MIDWEST **Opportunity Zone** FORUM

Nurtured by MCM CPAs & Advisors and Frost Brown Todd LLC

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Location Omni Severin Hotel, Indianapolis, Indiana

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What is a Qualified Opportunity Zone (QO Zone)?

- Enacted as part of sweeping federal tax legislation commonly referred to as the Tax Cuts and Jobs Act of 2017.
- Internal Revenue Code (IRC) Section 1400Z-2 provides significant tax incentives for taxpayers to reinvest unrealized capital gains in certain property and businesses located or operating in low-income census tracts that Treasury has designated as qualified opportunity zones ("QO Zone").

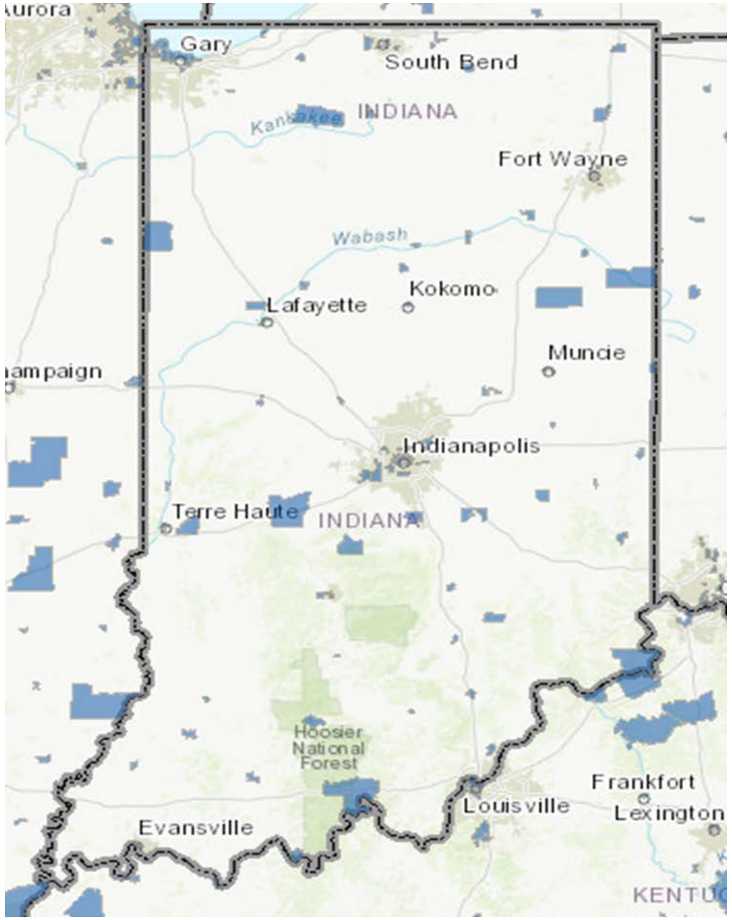
What is a Qualified Opportunity Zone (QO Zone)?

- Census tract determined to be a low-income community.
- Low-income census tract has individual poverty rate of at least 20% and median family income no greater than 80% of the area median.
- Governors of each State nominated eligible low-income census tracts and contiguous tracts. In each state, only 25% of qualified low-income census tracts could be designated as Opportunity Zones. Only 5% of the designated Opportunity Zones could qualify as contiguous tracts.
- The Department of the Treasury then designated the census tracts nominated by each state as QO Zones.
- QO Zones retain designation for ten years.

What is a Qualified Opportunity Zone (QO Zone)?

- Treasury has designated QO Zones in all 50 states, the District of Columbia, and five U.S. possessions.
- In Indiana, Treasury designated 156 tracts in 58 counties covering all or portions of 83 cities and towns throughout the state as QO Zones.
  - 36 designated QO Zones in Marion County.
- In Kentucky, Treasury designated 144 low-income census tracts in 84 counties across the state as QO Zones.
- In Ohio, Treasury designated 320 tracts in 73 counties across the state as QO Zones.

QO Zones in Indiana



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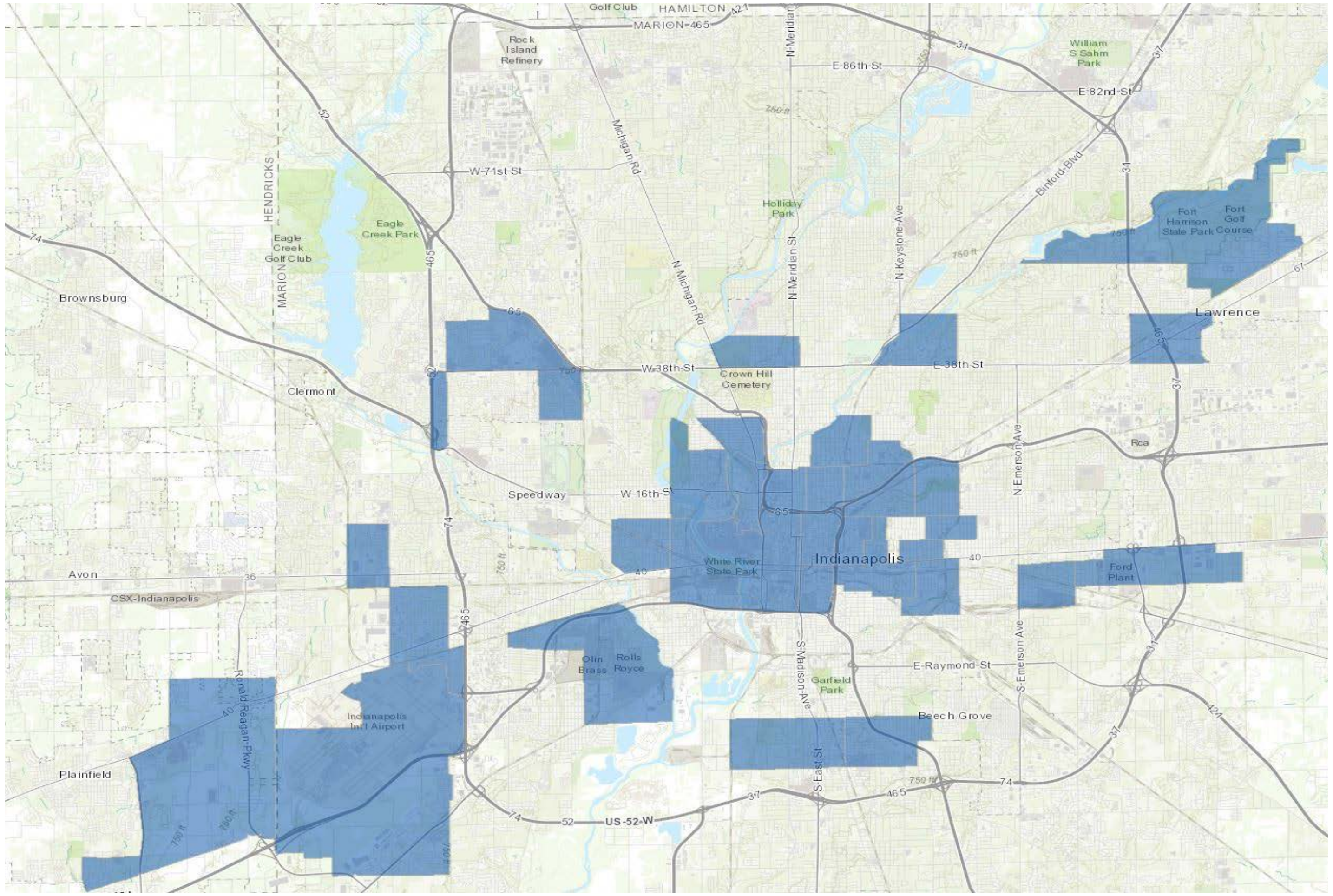
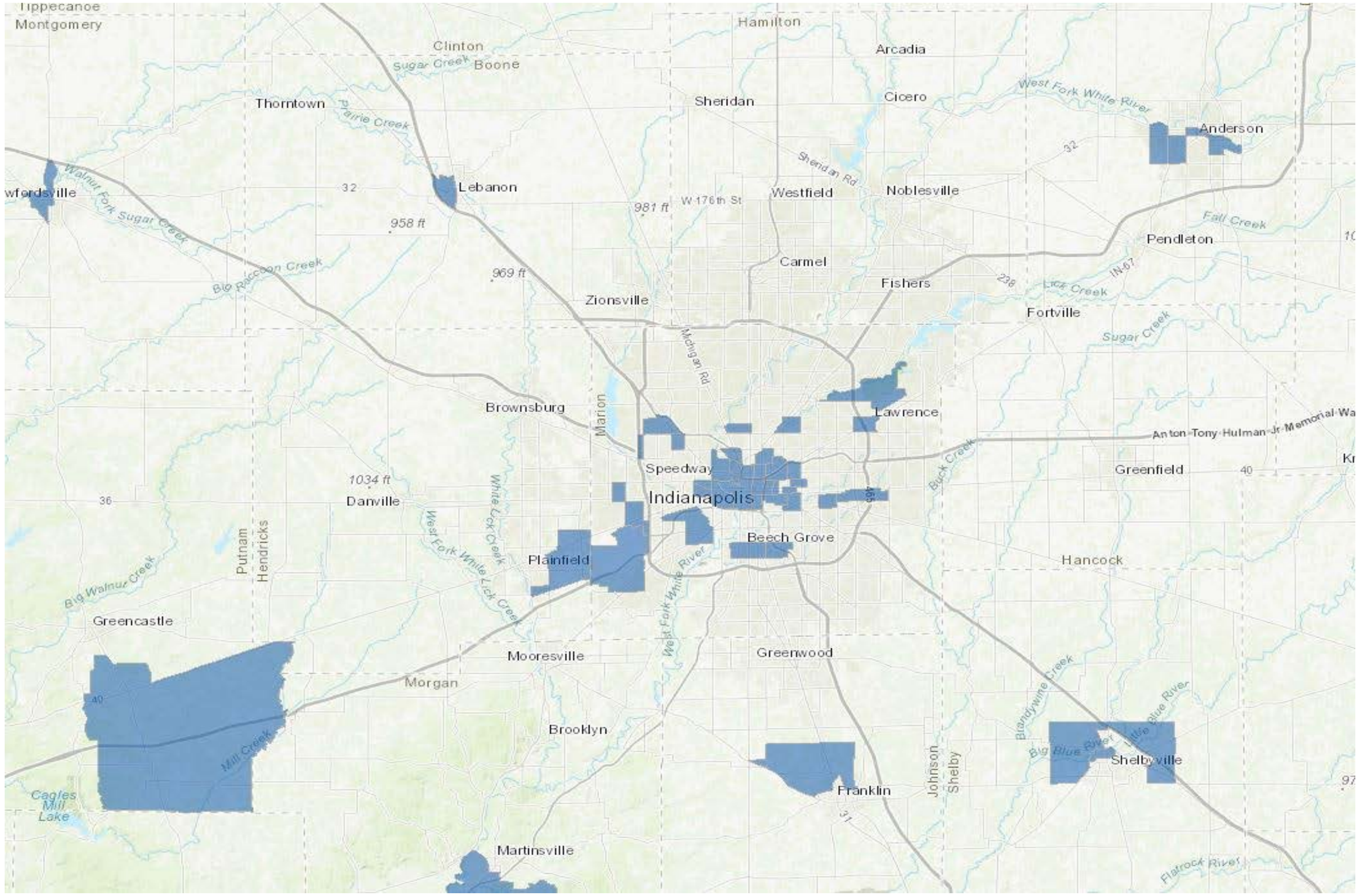
QO Zones in Marion County



QO Zones in Marion County and Surrounding Area



Opportunity Zones – Interactive Map

- An interactive map that permits the user to zoom in on specific addresses, census tracts, and opportunity zones across the country can be found at the following link:
  - https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml

Purpose of QO Zones

- To encourage economic development in "low income areas" by providing various tax incentives for private investments in QO Zones.
- Based on analysis of Federal Reserve data, the Economic Innovation Group, a bipartisan research and advocacy organization that helped plan the initial legislation that formed the basis for the QO Zones incentives, estimated that U.S. taxpayers held $6.1 trillion in unrealized capital gain at the end of 2017. https://eig.org/news/joint-economic-hearing-promise-opportunity-zones
- This significant amount of capital available for reinvestment makes the QO Zones program potentially the largest economic development initiative in the country.

QO Zones – What are the Incentives?

- There are **three** separate investment incentives that a taxpayer can elect to take advantage of with respect to their investment.
  1. Temporary deferral of capital gain.
  2. Step-up in basis.
  3. Permanent exclusion of gain on appreciation.

QO Zone Incentive – Temporary Deferral

- Taxpayer **<u>can elect</u>** under IRC Section 1400Z-2(a)(1)(A) to **<u>temporarily defer capital gain</u>** from the sale or transfer to an **<u>unrelated party</u>** of any property that the taxpayer owns as long as the taxpayer reinvests the deferred amount in a qualified opportunity fund ("QO Fund").
  - **<u>GAINS DEFERRED</u>** – There does not appear to be any restrictions on the types of gains that can be deferred – short-term, long-term, etc.
  - **<u>ANY PROPERTY</u>** – There does not appear to be any restrictions on the types of property that can be sold to generate the gain – not limited to real property or business property.
- Taxpayer must reinvest the deferred amount within the **<u>180-day period</u>** beginning on the date of the sale or transfer of the property generating the gain.

QO Zone Incentive – Temporary Deferral (cont.)

- Gain deferral is temporary because the taxpayer must recognize the income in the tax year the investment is sold **<u>or</u>** the tax year that includes December 31, 2026, whichever is earlier.
- Treasury recently released guidance in the form of an FAQ indicating that a taxpayer can make an election to defer gain when it files a 2018 federal income tax return. However, the form and contents of such an election are still unclear.

QO Zone Incentive – Basis Step-Up

- Where a taxpayer has elected temporary gain deferral, IRC Section 1400Z-2(b)(2)(B) provides a tiered **“step-up” in the taxpayer’s basis** in the gain it reinvests in the QO Fund depending on how long the taxpayer holds the investment.
- Absent this statutory “step-up,” the taxpayer’s initial basis in the reinvested gain is zero.
- **“Step-Up” Holding Period**
  - If the taxpayer holds the investment for at least five years, the taxpayer’s basis in the investment is increased by an amount that is equal to ten percent (**10%**) of the amount of capital gain that the taxpayer elected to defer.
  - If the taxpayer holds the investment for seven years, the taxpayer’s basis is increased by an additional five percent (**5%**) of the deferred gain.

QO Zone Incentive – Basis Step-Up (cont.)

- Because the temporary gain deferral period ends no later than the tax year including December 31, 2026, the taxpayer will need to reinvest capital gain in a QO Fund and elect deferral treatment **by December 31, 2019** to permit the taxpayer to hold the investment for seven years and receive the full benefit of the basis step-up provision.

QO Zone Incentive – Permanent Exclusion

- Taxpayer can **elect** under IRC Section 1400Z-2(a)(1)(C) for an additional basis "step-up" that **permanently excludes capital gain** on the sale or transfer of an investment that the taxpayer holds for at least ten years.
- Where the taxpayer makes an election and holds the investment for **at least ten (10) years**, the taxpayer's basis in the investment is equal to the fair market value of the investment on the date the investment is sold – **taxpayer is able to dispose of the property tax-free**.
- Recent IRS guidance is unclear when/how a taxpayer would elect permanent gain exclusion.
  - Optional – taxpayer can use stepped-up basis if FMV of property decreases.

QO Zone Incentives - Example

Acme Company sells underperforming Division generating $1 million of capital gain. Company reinvests $1 million of gain into a QO Fund and makes the appropriate elections with respect to that investment. Company holds the investment for 10 years and then sells the investment for $2 million.

- **<u>Temporary Deferral</u>**. Company would defer recognition of the original gain on the sale of its division until the December 31, 2026 tax year.
- **<u>Basis Step-Up</u>**. Company would recognize $850,000 of gain in the December 31, 2026 tax year (held investment for at least 7 years = 15% basis increase).
- **<u>Permanent Exclusion</u>**. Company would recognize **<u>no gain</u>** on the subsequent sale of the property in Year 10 (basis = FMV on date sold).

QO Zone Incentives - Example

INVESTMENT HOLDING PERIOD	GAIN ON SALE OF ORIGINAL ASSET	GAIN ON APPRECIATION OF OZ INVESTMENT*	TOTAL TAXABLE GAIN
3 Years	$1 million	$1 million	$2 million**
5 Years	$900,000	$1 million	$1.9 million
7 Years	$850,000	$1 million	$1.85 million
10 Years	$850,000	-0-	$850,000

***Assume OZ Investment is sold for $2 million at the end of each holding period.**
****Absent QO Zone investment option, this would likely be the tax result to Acme Company for the same course of action – initial sale of Division, reinvestment in new project, and eventual sale - $1 million of gain recognized at time of Division sale and $1 million of gain recognized when new project is sold.**

QO Zone Incentives – Example

<u>TAX SAVINGS TO ACME COMPANY</u>

- The tax impact of the QO Zone incentives to ACME Company is:
  - Temporary tax deferral on initial $1 million of gain until December 31, 2026 tax year.
  - Basis step-up in initial investment reducing deferred gain to $850,000.
  - Permanent exclusion of $1 million of gain on investment appreciation.
- **<u>Tax Savings</u>** = $1.150 million of gain that the Company does not have to recognize.

What is a Qualified Opportunity Fund (QO Fund)?

- A QO Fund is any investment vehicle organized as either a partnership (including an LLC treated as a partnership for tax purposes) or corporation that was formed for the purpose of investing in qualified opportunity zone property ("QOZ Property").
- At least 90 percent of the QO Fund's assets must consist of QOZ Property.
- IRS recently confirmed in an FAQ that a taxpayer can self-certify to become a QO Fund - Taxpayers are not required to seek pre-approval or related action to establish a QO Fund.
- To self-certify, the taxpayer will simply complete a form and attach the form to a timely filed federal income tax return for the relevant taxable year. At this time, the IRS has not released the QO Fund self-certification form.
- Self-certification process should simplify the general complexity typically associated with other federal incentive programs and expedite the ability of QO Funds to invest in or acquire QOZ Property.

What is QOZ Property?

- There are three categories of QOZ Property permitted under IRC Section 1400Z-2(d)(2)(A):
    - Qualified opportunity zone stock (“QOZ Stock”);
    - Qualified opportunity zone partnership interest (“QOZ Interest”); or
    - Qualified opportunity zone business property (“QOZ Business Property”).
- QOZ Property cannot include an interest in another QO Fund.

QOZ Stock

- Any stock in a domestic corporation if:
  a. the QO Fund acquired the stock after December 31, 2017 at its **original issue** for cash;
  b. at the time of issue, the corporation was a qualified opportunity zone business ("QOZ Business") or was organized to be a QOZ Business; and
  c. during **substantially all** of the time the QO Fund held the QOZ Stock, the corporation qualified as a QOZ Business.
- At this time, there is no guidance as to what period of time a corporation must qualify as a QOZ Business to satisfy the "substantially all" requirement for QOZ Stock.

QOZ Interest

- Consists of any capital or profits interest in a domestic partnership (including an LLC treated as a partnership for federal tax purposes) if:
    a. the QO Fund acquired the interest after December 31, 2017 in exchange for cash;
    b. at the time the QO Fund acquired the interest in the partnership, the partnership was a QOZ Business or was organized to be a QOZ Business; and
    c. during **<u>substantially all</u>** of the time the QO Fund held the interest, the partnership qualified as a QOZ Business.
- At this time, there is no guidance as to what period of time a partnership must qualify as a QOZ Business to satisfy the "substantially all" requirement for a QOZ Interest.

QOZ Business Property

- Tangible property that a QO Fund or QOZ Business purchased after December 31, 2017 and that is used by the QO Fund/QOZ Business in a trade or business operating in a QO Zone for **substantially all** of the time that the QO Fund/QOZ Business owns the property.
- The **original use** of the property in the QO Zone must begin with the QO Fund or QOZ Business, **or** the QO Fund/QOZ Business must **substantially improve** the property.
  - "Original use" – not defined in the statute. Regulations/caselaw address use of the term in other statutory contexts – "First use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer."

QOZ Business Property

- Property will be treated as "substantially improved" if the basis of the QO Fund or QOZ Business in the property increases over a 30-month period beginning at acquisition by an amount that exceeds its initial basis (i.e., the purchase price) in the property.
    - The improvement expenditures of the QO Fund or QOZ Business in the property over the 30-month period must **exceed** the original acquisition price.
    - Permits parties to purchase and develop property without having to meet the "original use" requirement. Does not permit parties to purchase developed property with little or no additional improvement.
- The statute does not define what period of time or what amount of use would satisfy the "substantially all" requirement for QOZ Business Property.

QOZ Business Property – Related Party Restriction

- To qualify as QOZ Business Property, the QO Fund or QOZ Business can only acquire the property from an **unrelated party**.
- Property that a QO Fund or QOZ Business purchases in a transaction involving certain prohibited relationships such as individuals from the same family, entities related through common ownership or control, or entities from the same controlled group, may **NOT** be considered QOZ Business Property.

What is a QOZ Business?

REQUIREMENTS:

1. The activity must be a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is QOZ Business Property.
2. At least 50% of the total gross income of the taxpayer must be from the active conduct of such trade or business activity, and the taxpayer must use a substantial portion of its intangible property in the active conduct of such trade or business.
3. Less than 5% of the average aggregate unadjusted bases of the property of the entity may be attributable to nonqualified financial property (e.g., debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, or annuities).
4. **"Sin Business" Restriction** The trade or business activity must not constitute a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

Mixed Fund Investment

- A taxpayer is permitted to invest funds in a QO Fund of which only a portion of the investment consists of gain for which the taxpayer made a deferral and exclusion election under IRC Section 1400Z-2.
- However, taxpayer will only be entitled to Opportunity Zone tax incentives on the portion of the investment for which the taxpayer made the election (i.e., the reinvested capital gain).
- If the taxpayer makes a "mixed fund" investment, the taxpayer is treated as having made two separate investments in the QO Fund – one investment to which the deferral election was made, and the other investment consisting of the remaining amount. The tax incentives only apply to the former investment and not the latter.

Civil Penalties for Noncompliance

- If a QO Fund fails to meet the requirement that it must hold at least 90 percent of its assets in QOZ Property, the QO Fund must pay a penalty for each month that the fund is in non-compliance.
- No penalty will be imposed where there is **reasonable cause** for the QO Fund's failure to meet the threshold. At this time there is no guidance as to what might constitute "reasonable cause".

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