Introduction to Opportunity Zones

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Overview

- Qualified Opportunity Zones ("QOZ") were created as a new tax incentive by the Tax Cuts and Jobs Act of 2017 passed on December 22, 2017 and codified in IRC Sec. 1400Z-1 and 1400Z-2
- The program is designed to attract long-term investments in low-income communities designated as QOZ by offering tax benefits to investors

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Benefit #1: Immediate Gain Deferral

- Capital gains are eligible for immediate tax deferral
- Cash must be invested in a Qualified Opportunity Fund ("QOF") within 180 days of the gain
  - For gains from pass-through entities, the 180-day period may begin on the last day of the pass-through entity's tax year.
  - No direct tracing of cash from gain required

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Benefit #2: Partial Forgiveness of Gain

- The period of tax deferral for the original gain ends upon the earlier of sale of interest in the QOF, or 12/31/2026
- If investment in the QOF is held for <u>less than 5 years</u>, 100% of the gain is taxable
- If investment in the QOF is held for <u>5 years</u>, only 90% of the original gain is taxable
- If investment in the QOF is held for <u>7 years</u>, only 85% of the original gain is taxable

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Benefit #3: Forgiveness of Appreciation

- If investment in the QOF is held for at least 10 years, any gains relating to appreciation are forgiven and are not taxable
- Gains on investments are not guaranteed, and the investment is still subject to risk of loss

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Example of Benefits

- In 2018, an individual sells a stock with an initial cost of $1,500 for $2,000 ($500 gain) and invests $500 cash in a QOF immediately
- The individual does not pay taxes on the $500 gain on their year-end tax return
- If the taxpayer sells their interest in the QOF in 2023 (after 5 years), taxes will be owed on $450 of the original gain (90%) on their 2023 tax return
- If the taxpayer sells their interest in the QOF in 2025 (after 7 years), taxes will be owed on $425 of the original gain (85%) on their 2025 tax return
- Even if the taxpayer still holds their interest in the QOF as of 12/31/2026, taxes will be owed on $425 of the original gain (85%) on their 2026 tax return
- If the taxpayer sells their interest in the QOF during 2028 (after 10 years) for $1,200 (at a gain), no taxes will be due.

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Qualified Opportunity Zones

- Designated QOZ are in effect for 10 years (through December 31, 2028)
- CDFI Opportunity Zone Resources page that includes a link to a map of all of the QOZ: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx
- IRS Opportunity Zones Frequently Asked Questions page: https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

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Qualified Opportunity Zones

- It may be malpractice if a client is purchasing property in an Opportunity Zone and is not notified. The client should seek advice on Opportunity Zones if they are interested in setting up the transaction for the tax benefits of purchasing property in an Opportunity Zone
- Colorado also has a mapping tool: https://choosecolorado.com/opportunity-zones/

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Qualified Opportunity Fund

- A QOF must be organized as a partnership or corporation for federal income tax purposes (LLCs work if classified appropriately)
- The fund is self-designated (does not need approval from any government entity)
  - The IRS has released a draft tax form that a QOF will file with its tax return
  - The taxpayer's return must be filed timely, including extensions
- A QOF must hold <u>90% of its assets</u> in Qualified Opportunity Zone Property ("QOZP") (see 2 options on next slides)
  - Measured at the end of the first 6-month period, and
  - Measured on the last day of the taxable year of the QOF (and 6-month intervals thereafter)
  - Penalty = shortfall% x (fed short-term rate + 3%), unless reasonable cause
  - Based on applicable financial statement, or original cost if no financial statements

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Option #1: Qualified Opportunity Zone Business Property

- A QOF may invest in Qualified Opportunity Zone Business Property ("QOZBP"), which is tangible property used in a trade or business
- Must be acquired from an unrelated party (no more than 20% related) after December 31, 2017
- During substantially all of the holding period, substantially all of the use must be in a QOZ
- Original use must begin with the taxpayer in the QOZ, or
- The taxpayer substantially improves the property
  - During 30-month period after acquisition (after 12/31/2017), cost of rehab must be greater than initial cost at the beginning of the period
  - Land and attached land improvements are carved out and need not be substantially improved

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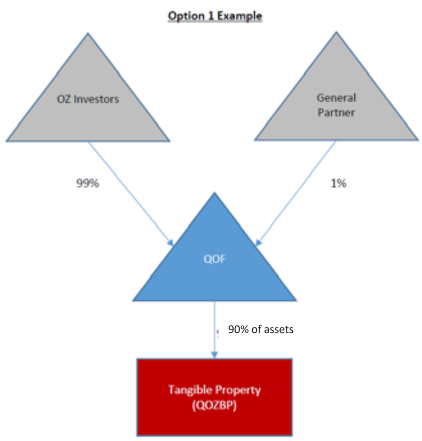
Option #1 Example



- 90% of QOF assets must be in QOZBP
  - Tested at the end of the first 6-month period and at the end of the QOF's tax year (and 6-month intervals thereafter)
  - Must be acquired after 12/31/2017 from an unrelated entity
  - Must be used in a QOZ
- 10% of assets may be in cash or intangible assets

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Option #2: Qualified Opportunity Zone Business

- A QOF may invest in a Qualified Opportunity Zone Business ("QOZB"), which is a trade or business in which substantially all of the tangible property owned or leased is QOZBP
  - Substantially all is defined as 70%
- Ownership of a QOZB must be either an interest in a partnership or stock in a corporation acquired after 12/31/2017 in exchange solely for cash
- Cannot be a "sin" business
  - Golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, store where principal business is selling alcohol for offsite consumption

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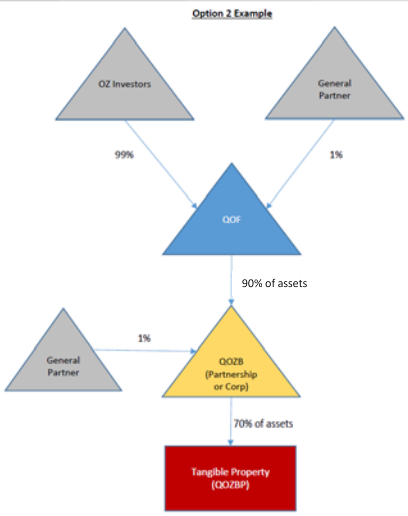
Option #2 Example



- 90% of QOF assets must be in QOZB
  - Tested at the end of the first 6-month period and at the end of the QOF's year, and every 6-month period thereafter
  - Must be acquired after 12/31/2017 from an unrelated entity
- 70% of QOZB assets must be in QOZBP
- Maximum of 5% of assets can be in cash plus reasonable working capital
- No limit on intangible assets, but must be used in business
- At least 50% of QOZB income must be derived from a QOZ
- "Sin" businesses are ineligible

Other Considerations

- Some states do not conform to federal law and may require the original capital gain to still be taxed for state purposes
- Some states may add their own Opportunity Zone incentives
- Proposed Regulations have been released that provide guidance on some questions, but there are outstanding questions needing clarification

Questions

- The Opportunity Zone rules and deal structuring can be very complex. Please do not hesitate to reach out to RubinBrown for additional questions by contacting one of the presenters listed on the title slide or any member of your engagement team.