



MIDWEST **Opportunity Zone** FORUM

Nurtured by MCM CPAs & Advisors and Frost Brown Todd LLC

Date: Wednesday, May 8, 2019

7:30am – 9:00am

Location Galt House Hotel – East Tower

Presenters Chris Coffman and Amy Curry, FBT

Stephen Lukinovich and Andy Ackermann, MCM

Agenda

- Highlight General Opportunity Zone Rules
- Highlight October, 2018 - 1st Round Proposed Regulations
- April 17, 2019 - 2nd Round Proposal Regulations
- Questions 8:45am – 8:55am
- Closing Remarks / Adjourn 9:00am

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 – proposed regulations provide that “permanent exclusion” election can be made until 12/31/2047

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
- An interactive map and general opportunity zone updates and information can be found at the following link:
 - www.midwestoppzone.com

QO Zones – What are the Incentives?

- Investment incentives a taxpayer can elect to take advantage of with respect to their Opportunity Zone investment:
 1. Up to 7 year temporary deferral of capital gain invested in an Opportunity Zone Fund, through 12/31/2026, taxed 85%
 2. Permanent exclusion of gain on appreciation – 10 year hold

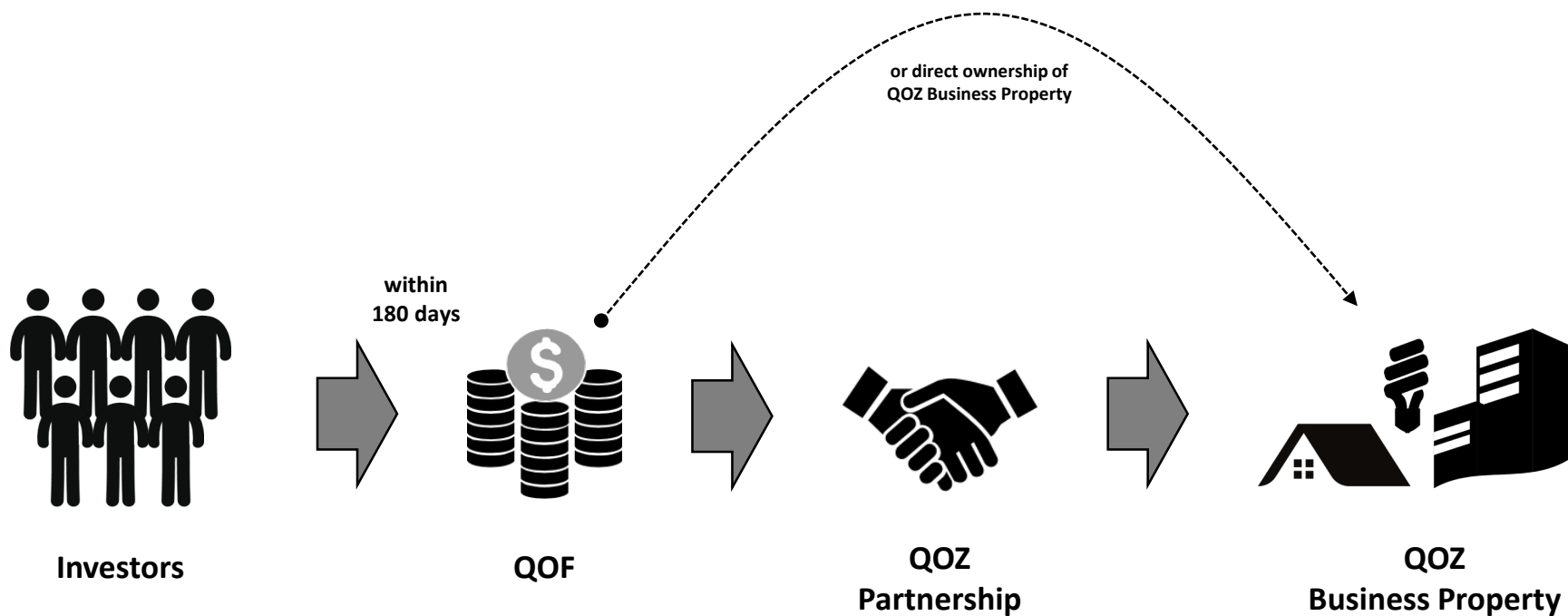
QO Zones Incentive – Temporary Deferral

- Gain deferral is temporary because the taxpayer must recognize the income in the tax year the investment is sold or the tax year that includes December 31, 2026, whichever is earlier.
- Treasury released guidance in the form of an FAQ indicating that a taxpayer can make an election to defer gain when it files a federal income tax return in the year gain would have been realized:
 - Taxpayers will use Form 8949 - elect to defer gain
 - Fund uses Form 8996 – self certify Fund: 90% test – six month rule

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**.
 - Unrelated party = less than 20% common ownership
- 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.

Basic Model for Rental Real Estate



Rental Real Estate

- New construction, or
- Substantial improvement of adjusted basis of building excluding land

October, 2018 - 1st Round Proposed Regulations

- **Existing Real Estate**
 - Real Estate Acquisition - Improve Building > 100%
 - Do not need to improve land
 - Rev. Rul. 2018-29
- **70% - 30% Test**
 - 70% of tangible property owned or leased by the operating business must be qualified opportunity zone business property.
- **50% Revenue Test**
 - Trade or Business – “Active Conduct” – 50% of gross income derived from within an Opportunity Zone

October, 2018 - 1st Round Proposed Regulations

- **Eligible Gains**
 - Long-term or short-term capital gains, including Section 1231 gains – does NOT include Section 1245 or Section 1250 ordinary recapture gains

- **Capital Gains Inside** Partnership, Trust or S-Corporation - “pass-through entity”
 1. Roll-over gain - 180 days, Entity level, or

 2. Partner/Shareholder/Beneficiary level – roll-over gain 180 days: date of gain or 12/31

April 17, 2019 - 2nd Round of Proposed Regulations

- 50% Gross Income Test

1. To be a QOZB, corporation or partnership must derive at least 50% of its total gross income from the active conduct of a trade or business within a QOZ.

2. 3 Safe Harbors and a facts and circumstances test for evaluating compliance.

- (a) 50% of the services performed (based on hours) for such business by its employees and contractors are performed within the QOZ;

Example: startup business develops software applications for global sale at campus located in an OZ.

- (b) 50% of the services performed (based on amounts paid)

Example: startup business uses non-OZ service center. More employee hours at service center, but 50% of total compensation is for services performed on the OZ campus.

- (c) Conjunctive test – Tangible property and management/operation functions of QOZB located in QOZ are necessary to generate 50% of gross income.

Example: landscaper's headquarters and equipment storage in QOZ.

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- What if property held by an Opp Fund is sold, triggering capital gains – is the rollover gain tax free?
 - No - the gain on property held by the Opp Fund must be taxed – no authority
 - However, can hold cash for 12 months and rollover into eligible property – “reasonable period of time to reinvest” – extension for delay based on government inaction
 - 12 month period protects against blowing 90% test.
 - Appears to be limited to QOF’s sale of qualifying property and reinvestment – what about sale of assets by QOZB?

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- Statute imposes **“original use”** requirement for both real property and tangible personal property – tangible property acquired by purchase must have its “original use” in a QOZ commencing with a QOF or QOZB, or be substantially improved, in order to qualify for tax benefits.

Issues

- Can tangible property be used property, or must it be new property? Does property previously placed in service in the OZ for one use, but now placed in service for a different use, qualify?
- May property used in the OZ be placed in service in the same OZ by an acquiring, unrelated purchaser?

Answer

- “Original use” of tangible property acquired by purchase by any person begins on the date when that person or a prior person first places the property in service in the qualified OZ for purposes of depreciation or amortization (or first uses the property in the OZ in a manner that would allow depreciation or amortization if that person were the property’s owner) – issuance of CO?

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- Tangible property located in an OZ that is depreciated or amortized by a taxpayer other than the QOF or QOZB would not satisfy the original use requirement. – Conversely, tangible property (other than land) located in the OZ that has not yet been depreciated or amortized by a taxpayer other than the QOF or QOZB would satisfy the original use requirement.
- **Used tangible property** will satisfy the original use requirement with respect to a OZ so long as the property has not previously been used within that OZ in a manner that would have allowed it to be depreciated or amortized by any taxpayer.

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- “Substantially All”
 - Prior regulations (October 29, 2018) – at least 70% of the tangible property owned or leased by a trade or business is QOZB property. 70% threshold was limited to this specific “substantially all” test.
- Other sections also use phrase “substantially all”
- During substantially all of the QOF’s holding period for such property, substantially all of the use of such property was in a qualified opportunity zone.
- During substantially all of the QOF’s holding period for QOZ stock or QOZ partnership interests, such corporation or partnership qualified as a QOZB.
- New regulations provide that: (1) substantially all requirement regarding “use” is satisfied if at least 70% of the use of such tangible property is in a QOZ; (2) substantially all requirement regarding the “holding period” is defined as 90%.

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- Profits Interest Partners – Opportunity Zone Fund

- Can an investor receive a profits interest in an Opportunity Zone Fund in exchange for services?

- Profits interest partner ineligible for Opportunity Zone incentive/benefit

- What about a low basis Opportunity Zone investor?

- Small capital/equity interest in Opportunity Zone partnership

April 17, 2019 - 2nd Round of Proposed Regulations

- Property Owners/Landlord - No Triple Net Leases. Not considered a trade or business – some active management role required. – trade or business defined within the meaning of IRC section 162.
 - Ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business for OZ purposes – not intended to apply to the meaning of “active conduct of a trade or business” in other IRC Sections.
- 5 year Test – Vacant/Unused Property – Considered original use – great news!
 - Although no substantial improvement is required, vacant property must be used in a trade or business (as defined within the meaning of IRC Section 162) of a QOF or QOZB.
 - Must make new capital investment in the property or increase the economic activity or output of the property – not solely for investment

April 17, 2019 - 2nd Round of Proposed Regulations

Unimproved Land

- Rev. Rul. 2018-29 - Can unimproved land be considered QOZB property? Land can be treated as QOZB property **ONLY** if it is used in a trade or business (as defined within the meaning of IRC Section 162) of a QOF or QOZB.
- Holding of land for investment does not give rise to a trade or business and such land could not be QOZB property.
- QOF or QOZB should make new capital investment in the land or increase the economic activity or output of the land. –
 - Example: QOF's acquisition of land currently used entirely by a business for the production of an agricultural crop – no new investment or increased economic output = no tax incentive.
- If a significant purpose for acquiring unimproved land was to achieve an inappropriate tax result – general anti-abuse rule treats the acquisition of the unimproved land as an acquisition of non-qualifying property. – prevent abusive transactions such as “land banking.”

April 17, 2019 - 2nd Round of Proposed Regulations

Lease Items

- **Uncertainty Under Previous Guidance**
 - 70/30 test required threshold amount of QOZB property either owned or leased.
 - Statute defined QOZB property as “purchased”.
 - **ISSUE** – Could leased tangible property be treated as QOZB property?
- **Leased Tangible Property Can Qualify**
 - Lease entered into after 12/31/2017
 - Substantially all of the use of the leased property must be in the QOZ.
 - Market-Rate Lease – arms length terms consistent with market (IRC § 482).
 - No “original use” requirement = No requirement to substantially improve

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Lease Items

- **Related Party Rent is appropriate**

- Must be Market Rate Lease – terms arms-length, consistent with market
- No prepayment for a period of use exceeding 12 months
- Lessee must acquire qualified property in excess of lease value within 30 months
- General anti-abuse provision – intent to avoid “substantial improvement”

- **Value Lease Arrangements**

Value of lease eligible for purposes of meeting the 90% and 70%/30% tests – “present value” = sum of the present values of the payments to be made under the lease.

- **Improvements to Leased Property**

Satisfy the original use requirement and are considered purchased property

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Accelerating Investor Deferred Capital Gain

- **General Rule**

Deferred gain recognized on the earlier of disposition of qualifying investment or 12/31/26

- **Transfer by Gift of a Partner's Ownership Interest**

However, transfer by gift to grantor trust and taxpayer is the deemed owner – no inclusion event

- **Distributions in Excess of Partner's/Shareholder's Basis**

For a Partnership - includes eligible debt Basis: QNR and Recourse Debt

- **Dissolution of the Opportunity Zone Fund**

- **Claim of Worthlessness by an Opp Zone Investor**

- Transfer by reason of Death – From deceased Estate – no inclusion event

- Contribute membership interest to another partnership, unless upper tier

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QOF Investments held at least 10 years

- **General Rule**
 - Where the taxpayer sells or exchanges a qualifying investment held for at least 10 years, the taxpayer can make an election to adjust the basis to FMV.
 - Fosters sale of QOF assets rather than equity interest in QOF.
- **Special Election Rules for QOF Partnerships**
 - Basis of the partnership interest is adjusted to an amount equal to the FMV of the interest including debt.
 - Immediately prior to the sale the basis of the QOF partnership assets are also adjusted.
 - Regulations do not address whether a QOZB is entitled to make the same election.

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QOF Investments held at least 10 years

- If a taxpayer holds a qualifying investment for at least 10 years, and the QOF partnership or QOF S corporation disposes of QOZ property after the 10 year period:
 - The taxpayer may make an election to exclude from gross income some or all of the capital gain arising the disposition reported on the QOF's K-1 and attributable to the qualifying investment.
 - Again, the regulations do not address whether a QOZB is entitled to make the same election.

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Partnership Distributions

- **General Rule**
 - Actual or deemed distribution of property is an inclusion event to the extent the distributed property has a FMV in excess of the partner's basis.
- **Reduction in Investment – Disguised Sale**
 - A transfer to a partnership will not be treated as an eligible investment to the extent the partnership makes a distribution to the partner and the transfer to the partnership and the distribution would be recharacterized as a disguised sale.
- Distributions that a QOF partnership makes to its partners that are made more than 2 years after the investors' contribution and that do not exceed the investors' basis will likely not be an inclusion event.

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Eligible Investments in Opportunity Zone Fund

- **Section 1231 Gains – 180 day rollover period begins last day of taxable year**
Not a good answer if looking to make roll-over sooner – could slow investment for some taxpayers even where the taxpayers do not anticipate any 1231 losses.
- **Need to watch Section 1231 ordinary Gains, including 5 year look back**
- **Regulations are Proposed – Depart from this position?**
Can you bifurcate Section 1231 Gains – Ordinary (ineligible for incentive – taxable) and Capital Gains (eligible for Opportunity Zone incentive)

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Eligible Investments in Opportunity Zone Fund

- **Contributed Property counts!**

Not just cash!

Only Adjusted Basis of Property counts

Contributed property will not be a good asset in the Fund

- **Property can transfer to a Opp Fund – fully taxable transaction – gain ineligible for Opportunity Zone incentive**

Gain from sale of property to QOF in exchange for equity interest in QOF is not eligible for deferral.

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- **Qualified Opp Zone investor can sell ownership interest to another Qualified Opp Zone investor**
- **For purposes of Original Use – when taxpayer depreciates property**

Only Adjusted Basis of Property counts

Contributed property will not be a good asset in the Fund

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Miscellaneous

- Real Property Straddling a QO Zone – may be considered in the QOZ if the cost of the real property inside the QOZ is greater than the cost of the real property outside the QOZ.
- Inventory in Transit - Proposed regulations clarify that inventory (including raw materials) of a trade or business does not fail to be “used” in an OZ solely because the inventory is in transit from a vendor to a facility of the trade or business that is in an OZ, or from a facility of the trade or business in an OZ to customers located outside the OZ. Inventory in transit at testing period does not count against the QOF or QOZB regarding substantially all (90%) of the “use” was in an OZ.
- No Aggregation for Substantial Improvement Purposes - The determination of whether the substantial improvement requirement is satisfied for purchased tangible property is made on an asset-by-asset basis. No aggregate approach for substantial improvement of property grouped by the same location.

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Miscellaneous

- Use of Intangibles – For purposes of determining whether a substantial portion of intangible property of a QOZ Business is used in the active conduct of trade or business, the term “substantial portion” means at least 40 percent.
- Working Capital Safe Harbor – 2 changes to “safe harbor” – (1) written designation for planned use of working capital now includes development of trade or business, and (2) exceeding 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action – application for such action completed during 31-month period.
- Relief for Newly Contributed Assets – QOF allowed to apply 90% test without taking into account any investments received in the preceding 6 months.

Presenters



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