QUALIFIED OPPORTUNITY ZONES – AN INTRODUCTION TO A NEW TAX INCENTIVE FOR INVESTORS

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OVERVIEW

- The 2017 Tax Cuts and Jobs Act (P.L. No. 115-97) (“the TCJA”) contains a Qualified Opportunity Zone (“QOZ”) program intended to encourage taxpayers to invest part of their unrealized capital gains, estimated to exceed over $1.1 trillion, in low income communities (“LICs”). This program allows deferral and possible forgiveness of tax on capital gains invested in LICs.
- The QOZ program encourages patient long-horizon investment in QOZs.
- The QOZ program is contained in newly-enacted Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code.
- The new QOZ program has great promise to transform LICs.
- The Treasury Department released on Friday, October 19, 2018 the first tranche of proposed regulations, a related revenue ruling, and a draft of Form 8996, used to self-certify fund and to compute each year possible penalties for not meeting investment standards. Treasury asked for and is accepting comments for 60 days on the proposed regulations.
- There may be more guidance issued before yearend.

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EXAMPLE
(WE WILL REVISIT AT THE END OF THE PRESENTATION)

References below to “gain” are to “capital gain”

Megan holds stock in Company A that has appreciated over several years.
She purchased the stock for $200,000 and it is now worth $1,000,000.
In Year 1, Megan sells the stock and within 180 days she invests $800,000 in cash in a QOF.

Year 1	Year 5	Year 7	December 31, 2026	Year 10 and after
$800,000 investment in fund; deferred gain; zero basis in investment in the QOF	$80,000 (10 percent of deferred gain) basis in investment in the QOF	Additional $40,000 (5 percent of deferred gain) basis in investment in the QOF	Deemed recognition of $680,000 of deferred gain	Basis in investment in QOF equal to fair market value, if elected. Thus, gain on investment in the fund is excluded from Megan's income.

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THE QOZ PROGRAM STARTS WITH A SALE OR EXCHANGE AND INVESTMENT OF CAPITAL GAIN IN A QOF

- Basically, the new QOZ program provides that an eligible taxpayer can defer tax on capital gains in an unlimited amount by investing the gains in a Qualified Opportunity Fund (“QOF”).
- Eligible taxpayers include individuals; C corporations, including RICs and REITs; partnerships; S corporations; trusts and estates.
- The taxpayer must invest money in the QOF in the amount of the capital gain from the sale or exchange of property to an unrelated party within 180 days of the sale or exchange.
  - In the case of partnerships, the partnership may make the QOF election, or if no partnership election, eligible taxpayer partners may make the QOF election.
  - Partners have some flexibility on the determination of the 180-day period.
- Investments in a QOF that are not part of a capital gain deferral are not eligible for the special QOZ tax benefits.

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THE POSSIBLE TAX BENEFITS OF CAPITAL GAIN INVESTMENT IN A QOF

- Tax on invested capital gains is deferred until the earlier of
  - Sale of the QOF investment
  - December 31, 2026.
- If the taxpayer holds the QOF investment for five years, tax is forgiven on 10% of the deferred gain.
- If the taxpayer holds the QOF investment for seven years, tax is forgiven on an additional 5% of the deferred gain.
- After 10 years of holding the QOF investment, the gain on the investment in the fund itself will be excluded from income, upon proper election.
- *QOF investment should be compared to alternative gain tax deferral mechanisms, such as 1031 exchanges for real estate, exchange funds for appreciated stock positions, 1045 rollovers of qualified small business stock.*
- State tax implications must be considered.

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WHAT IS A QOF?

- A QOF is a corporation or partnership organized for the purpose of investing in Qualified Opportunity Zone Property ("QOZ Property").
- A QOF must hold at least 90 percent of its assets in QOZ Property. A monthly penalty is assessed on an amount falling short of the 90 percent mark.

WHAT IS QOZ PROPERTY?

- Qualified Opportunity Zone Stock
- Qualified Opportunity Zone Partnership Interest
- Qualified Opportunity Zone Business Property
- Other QOFs are excluded from the definition of QOZ property – no “fund of funds.”

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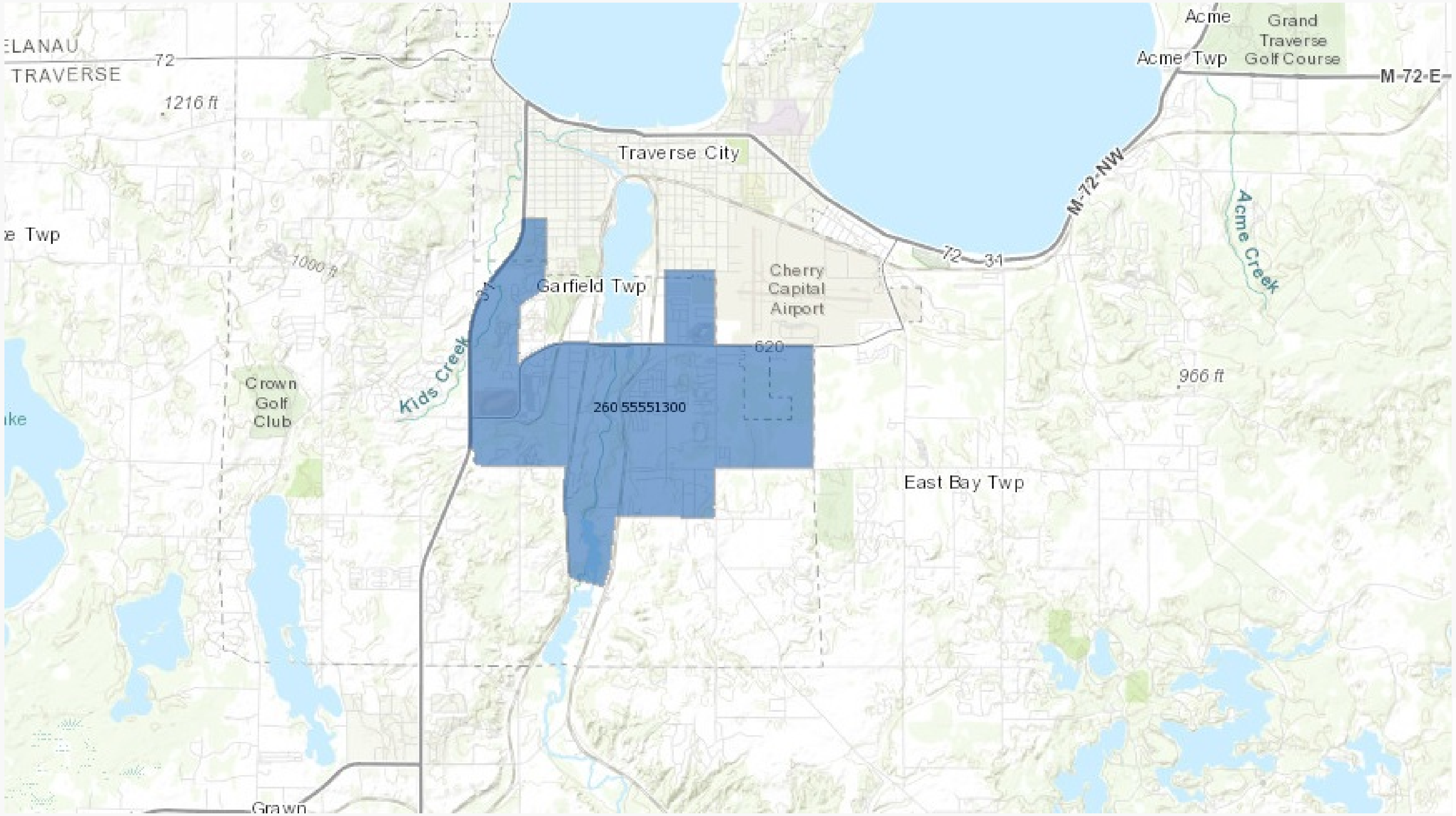
FIRST, WHAT IS A QOZ?

- A QOZ is a Low Income Census Tract (“LICT”) designated by the chief executive officer of each state, DC and possession of the U.S. Almost all of Puerto Rico is a QOZ. We’ll refer to governors and states.
- Some non-LICT census tracts adjacent to LICTs could be designated.
- Generally, the governor of a state could nominate, during a short period of time following the enactment of the TCJA, up to 25 percent of LICTs in his/her state as QOZs. The Secretary of Treasury then certified and designated the QOZs.
- QOZ designation ends 12/31/2028, but the gain exclusion election can be applied for dispositions of QOF interests through December 31, 2047.
- Thanks to some good work by some of your friends, Traverse City has a QOZ.

THE TRAVERSE CITY QOZ



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QOZ STOCK

Among other requirements –

- Stock in a domestic corporation acquired in 2018 or later
- Must be original issue stock, acquired solely in exchange for cash
- At issue corporation was a QOZ business, or was newly organized to be a QOZ business
- During substantially all of the QOF's holding period for the stock, the corporation qualified as a QOZ business.

QOZ PARTNERSHIP INTEREST

Among other requirements –

- Any interest in a domestic partnership acquired by the QOF in 2018 or later
- The interest must have been acquired from partnership solely in exchange for cash
- When the interest was acquired, the partnership was a QOZ business or newly organized to be a QOZ business
- During substantially all of the QOF's holding period for the interest, the partnership qualified as a QOZ business
- While not specifically mentioned in the statute, an LLC taxed as a partnership can be a QOZ Partnership Interest (or QOZ Stock, if taxed as a C corporation). The QOF can be an LLC, too.

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QOZ BUSINESS PROPERTY

Among other requirements –

- Tangible property used in a trade or business
  - That is acquired by purchase after December 31, 2017
  - The original use of which in the QOF commences with QOZ Business
    - Or the QOF substantially improves the property
  - Substantially all of the use of which in the QOZ
  - “Substantially Improves” – during any 30-month period following the acquisition of such property there are additions to basis that equal the adjusted basis as of the beginning of such 30-month period.
    - During the 30 month-period, cash expected to be used to substantially improve property can be treated as QOZ business property (if properly documented).
    - See Revenue Ruling 2018-29 regarding substantial improvement of building, where building and land owned by QOF.
- Must be acquired from an unrelated party.

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QOZ BUSINESS

Among other requirements –

- A trade or business in which substantially all (70% per proposed regs) of the tangible property owned or leased by the owner is QOZ Business Property
- The original use of the property in the QOZ commences with the QOZ business, or the QOZ business substantially improves the property.
- Trade or business is not engaged in various “sin businesses” (much broader definition than what you are thinking!)

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IN CONCLUSION

- Many questions still remain, but recent guidance is helpful.
- Because of the limited time for this benefit, getting more guidance soon is critical and is expected.
- However, investors looking at real estate investments in QOZs may have enough guidance to begin the process of forming and investing in QOFs, which, in turn, could invest in QOZ property.
- The QOZ program and patience can yield substantially improved after-tax rates of returns for investors.

THANK YOU

If you have questions about the presentation, contact HM&M today –

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