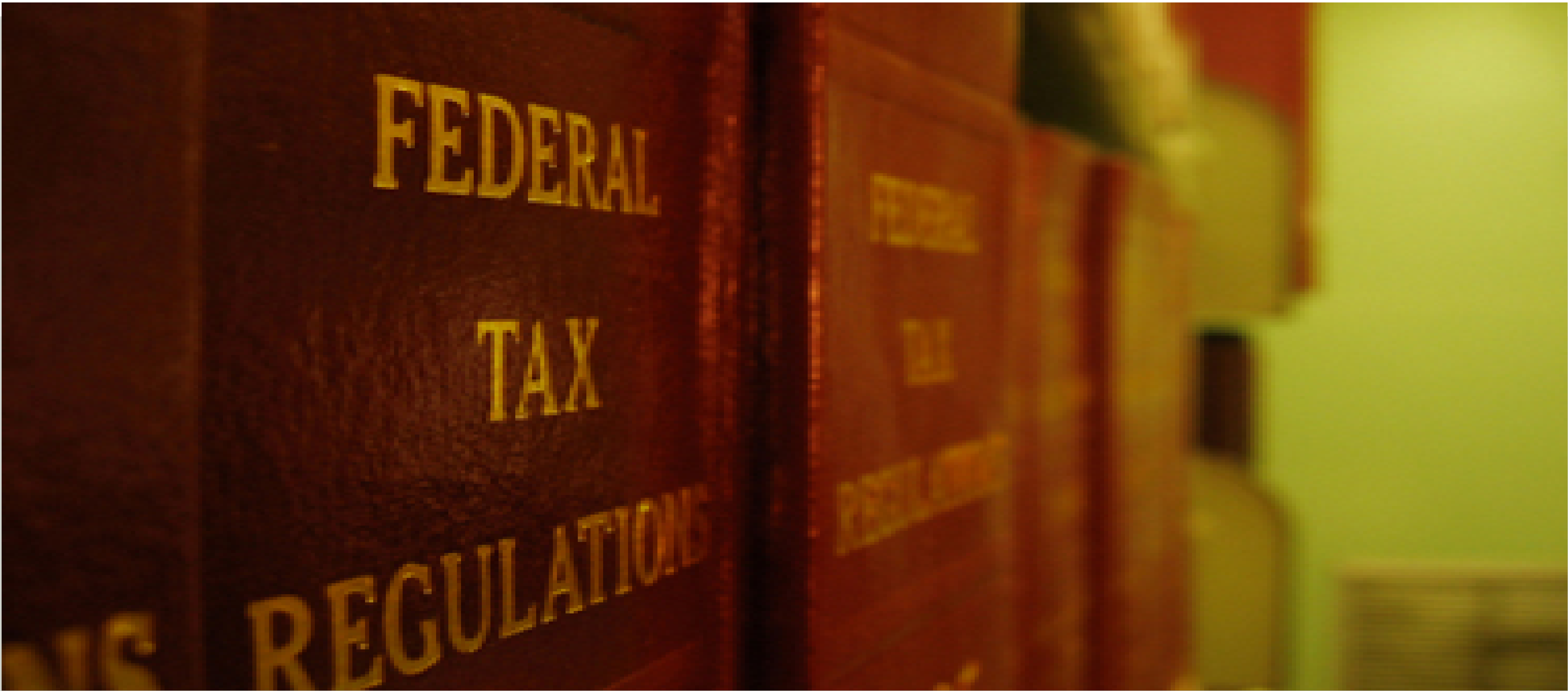
Ballard Spahr LLP

Helps Build the Nation

Qualified Opportunity Zones



Welcome and Introductions

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Introduction

- Opportunity Zones provide **capital gains** relief to investors who invest gains from prior investments into a **Qualified Opportunity Fund,** which uses the invested cash to invest in a **Qualified Opportunity Zone Business** operating in any of approximately 8,700 **Qualified Opportunity Zones** in the 50 states, District of Columbia, and 5 possessions.

Introduction

- Economic development program created by the Tax Cuts and Jobs Act of 2017
- New section 1400Z-1 and 1400Z-2 of the Internal Revenue Code
- Many unanswered questions; various groups have submitted comment letters that request specific guidance

Introduction

- The Qualified Opportunity Zone Program has its roots in prior incentives for Empowerment Zones and New Markets Tax Credits

- Empowerment Zones (enacted in 1994)
  - Empowerment Zones were designated by census tracts through competitive application to HUD or USDA, with limitations on aggregate population and size of census tracts, low income, and unemployment criteria
  - Broad list of tax incentives, including exclusion of capital gain and rollover of capital gain, tax credit for hiring people who lived and worked in Empowerment Zones
  - Capital gain incentives available only if business met very restrictive definition of qualified business, including requirement that 35% of employees be residents of the Empowerment Zone

Introduction

- New Markets Tax Credit (NMTC) (enacted in 2000)
  - Tax credits for entity making an equity investment in a "Community Development Entity" ("CDE") certified by the Community Development Financial Institutions Fund of the US Treasury ("CDFI Fund")
  - CDE required to make an equity investment or loan to a qualified business, defined similarly to an Empowerment Zone business but with no requirement that the qualified business hire employees from the Zone
  - Return is primarily the tax credits taken over 7 years, not appreciation in equity interest in CDE
  - There is an annual cap on dollar amount invested in certified CDEs that could qualify for credits
  - CDFI Fund runs a highly competitive process for allocation of tax credit authority

Ballard Spahr Offices and QOZs

Located in QOZ:

New York
Boulder
Minneapolis
Phoenix
Salt Lake City
Sioux Falls
Baltimore
Wilmington

Not located in QOZ:

Philadelphia
Cherry Hill
Los Angeles
Denver
Las Vegas
Atlanta
Washington, DC

Benefits of Investing Gains Into Opportunity Funds

- Deferral
- Gain Elimination

Who and What

- Who gets the benefits:
  A taxpayer (corporation, partnership, or individual) that rolls over gain within 180 days of sale to an unrelated party into a Qualified Opportunity Fund ("QOF")

Deferral

All or part of the gain rolled over is recognized on the earlier of:

December 31, 2026

or

When taxpayer sells its interest in the QOF

How Much Deferral?

- When the taxpayer contributes its money to the QOF, the taxpayer gets no tax basis for the roll-over gain. Then, if the taxpayer holds its interest in the QOF for:

  - at least 5 years, 10% of the taxpayer's roll-over gain is eliminated because the taxpayer's basis for its interest in the QOF is increased by 10% of the taxpayer's roll-over gain

  - at least 7 years, another 5% (for a total of 15%) of the taxpayer's roll-over gain is eliminated because the taxpayer's basis for its interest in the QOF is increased by 15% of the taxpayer's roll-over gain

How Much Deferral?

On December 31, 2026, if the taxpayer still holds its interest in the QOF, the taxpayer recognizes the lesser of:

1. the roll-over gain less the gain excluded if the taxpayer held its interest in the QOF for at least 5 or 7 years, or

2. the excess of fair market value of the taxpayer's interest in the QOF over the taxpayer's basis for its interest in the QOF

How Much Deferral?

Example 1:

- Taxpayer sells stock on the market on August 1, 2018, for a $1,000,000 gain and rolls-over $1,000,000 into a QOF on December 1, 2018. Under Section 1400Z-2 of the Code, the Taxpayer initially has a basis of -0- for its interest in the QOF and the gain is deferred.

- If the Taxpayer holds its interest in the QOF until December 1, 2023, $100,000 of Taxpayer's $1,000,000 deferred gain never will be recognized because Taxpayer's basis is stepped-up.

- If the Taxpayer holds its interest in the QOF until December 1, 2025, another $50,000 of Taxpayer's deferred gain (for a total of $150,000) never will be recognized because Taxpayer's basis is stepped-up.

How Much Deferral?

Example 1:

On December 31, 2026, if Taxpayer still holds its interest in the QOF, Taxpayer recognizes the lesser of

A. $850,000 (Taxpayer's $1,000,000 roll-over gain less the gain excluded because Taxpayer held its interest in the Fund for at least 7 years.)

or

B. The excess of the fair market value of Taxpayer's interest in the QOF over the Taxpayer's basis for its interest in the QOF, which has been increased by the $150,000 of excluded gain.

These rules make sure that if a Taxpayer's interest in the QOF declines in value, Taxpayer's gain is reduced by that reduction.

How Much Deferral?

Example 2:

If in Example 1, on December 31, 2026, the fair market value of Taxpayer's interest in the QOF is $500,000 (instead of at least $1,000,000) on December 31, 2026, Taxpayer would recognize $350,000 of its roll-over gain which is the lesser of

1. Taxpayer's $1,000,000 roll-over gain less the $150,000 excluded gain, or $850,000

   or

2. The excess of the fair market value of Taxpayer's interest in the QOF ($500,000) over Taxpayer's basis for its interest in the QOF ($150,000), or $350,000.

Deferral Observations

1. It is not entirely clear that the gain rolled-over must be capital gain.

   - Most likely the only gain eligible to be rolled-over is capital gain
   - Most likely gain on sale of 1231 property (depreciable property used in a trade or business held for more than 1 year and real estate used in a trade or business held for more than 1 year)
   - Should include gain on a sale of real estate subject to the 25% rate
   - Most likely not gain/income from the sale of inventory

Deferral Observations

2. If a partnership sells an asset, it is uncertain whether the partnership, as opposed to a partner, must roll-over the gain into a QOF to be eligible for Qualified Opportunity Zone (QOZ) benefits.

3. All or a portion of the rolled-over gain will be recognized.

4. If the taxpayer dies, the gain still is recognized as described above. There is no step up at death.

Contrast this with a like-kind exchange of real estate. The gain deferred in a like-kind exchange can be eliminated forever if the exchanging taxpayer holds the replacement property until death.

Another Benefit: Gain Elimination

No Tax on Appreciation of the QOF

If a taxpayer holds its interest in a QOF for at least 10 years, none of the taxpayer's gain from a disposition of its interest ***in the QOF*** (appreciation in the QOZ) is taxed.

Appreciation in the QOZ Observations

Opportunity Zones expire December 31, 2028.

- To be eligible to eliminate tax on appreciation within a QOZ, a taxpayer must hold its interest for at least 10 years. To be a QOF, the QOF must invest in a QOZ. If the QOZ expires, a fund cannot be a QOF. The IRS will need to provide guidance on whether the appreciation incentive will be available when the 10-year holding period extends beyond the termination of the Opportunity Zone, or Congress can correct the Code.

- To obtain the benefit of no tax on appreciation within a QOZ, the taxpayer must dispose of its interest in the QOF. Gain on a sale by the QOF of its assets is not excluded.

Establishing and Qualifying an Opportunity Fund

A QOF must be certified by the U.S. Treasury

- To be a QOF there are 3 tests that must be satisfied on an ongoing basis:

    1. Organizational Test

    2. Purpose Test

    3. Asset Test

What is a QOF?

Opportunity Fund certification

- Statutory requirement straightforward – investment vehicle formed for purposes of investing in QOZ property
- IRS Form to be released this summer for self-certification
- IRS Form likely to be used to certify to ongoing compliance with statutory requirements
- Question of whether QOF must also provide information on impacts and outcomes on economic indicators including job creation, poverty reduction and new business starts and other similar data required by U.S. Treasury for report to Congress

What is a QOF?

Self-certification process indicates no limit on number of QOFs

- Legislative history suggests that certification process would follow that used for NMTC
- Certification as CDE for NMTC was streamlined, but number of CDEs receiving allocation authority is competitive and application process run by CDFI Fund, which is experienced in community development
- Competitive nature of allocation process permitted CDFI Fund to add requirements directly related to community benefit and measurable results

What is a QOF?

Organization Test:
To be a QOF, an entity must be organized as a corporation or partnership

Purpose Test:
To be a QOF, the corporation or partnership must be an "investment vehicle" formed for the purpose of investing in QOZ Property

Asset Test:
To be a QOF, the corporation's or partnership's assets must be composed of at least 90% QOZ Property

What is a QOF?

- The 90% test is an average of (1) the QOZ Property held by the QOF on the last day of the first 6-month period of the QOF's tax year, and (2) the QOZ Property held by the QOF on the last day of the QOF's tax year.

- Failure to satisfy the 90% test, unless such failure is due to reasonable cause, will subject the QOF to a penalty equal to the federal income tax underpayment interest rate multiplied by the excess of 90% of the QOF's aggregate assets over the aggregate amount of QOZ Property held by the QOF.

QOZ Property

QOZ Property is:

- QOZ Stock
- QOZ Partnership Interest
- QOZ Business Property

Cash/Working Capital is not QOZ Property.

A QOF <u>cannot</u> invest in another QOF; there cannot be a QOF fund of QOFs.

QOZ Stock/QOZ Partnership Interest

QOZ Stock/QOZ Partnership Interest

- Stock or a partnership acquired at original issuance solely for cash after December 31, 2017
- When the stock or partnership interest is issued, the corporation or partnership is a QOZ Business. In the case of a new entity, the entity is organized for purposes of being a QOZ Business.
- During substantially all of the time the QOF owns the QOZ Stock or QOZ Partnership Interest, the corporation or partnership qualifies as a QOZ Business.

QOZ Business Property

- Tangible property used in a QOF's trade or business if:
  - The property was acquired by the QOF by purchase from an unrelated party (at least 20% common ownership)
  - The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property
    - Substantial improvement means that during any 30-month period after the QOF acquires the property, the QOF makes capital improvements in an amount at least equal to the QOF's basis of the property at the beginning of the 30-month period

QOZ Business Property

- During substantially all of the QOF's holding period for the property, substantially all of the use of such property was in a QOZ.
  - Property that ceases to be QOZ Business Property will continue to be treated as QOZ Business Property for the lesser of 5 years after the property ceased to qualify or the date the property no longer is held by a QOZ Business.

Structuring Opportunity Fund Investments

Direct investment by QOF in QOZ Business Property

Investors

Taxpayers who roll-over gain

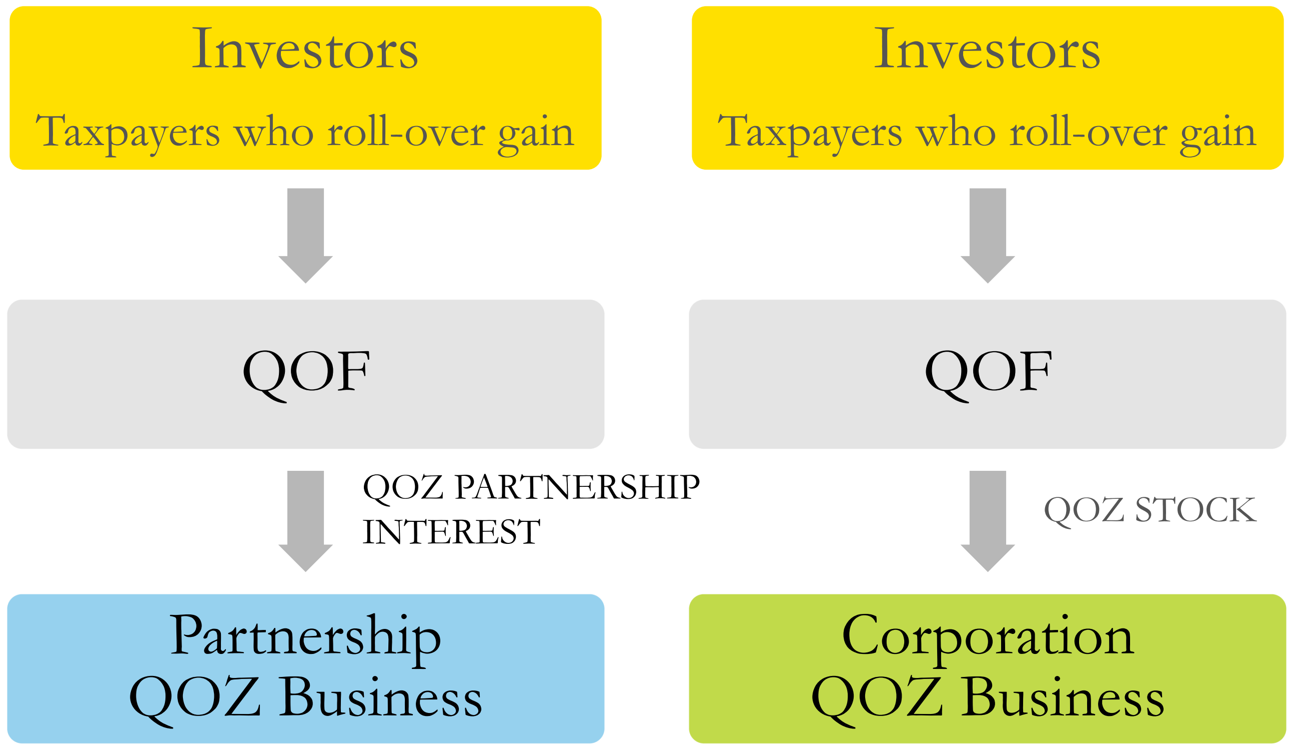
↓

QOF

QOZ Business Property

QOF Investments

Direct investment in QOF Stock / Partnership Interest



Combining Tax Credits with QOZs - Increasing Yield

- Low-Income Housing Tax Credits:
  - Complementary 10-year credit period
  - Installment equity pay-ins
  - Could help with exit taxes
  - Great for 4% LIHTC substantial rehab
- Historic Tax Credits:
  - 5-year credit period, so typical investment could still reap some benefits
  - Installment equity pay-ins

Combining Tax Credits with QOZs

- New Markets Tax Credits:
  - 7-year credit period, so typical investment could still reap some benefits
  - CDE must make an equity investment in a qualified business, not a loan
  - Could help with exit taxes

Capital Raising Regulatory Framework - General

- Securities Act of 1933, as amended
- State securities laws ("blue sky")
- Three kinds of offerings:
  - Registered
  - Exempt
  - Illegal
- Private right of action and remedy of rescission; enforcement; jeopardize future capital raising; reputational risk
- State and Federal Broker Dealer Laws / Regulations – generally, any person or entity paid a transaction based "commission" on investment must be registered
- Investment Company Act of 1940
- Investment Advisers Act of 1940 / Comparable State Laws

Capital Raising - Regulatory Framework – Important Definitions

- "Accredited Investor"
  - For individuals:
    - Income: $200,000/$300,000
    - Net Worth: $1 million (excluding principal residence)
    - Status: director, executive officer, general partner
  - For entity:
    - Assets: $5 million in assets / not formed for purpose of the investment
    - Ownership: all equity owners are accredited
    - Status: banks, broker/dealer, insurance company

Capital Raising - Regulatory Framework – Important Definitions

- “General Solicitation” or “General Advertising”
  - advertisements, articles, notice or communication published in newspaper, magazine, or broadcast
  - any seminar or meeting whose attendees have been invited by any general solicitation or advertising
  - Social media, open websites are de facto “general solicitation” and “general advertising”
  - To avoid, show “pre-existing substantive business relationship”

Capital Raising – Qualified Opportunity Fund

- Given Facts/ Observations
  - QOF investors with significant capital gain are likely to be "accredited investors"
  - QOF holding period requirements mean near term liquidity may not be a priority
  - Unique QOF investor profile may require general solicitation
  - Evolving QOF tax regulations mean increased uncertainty and investor risk
- Registered offering is costly and primary benefits are ability to include non- accredited investors and increased liquidity

Capital Raising – Qualified Opportunity Fund

- Illegal is not as option
- Exempt Offerings
    - Section 4(a)(2) – transaction not including a public offering
    - Crowd funding – limited to $1 million in a 12-month period
    - Regulation D – safe harbor limits investor recourse
    - Regulation A+ – requires SEC filing and mandated disclosure

Capital Raising – Regulation D

- Rule 506(b)
    - unlimited dollars, max 35 non-accredited investors
    - *no* general solicitation or advertising
    - restricted, covered security (limits "blue sky" issues)
    - reasonable belief of accredited status
    - 4(a)(2) safe harbor
    - no "bad actors"
    - limited information requirements if all investors are accredited

- Rule 506(c)
    - unlimited dollars, only accredited investors
    - general solicitation and advertising *permitted*
    - restricted, covered security (limits "blue sky" issues)
    - must "verify" accredited status – additional burden
    - safe harbor
    - no "bad actors"
    - limited information requirements

Capital Raising – Qualified Opportunity Fund

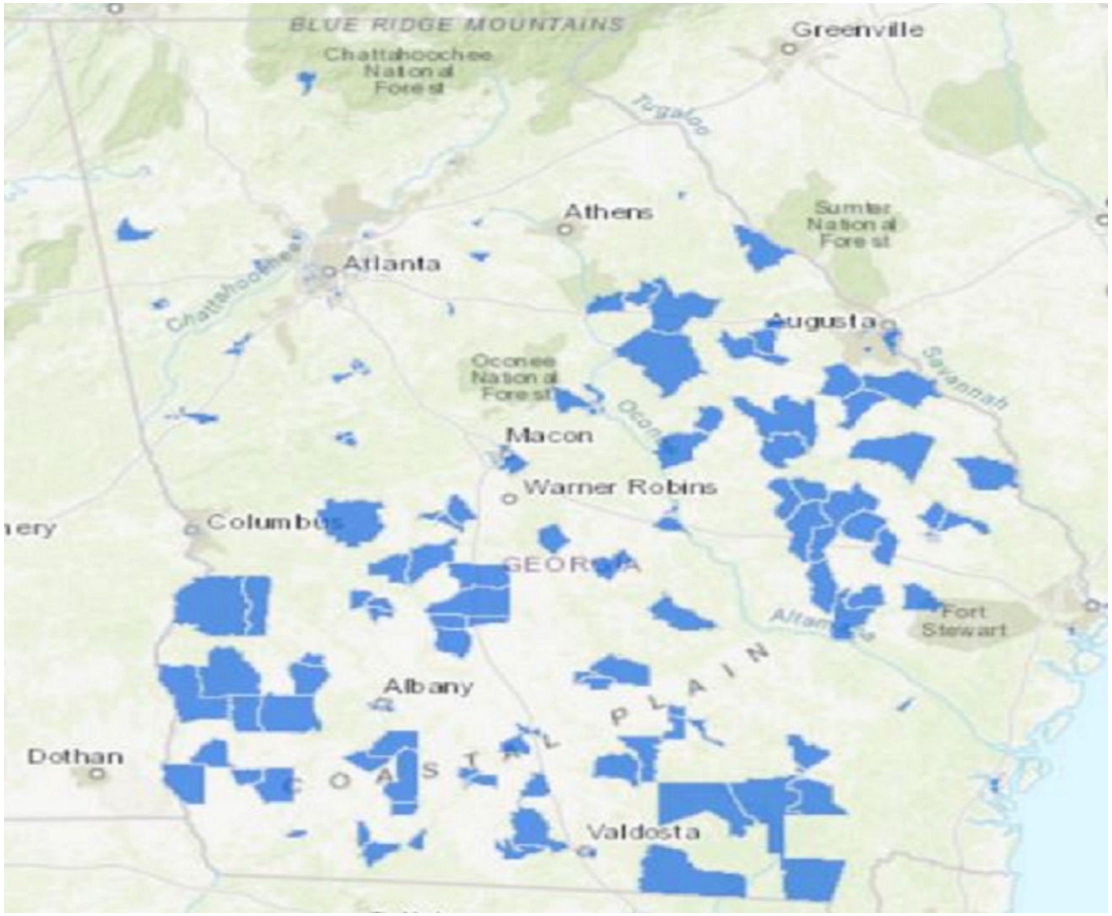
- Avoid "commission" on procurement of investors or use registered broker dealer
- QOF may be subject to the registration under the Investment Company Act of 1940 - exempt if less than 100 beneficial owners, or more if all are "qualified purchasers" (investments of $5 million for individuals/$25 million for entities)
- Sponsor may need to register under Investment Advisers Act of 1940 and comparable state laws, although short form registration available for funds up to $150 million, and registration may be determined unnecessary, particularly for real estate funds

Locating Designated Opportunity Zones

More than 8,700 census tracts located in each State, DC and possessions have been designated

- The Opportunity Zones meet basic low income criteria, but contiguous census tracts not meeting low income also are designated
- List is final and essentially unchanging
- The list is available from IRS organized by state
- States also have interactive websites for confirming address in a QOZ
- http://www.arcgis.com/home/webmap/viewer.html?webmap=0901a81958474a54a333f9cc180f1852&extent=-86.9909,30.8937,-78.8775,34.8282

Georgia Zones



Positioning Your Business (QOZ Business)

A QOZ Business is:

- A trade or business in which substantially all of the tangible property owned or leased by the taxpayer is QOZ Business Property.
  - Property acquired by purchase from an unrelated person (at least 20% common ownership).
  - The original use of the property in the QOZ commences with the QOZ Business or the QOZ Business substantially improves the property.

QOZ Business

- Property is substantially improved if during any 30-month period after the QOZ Business acquires the property, the QOZ Business makes capital improvements in an amount at least equal to the QOZ Business' tax basis for the property at the beginning of the 30-month period.

- During substantially all of the QOZ Business' holding period for the property, substantially all of the use of such property was in a QOZ.

- The same rule about property ceasing to be QOZ Business Property applies.

QOZ Business

- At least 50% of the total gross income of the QOZ Business is derived from the active conduct of the QOZ Business.
- A substantial portion of the QOZ Business' intangible property is used in the active conduct of its business.
- Less than 5% of the aggregate adjusted basis of the QOZ Business' property is in "Nonqualified Financial Property." Nonqualified Financial Property is debt, stock, partnership interests, options, future contracts, forward contracts, warrants, national principle contracts, annuities, and other similar properties to be set forth in regulations.
- Reasonable working capital and accounts receivable are not within the 5% limit.
- The QOZ Business is not a "sin business." A sin business is a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, race track or other facility used for gambling, and any store the principal purpose of which is the sale of alcoholic beverages for consumption off the premises.

QOF – Structural Observations

- Tax benefits are available only with respect to "originally issued" QOF interests
- 5/7/10 year periods are based on acquisition date of QOF interest
  - Issuances by QOF at different times could result in potential divergence among investors as to when QOF interests should be disposed of
  - Redemption of QOF interests likely will be limited to available cash flow
- Tax exemption on appreciation after 10 years applies only upon a sale of interests in the QOF – not QOF assets
  - Suggests a typical QOF will hold a single asset for flexibility of sale – otherwise sale of QOF interests will include an indirect sale of all assets when sale of only select assets is optimal
  - QOF organization documents will have to include "drag along" provisions and other terms consistent with pre-determined tax objectives
- QOF likely to be long term investments, perhaps with predetermined 5/7/10+ year objectives, with prospect of development of exit strategies

Qualified Opportunity Zone Business

Examples of businesses that could qualify:

- affordable and market rate rental housing
- mixed-use developments
- strip centers
- parking facilities
- retail-grocery stores
- sports facilities
- hotels
- restaurants
- health clinics
- offices
- manufacturing

Qualified Opportunity Zone Business

Businesses that do not qualify:

- Bank/financial institution – fails nonqualified financial property limit
- Branch of a business that is not a separate legal entity – nonqualified if fail test of 50% of gross income or property in the QOZ
- Nonprofit corporation unless taxable subsidiary created or nonprofit is lessee not owner
- Grocery or convenience store if large portion of business is liquor sales

Players, Benefits, Obligations

- Investor - entity/person with capital gains to roll over
  - obtains tax benefits of deferral and/or exclusion of capital gains
  - obligation to elect tax treatment for deferral and/or exclusion in timely manner on tax return
  - potential for other returns from investment in QOF
- QOF
  - new incentive to attract investors in a fund
  - fees for services
  - obligation to self-certify as to qualification as QOF
  - ongoing obligation to report that 90% test met, and pay penalties if test not met
  - obligation to determine qualification of investments and monitor ongoing compliance by business

Players, Benefits, Obligations

- Qualified Opportunity Zone Business
  - additional sources of capital
  - able to offer additional return that may increase the price paid for interest in QOZB
  - obligation to qualify and maintain status as QOZB
  - no obligation to report as to qualifying status on tax returns

State Websites and Resources

- Arizona – https://www.azcommerce.com/arizona-opportunity-zones/
- California – http://dof.ca.gov/Forecasting/Demographics/opportunity_zones/
- Colorado – https://choosecolorado.com/opportunity-zones/
- Delaware – https://news.delaware.gov/2018/04/19/opportunity-zones/ (very limited)
- Georgia – https://gov.georgia.gov/press-releases/2018-04-16/deal-department-treasury-designates-qualified-opportunity-zones-georgia
- Maryland – http://dhcd.maryland.gov/Pages/OpportunityZones.aspx

State Websites and Resources

- Minnesota – https://mn.gov/deed/business/financing-business/tax-credits/opp-zones/
- Nevada – http://www.diversifynevada.com/programs-resources/opportunity-zones
- New Jersey – https://www.state.nj.us/dca/divisions/lps/opp_zones.html
- New York – https://esd.ny.gov/opportunity-zones
- Pennsylvania – https://dced.pa.gov/programs-funding/federal-funding-opportunities/qualified-opportunity-zones/
- Utah – https://business.utah.gov/opportunity-awaits-statewide-opportunity-zones-announced/
- Washington, DC - https://dmped.dc.gov/page/opportunity-zones-washington-dc

Interactive Maps on State Sites

State-Powered Maps

Pennsylvania
Colorado
Nevada

No Interactive Map

South Dakota
Delaware
Minnesota
Utah

Map Powered through Cdfifund.gov

New York

Map Powered through ArcGIS

New Jersey
California
Georgia,
Washington, DC
Arizona
Maryland

For states that do not have interactive websites, see:
https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml

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Resources

For updates on this topic and more visit:
https://www.ballardspahr.com/trac

A copy of these slides and a recording of the presentation will be available at:
https://www.ballardspahr.com/opportunityzones

Ballard Spahr LLP

Questions?

Thank you for your time!