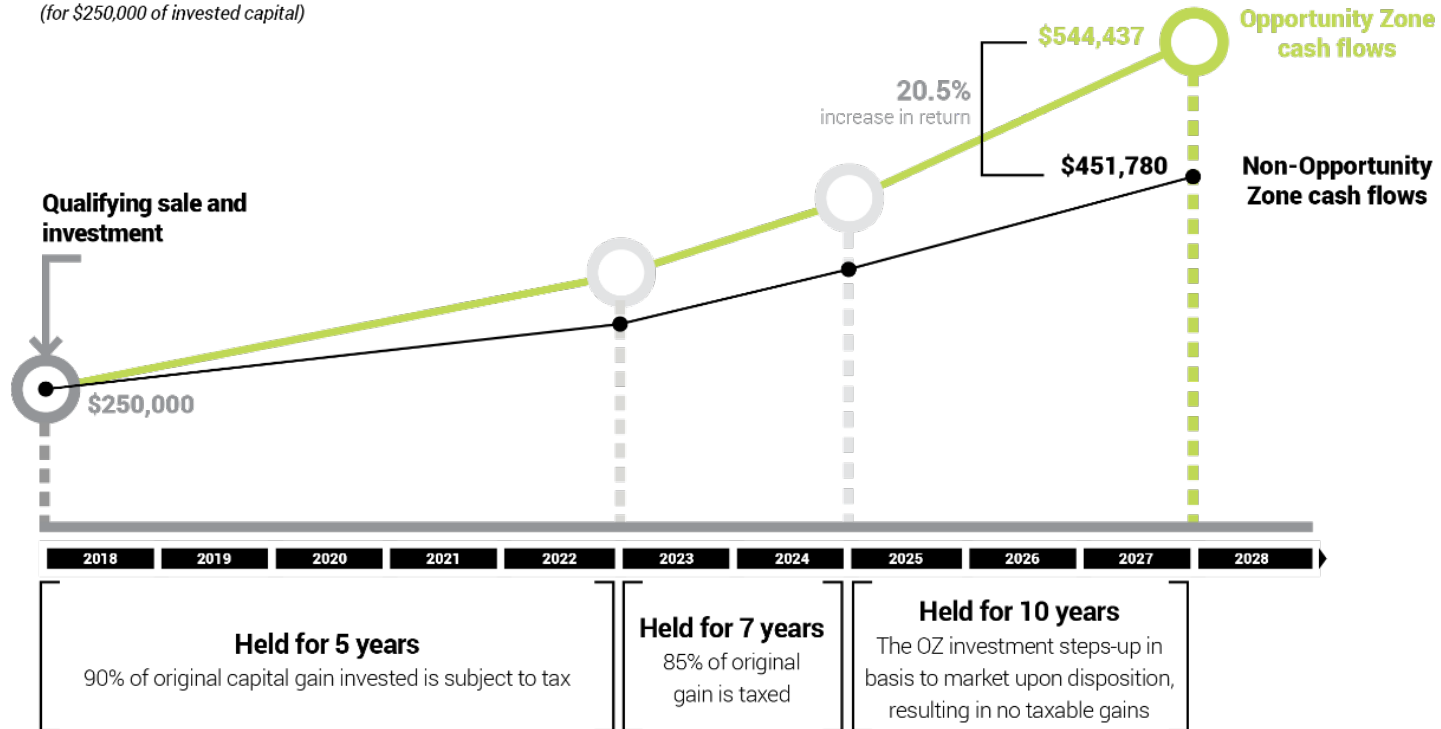
- The Opportunity Fund has a 30-month window to improve the property, such that the basis of the property increases by an amount that exceeds the amount of the adjusted basis at the beginning of the 30-month period.
- The basis of the land is excluded from the underlying calculation.
- For example, an Opportunity Fund acquires a building for \$10 million, \$4 million attributable to the land and \$6 million attributable to the improvement; at the end of 30-month period, improvements of \$6 million + \$1 must be made.

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Benefits of the OZ

Opportunity Zones investment over 5-, 7- and 10-year horizon

(for \$250,000 of invested capital)



***This model assumes a 23.80% federal tax rate and state tax rate of 5.36%. This model is for illustration purposes only, and contains certain financial assumptions as to the possible future results that are inherently uncertain and subjective. We make no representation or warranty as to the attainability of those assumptions or whether future results will occur as illustrated.*

OPPORTUNITY ZONES

Example impact on IRR

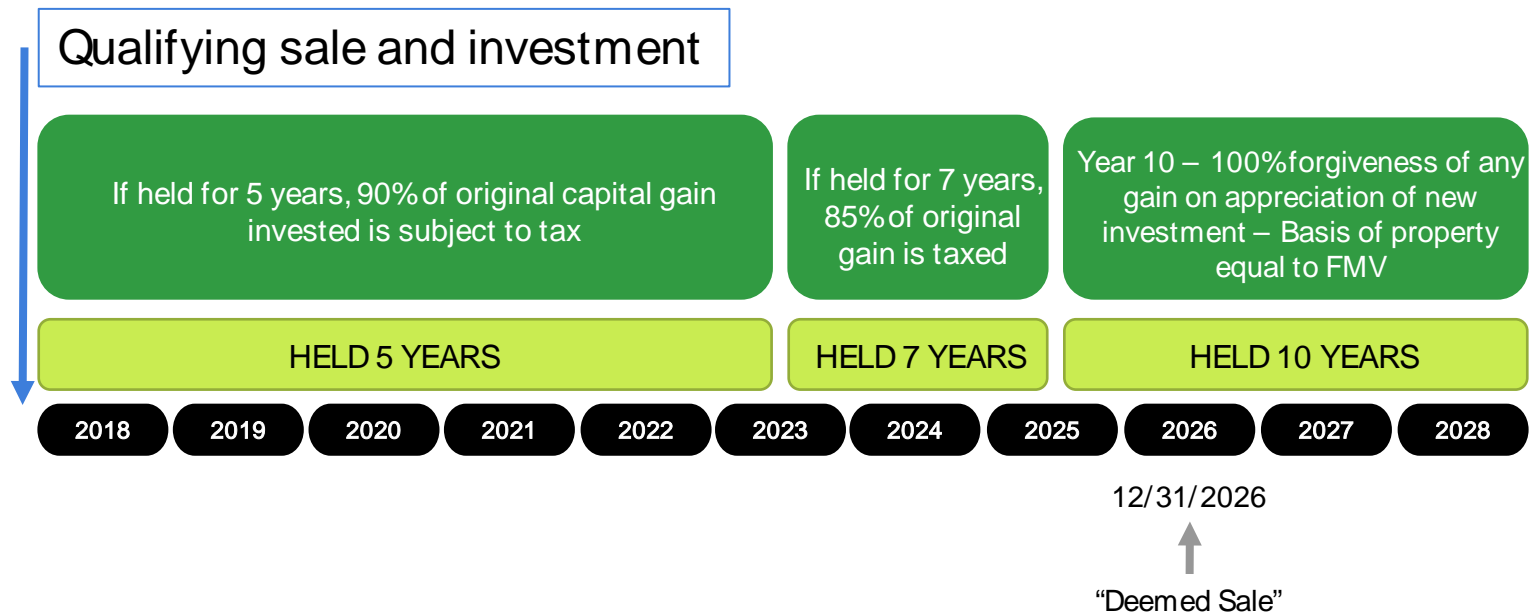
Assumptions

- 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 investors pay 23.8 percent capital gains tax (all investors are 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 passive income taxed at 29.6 percent and tax losses assumed to be used in current year

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

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Capital gain deferral, forgiveness and tax-free appreciation



The year 2026 is important because a QOF investor will be responsible for paying tax on the original deferred gain at rates in existence in 2026. This is true even if the investor does nothing to impair or reduce its QOF investment. The original tax liability may be reduced based on the number of years held, but some portion of it will become due in 2026. The tax that is due is the lesser of (a) FMV over basis of investment or (b) original gain over basis of investment. Investors will need to anticipate this tax liability and plan for the obligation.



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What investment types does the OZ program favor?

Commercial real estate: Works well since the program is focused on long-term investment and real estate is not going to grow out of compliance like an operating business potentially could

New business startup in an OZ after Dec. 31, 2017 Application to a start-up business is significantly easier following recent Treasury guidance. Qualification for OZ benefits is not limited to businesses that only generate revenue from sales within the OZ.

Expanding an existing business into an OZ This investment type is also contemplated, but if the business outside of the OZ is a substantial part of your business, may have to set up a regarded entity to run operations inside the OZ and also for every year thereafter to ensure compliance; 70/30 rule for qualified Opportunity Zone business affords some leeway


Small business already in an OZ with large expansion If already in an OZ at Dec. 31, none of the assets would be qualified Opportunity Zone Business Property; would have to meet "substantial improvement" requirement for new expansion. Challenge for this business model as there is currently a requirement that each asset must be substantially improved, no aggregate test.

OPPORTUNITY ZONES

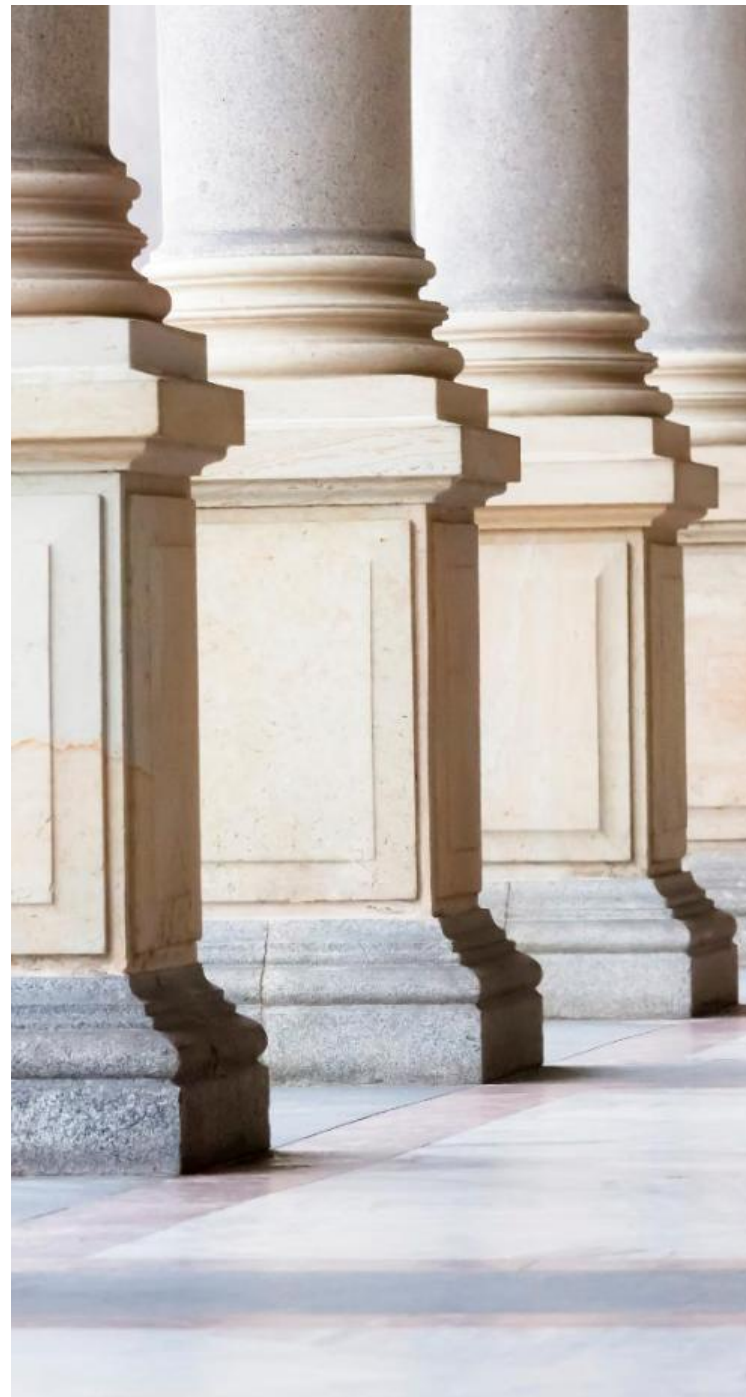
Fund certification

IRS recently provided guidance regarding Opportunity Zone Fund certification:

- To establish an Opportunity Fund, the IRS states that there is no formal approval or action required by the IRS
- **An eligible taxpayer “self-certifies” the investment**
- An informational form (Form 8996) is completed and attached to the taxpayer’s timely filed federal income tax return for the year in which the investment is made and annually thereafter
- This process appears to be very informal with no official IRS consent required for the Opportunity Fund investment



Guidance from Treasury
released on April 17, 2019
significantly improves the
ability of various asset types to
avail themselves of
opportunity zone benefits



NEW GUIDANCE

Investor related provisions

- Gifting of a QOF investment results in termination of QOZ benefits, but a transfer to a grantor trust does not
- Dying with a QOF investment does not terminate benefits, but recipient does not get step-up and is responsible for tax in '26
- Net Section 1231 gains only are qualified gains; 180-day period runs from end of tax year
- Investor may owe tax if QOF partnership or S corporation sells underlying investment before end of 10-year hold
 - Interim gains issue not resolved
- Can contribute cash as well as property, but best to contribute cash as OZ benefits not available for any appreciation attributable to contributed property
- Certain "inclusion events" will cause acceleration of tax on originally deferred gain, many listed in new guidance

NEW GUIDANCE

Exiting the OZ investment

Investors have alternative way to exit OZ after 10-year hold:

- Originally, investors had to sell their QOF interest to get the tax-free appreciation after 10 years.
- Now, alternatively, investors in QOFs organized as partnerships or S corporations can elect to exclude all of the gain flowing from the QOF sale of its equity interest in the lower tier entity.
- If a QOF organized as a partnership has held an interest in a QOZ business taxed as a partnership, and the QOZ business sells property, the proposed regulations do not address whether gain can be avoided for the QOZ business. In the absence of a regulation addressing the issue, it would appear that gain would be currently taxable.
- Consequently, the nature of the QOF investment will dictate the method of investor exit.

NEW GUIDANCE

QOF manager provisions

The new guidance gives QOF managers needed flexibility with one exception:

- Six-month safe harbor for new cash contributed to a QOF. This permits additional time for deployment as it can create as much as a one-year grace period after a QOF receives funds before they need to be expended.
- Rolling investment strategy by QOF permitted if funds are invested in another OZ project within 12 months. Proceeds must be held in cash, cash equivalents or short-term debt instruments.
- The recycling of QOF assets does not cause the recognition of the originally deferred gain; however, interim gains are recognized by QOF investors.


NEW GUIDANCE

Additional QOF related provisions

- If a QOF partnership interest is sold after 10 years with an election to step-up the basis of the QOF interest to fair market value, the QOF investor will not have to pay tax on any ordinary income from depreciation recapture. The proposed regulations provide that when electing to step-up basis when selling the QOF partnership interest after 10 years, the result is that all QOF partnership assets are stepped up and there will be no ordinary or capital gain.
- Carried interests, however, are not eligible for OZ benefits.
- Broad anti-abuse rule applies. If a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of the OZ rules, then the transaction may be characterized by the IRS.

NEW GUIDANCE

Clarification on qualification for operating businesses

- Four different ways for a QOZB to satisfy the 50% income test. The methods are based on either hours of employees and independent contractors, amounts paid for these services, tangible property and management functions, or a facts and circumstances analysis
- Leased property qualifies as active trade or business
- Property leased by either a QOF or QOZB does not need to satisfy the substantial improvement or original use tests
- Some additional requirements for related party leases
- 31-month working capital safe harbor applies to the development of a trade or business, in addition to the acquisition, construction, and improvement of tangible property

NEW GUIDANCE

Real estate questions answered

- Debt-financed distributions permitted with some caveats, e.g., distribution at least 2 years from refinance
- "Original use" was given broad interpretation: eligible property includes used property, property vacant for 5 years, as well as construction in progress. Eligibility tied to depreciation and amortization.
- The leasing of real property is treated as an active trade or business, a "mere" triple-net lease is not eligible
- To meet the requirement that a property be "substantially improved", the determination is on an asset-by-asset, not aggregate basis
- 31-month safe harbor for expenditure of working capital is tolled while waiting for government action; may have multiple 31-month safe harbors tied to tranches of investor capital

NEW GUIDANCE

Questions remain

- Will “substantial improvement” only be considered on an asset-by-asset basis, or will the IRS move toward an aggregate approach?
- Will the tax consequences continue to differ for an investor exit based on the sale of QOF equity versus a sale of the underlying QOZ property?
- What are the implications on the use of Section 1202 Small Business Stock?
- What will be the ongoing QOF reporting requirement for an OZ investment (bills pending in Congress)?
- The IRS specifically exempted from taxpayer reliance the provision concerning the exclusion of gain on sales of underlying QOF assets being excludable from 10-year investor’s income. How might this impact QOF structures going forward?



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