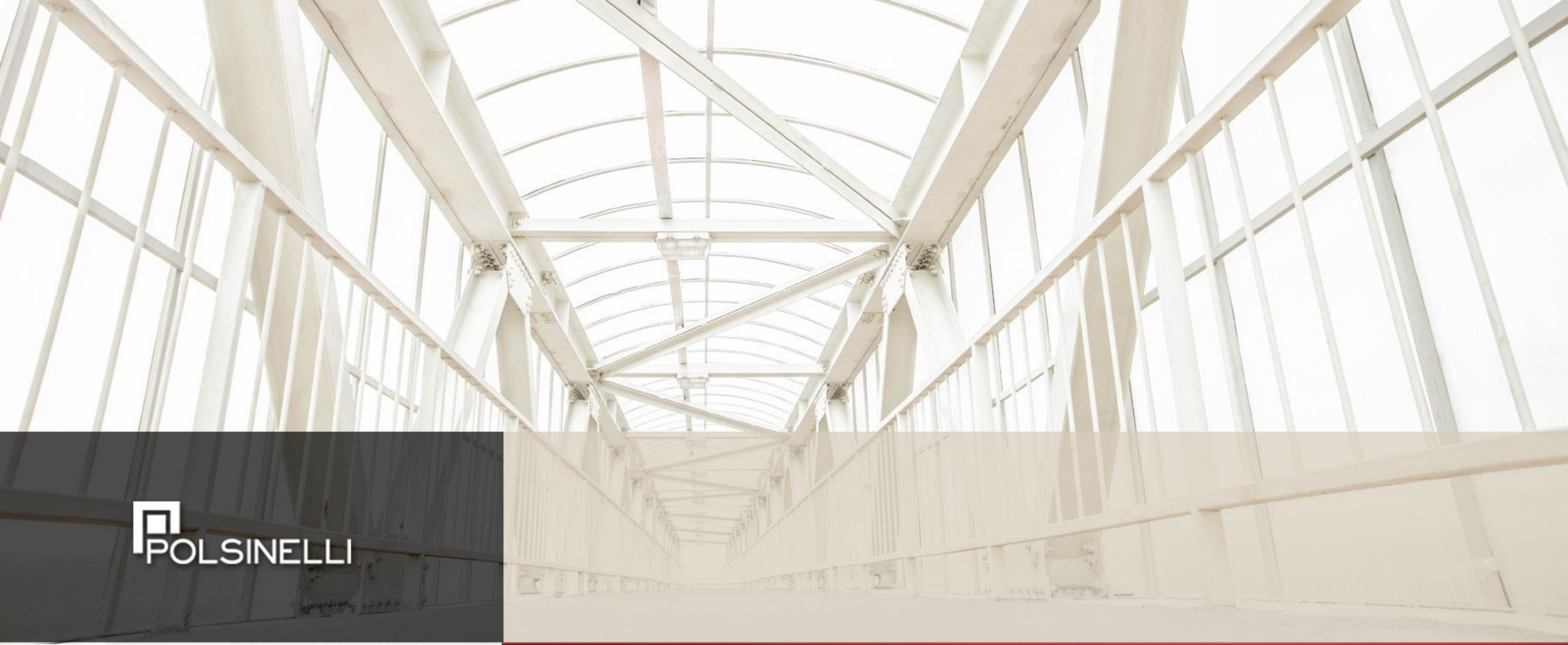

Investment in Federal Opportunity Zones

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Tax Incentive Benefits – How the Deferral Works

1. **Deferral of Gain** **2.** **Partial Forgiveness of Deferred Gain** **3.** **Forgiveness of Additional Gains**

- Time value of money – earlier of:
  - Date the investment is sold or exchanged; or
  - December 31, 2026
- Gain recognition
  - Amount of gain (or FMV)
  - less: the taxpayer's basis in the fund
- Partial Forgiveness of Gain – Step up in basis
  - 5 year (10%)
  - 7 year (15%)
- Forgiveness of additional gain
  - Timing – 10 years
  - Basis

Investment Timing

Timing of investments Prior to the Proposed Regulations

- An investor realizes gain from the sale or exchange of a capital asset
- This investor then has 180 days from the disposition to reinvest the gain in a Qualified Opportunity Fund, and have test dates at half-year and full-year mark to meet 90% asset test
- Partial forgiveness would happen after 5 and 7 years
- Full step-up after 10 years

Qualified Opportunity Zone Business

- A trade or business
- **Substantially all** of its tangible property (whether owned or leased) is **Qualified Opportunity Zone Business Property**

AND

- At least 50 percent of its gross income must be from the **active** conduct of a trade or business in an Opportunity Zone,
- A substantial portion of its intangible property must be used in the **active** conduct of its business in an Opportunity Zone,
- No more than 5 percent of the average unadjusted basis of its assets may consist of "non-qualified financial property,"
- Cannot be a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off-premises

Qualified Opportunity Zone Business Property

Qualified Opportunity Zone Business Property is tangible property used in a trade of business if:

- It is acquired by purchase (as defined in Section 179(d)(2) related party rules, but using a 20% related party test instead of 50%) after December 31, 2017;
- The original use in the Qualified Opportunity Zone commences with the Qualified Opportunity Zone Business

OR

- The Qualified Opportunity Zone Business **substantially improves** the property; and
- During **substantially all** of the holding period for such property, **substantially all** of the use of such property is in an Opportunity Zone.

Proposed Regulations Issued by the IRS

On October 18, 2018, the IRS issued proposed regulations concerning the investing in Opportunity Zones.

- Addressed a lot of questions, but more regulations are coming
- Generally, the proposed regulations are investor friendly
- While not finalized yet, taxpayers are permitted to rely on these regulations if applied entirely and in a consistent manner

Land

Issue: Under the original use and substantial improvement test how is land treated?

Guidance: Under a revenue ruling released at the same time as the regulations, the IRS concludes that where there is a purchase of land and an existing building, only the amount allocated to the existing building must be "doubled"

Polsinelli Practice Points:

- Very investor friendly
- Lemonade stand?
  - New property on vacant land
- Value add rehabilitation projects
- Coasts opened up

Investment of Capital Gains for Pass-Thru Entities

Issue: What timeline do partnerships have to invest after capital gain event? Partners?

Guidance:

- Partnerships have the option of investing capital gains in an Opportunity Zone itself
- If the partnership does not invest in an Opportunity Zone, then the partners have 180 days from the end of the partnership's taxable year to invest
  - Partners can also select the 180-day period starting from the date the partnership sold the property
  - Because of these rules, partners may still be able to invest capital gains, even if 180 days has already passed
- These rules will also apply to S corporations and other pass-thru entities

Polsinelli Practice Points:

- Consider adding capital gain notice provisions to partnership agreements
  - Gives partners flexibility as to which 180 window to invest
  - a K-1 received following a partnership return filed on extension would be received after the partner's 180-day period has expired
- Donut-Hole?

Working Capital

Issue: How will funds be able to ramp-up/deploy all of their capital?

Guidance: The proposed regulations contain a safe harbor for working capital that is invested in Opportunity Zone Businesses that acquire, construct, or rehabilitate tangible business property

- The safe harbor permits working capital to be held for 31 months if there is a written plan identifying the funds and a schedule of the expected expenditures, and the funds are actually used in a manner that is "substantially consistent" with the write-up
- Working capital can be held in cash, cash equivalents, or debt instruments with a term of 18 months or less

Polsinelli Practice Points:

- Way to smooth out the timeliness and "clunkiness" of the law
- Applies to opportunity zone businesses—not funds
  - Direct investment by a fund into property may not be ideal
- Need for plan favors concrete business model, blind pools disfavored

Tangible Assets “Substantially All” Test

Issue: Will opportunity zones be solely a real estate play or will it work for the “real economy?”

Guidance: Proposed regulations define “substantially all” in this case as 70%

- This will help investors in non-real estate businesses take advantage of Opportunity Zone benefits
- Proposed regulations provide alternative methods for complying with the “substantially all” test:
  - Values in an applicable financial statement; or
  - Methodology used by fund investors (if no applicable financial statements)

Polsinelli Practice Points:

- This was a substantial move by Treasury
  - Open the door to operating businesses
- This rule is also applied to intangible assets; issue?
- “Delivery Truck” issue

Leverage

Issue: Will leverage be allowed by Opportunity Zone Funds?

Guidance: The proposed regulations provide that deemed contributions of money derived from a partner's share of partnership debt do not create a separate, non-qualifying investment in the Opportunity Zone Fund.

Polsinelli Practice Points:

- Opportunity Funds will be able to borrow funds without creating a separate investment that is ineligible for the 10-year exclusion
- Proposed regulations imply that partners in Opportunity Funds do get outside basis for amounts borrowed by the Opportunity Zone Fund
  - This potentially permits investors to take advantage of Opportunity Zone Fund losses (such as depreciation).
- Treasury requested comments regarding whether there should be anti-abuse rules in the final regulations

Early Dispositions of Opportunity Zone Interest

Issue: What happens if an investor wants to sell all of its interest before the end of the deferral period?

Guidance: The original gain deferral can continue if reinvested in new Opportunity Zone Fund within 180 days

Polsinelli Practice Points:

- Helps investors that have invested poorly
  - Risk that the 10 year clock will restart
- Future regulations will address what happens when the fund sells the property

Other Topics Covered in the Proposed Regulations

Special Allocations are Permitted

- For Opportunity Zone Funds organized as partnerships, the proposed regulations specifically permit special allocations.
- Possibly allow for some “carried interest” but to what extent?

Testing Dates for 90% Compliance

- Last day of the 6th month following formation; and
- Last day of the tax year
  - Funds started later in a year might have 1 testing date
  - Potential “End of Year Trap”

LLCs as Opportunity Zone Funds

- Permitted so long as the LLC is taxed as a partnership or corporation

Valuation of Assets for the 90% Test

- Applicable Financial Statement; or
- Cost Basis

Topics Not Covered

This set of proposed regulations did not cover these topics:

- Original use
- Interim gain
- “Substantially all” (besides tangible assets)

Qualified Opportunity Zones

Questions?

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