Opportunity Zones: A New Tool for Economic Development

presented by

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McAFEE & TAFT

Overview

- Brand New Tool
  - Originally introduced in 2016 and 2017 thru stand-alone bipartisan legislation
  - Included at last minute in Tax Reform Act at end of 2017
  - Different from former Oklahoma state program with the same name (they now changed name)
- Designed to spur long-term investments in "low-income communities"
- 568 MILLION Google search results

Overview (cont'd)

- Similar to 1031 like-kind exchanges
  - Deferring gains realized on other investments if a taxpayer agrees to reinvest them into Opportunity Zones
- Can complement certain existing tools
  - New Markets Tax Credits
  - Low-Income Housing Tax Credits
  - Historic Rehabilitation Tax Credits

Where Did OZ Come From?

"I grew up poor, in a single-parent household. My mom was focused on, 'How can we reach that brighter future'? My mother didn't care who was proposing solutions – she was too busy working 16-hour days and raising two young boys."

"I realized part of my story of progress came from the private sector, so I wanted to find a way to spark private sector investment in distressed communities."

Sen. Tim Scott, R-S.C.

Economic Innovation Group

Sean Parker, Napster & Facebook

"This has been a decade-long journey. I really began thinking about this around 2008. You could see that the financial crisis disproportionately affected certain communities, and that when the recovery happened, it really only happened in certain major cities. These places have rebounded nicely. Most everybody else is left behind."

Economic Innovation Group – Empowering Investors and Entrepreneurs to Forge a More Dynamic U.S. Economy (eig.org)

Policy Objectives

- Free Market Based Tax Incentive
  - tax deferral and exclusion, **not** a tax credit
- Easy to Use
- "Do Good by Doing Good"
  - $6 *Trillion* in Unrealized Capital Gains
  - One in six (52.3 million) Americans live in economically distressed communities
  - More than half of these areas contained both fewer jobs and businesses in 2015 than in 2000

Policy Concerns

- Lack of Oversight
  - Self-Certification
  - No Reporting
- Rising Demand = Rising Prices
- Gentrification
- Mass Exodus Leads to Destabilization
  - After Year 7
  - After Year 10
  - Before 2047

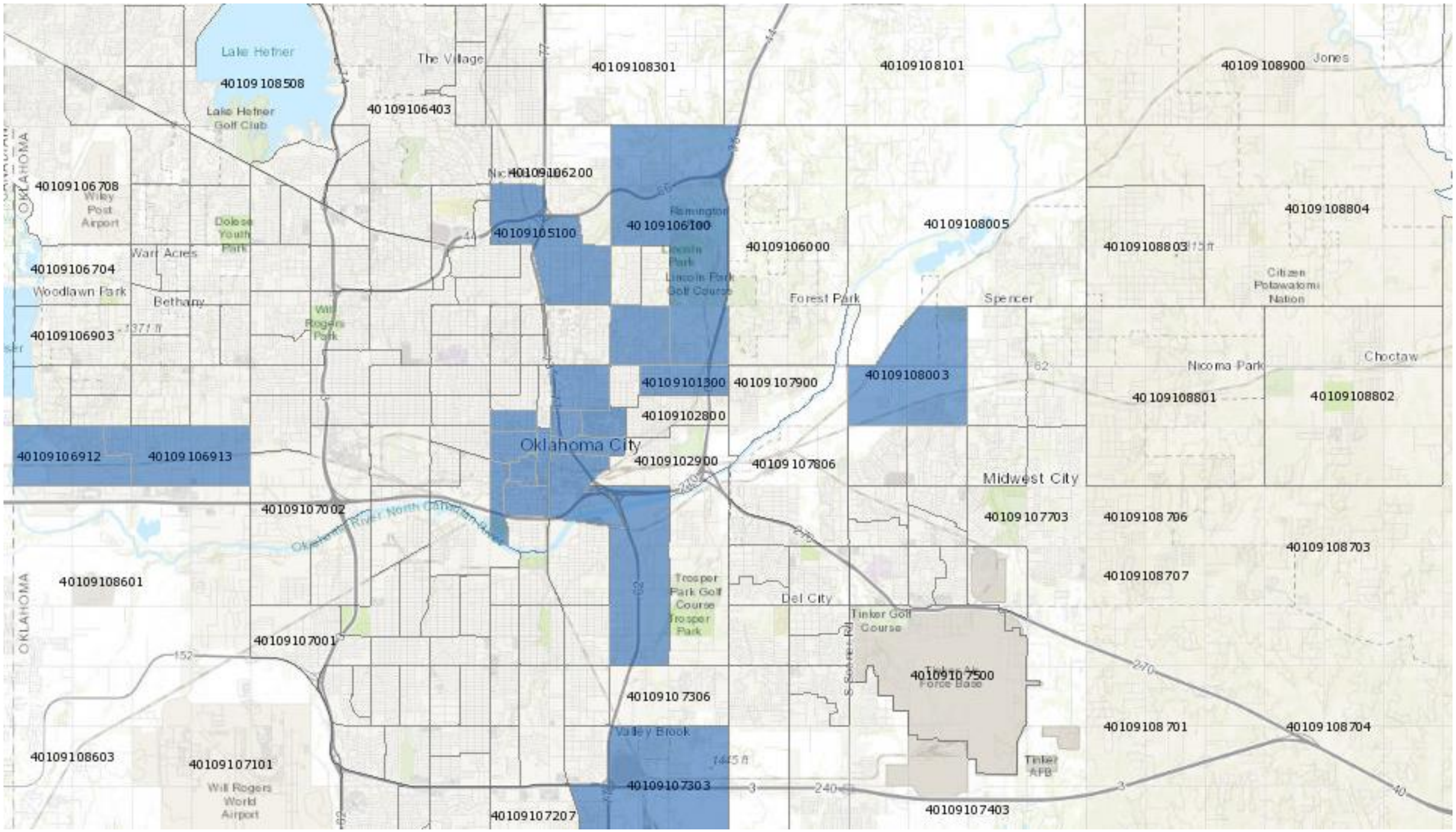
What is an Opportunity Zone?

- Census Tract Designation
- "Low-Income Community"
  - NMTC Definition
    - Poverty Rate – at least 20%
    - Median Family Income – up to 80% of area median
    - High Out-Migration Rural County Census Tract
  - Adjacent To
    - Contiguous to a designated OZ
    - Not exceed 125% of area median family income of contiguous OZ

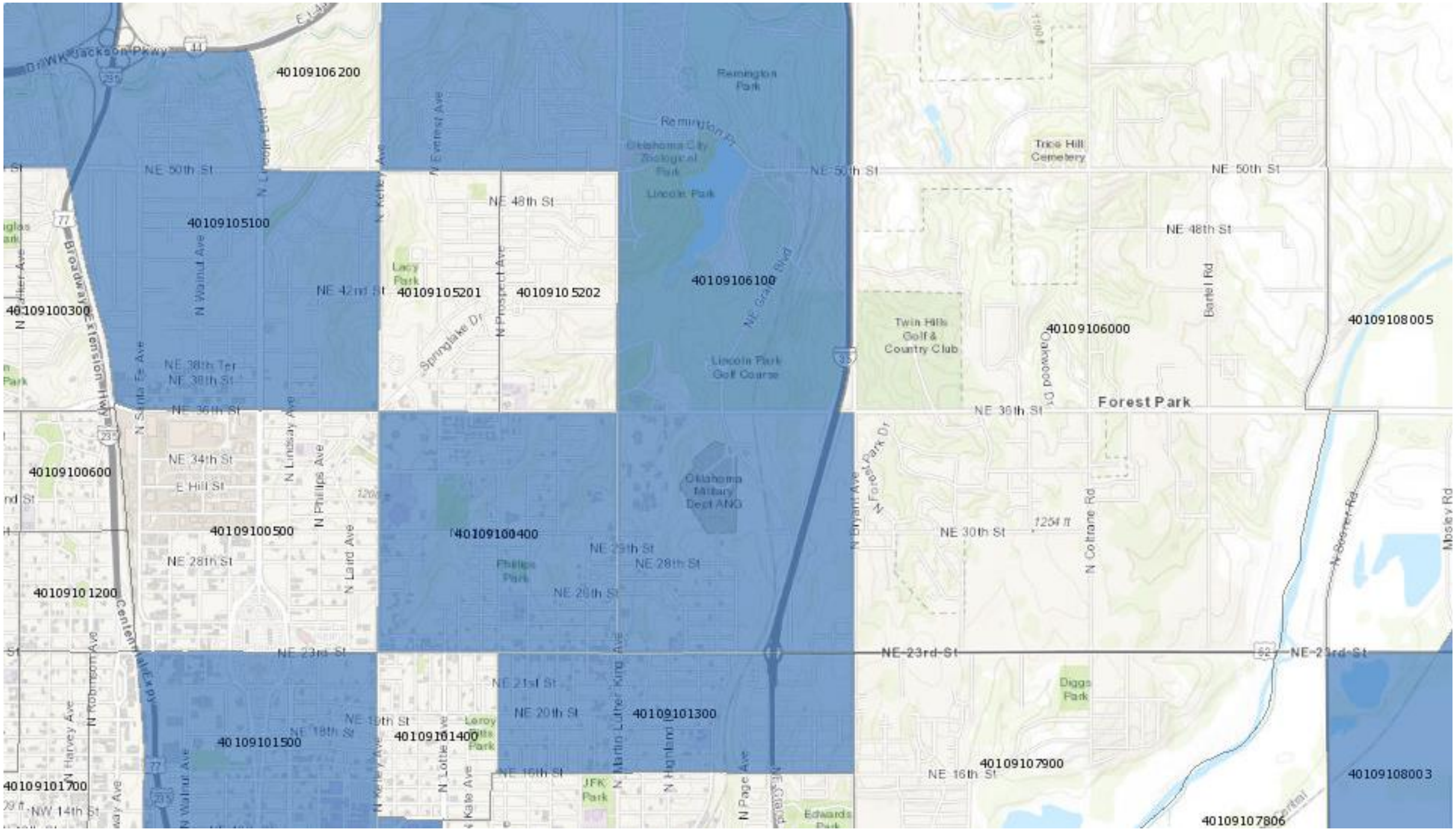
What is an Opportunity Zone

- Governors designated 25% of “low-income communities” to also qualify as “Opportunity Zones”
- Ratified by Treasury in mid-2018
- Current OZ statute does not contemplate any changes or modifications
- Official list and map can be found via mcafeetaft.com/Opportunity-Zones-map

OKC Opportunity Zones



OKC Opportunity Zones




Investor/Taxpayer
Opportunity Zone Fund
Opportunity Zone Property

Structure

- Investment must be made
  - In an Opportunity Zone Fund
    - Self-Certified
    - Must hold 90% of assets in Opportunity Zone Property
  - Opportunity Zone Property
    - Equity in a business in which substantially all (70%) of its tangible property is used in an Opportunity Zone
    - Property held by the OZ Fund and used in an Opportunity Zone
  - Opportunity Zone
    - 25% of "low-income communities" designated by Governor
    - Roughly 10% of country covering 30 million Americans

Investor/Taxpayer

Why are Investors Excited?

1) Taxpayer can defer tax on capital gain if reinvest gain in Opportunity Zone within 180 days
   - Deferred until earlier of sale of investment or end of 2026
   - The 180 days starts at the time the gain would be recognized for federal income tax purposes

2) If the OZ investment is held for at least 5 years, then taxpayer pays less tax on the original gain transaction

   1) 10% if held for at least 5 years

   2) Additional 5% if held for at least 7 years

Why Are Investors Excited?

3) If hold for at least 10 years, then **no** tax on increased value of the investment in the Opportunity Zone
   - Viewed by long-term investors as most attractive benefit
   - Under the proposed regulations, the investment in the Fund must be sold by 2047 to be able to elect the FMV basis step-up

Example

Robin has $100 of unrealized capital gains in her stock portfolio. She decides on 1/1/19 to reinvest those gains into an Opportunity Zone Fund and holds the investment for 10 years.

- Robin has an initial basis of $0 in her investment
- On 1/1/24, Robin's basis is $10 (10% step up)
- On 1/1/26, Robin's basis is $15 (5% step up)
- On 12/31/26, Robin realizes the gain and has to pay taxes on the $85 ($100 less the $15 basis)
- On 1/2/29, Robin sells the investment for $200 and elects the FMV basis step up
    - Robin recognizes $0 gain and has no tax liability

Example *(cont'd)*

In short, Robin will pay taxes on 85% of her original capital gains that were deferred by investing in the O-Zone Fund. She will not pay taxes on any of the appreciation because the Opportunity Zone investment was held for over 10 years.


Investor/Taxpayer
Opportunity Zone Fund
Opportunity Zone Property

Opportunity Zone Fund

Opportunity Zone Fund

- An OZ Fund must be taxed as a corporation or partnership for federal income tax purposes
  - An LLC will be eligible, but must have two or more members (no disregarded entities)
- Self-certification
  - File Form 8896 along with income tax return
  - A pre-existing entity is eligible as long as it meets the other tests (property acquired after 12/31/17)

Opportunity Zone Fund

- Organized in one of the 50 states, D.C., or a U.S. possession
- The O-Zone Fund must hold at least 90% of its assets in Qualified O-Zone Property
- The 90% test is conducted on two dates each year:
  - The last day of the Fund's first 6-month period and
  - The last day of the Fund's taxable year
- Ramp Up Period

Investor/Taxpayer

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Opportunity Zone Fund

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Opportunity Zone Property

Opportunity Zone Property

Opportunity Zone Property

- Qualified O-Zone stock
  - Stock of a Qualified Opportunity Zone Business (QOZB) that is a C- or S-Corp
  - ***Acquired after 12/31/2017***
- Qualified O-Zone partnership interest (membership interest in the case of an LLC)
  - Interest in QOZB that is a partnership or LLC
  - ***Acquired after 12/31/2017***
- Qualified O-Zone business property
  - The O-Zone Fund may own the property directly
  - ***Acquired after 12/31/2017***

What If I Already Own OZ Land?

- Restrictions on related party transactions
  - An O-Zone Fund may not purchase O-Zone Property from a related party
  - This limits a seller from selling directly to an O-Zone Fund in which the seller owns more than 20% of the O-Zone Fund
- Other Options
  - Raw land generally okay but must be used in trade/biz
  - Consider land a “bad asset”
  - Leasing
  - Sell land at potentially higher price

Qualified Opportunity Zone Business (QZOB)

- A trade or business that:
  - Substantially all (70%) of the tangible property owned or leased is qualified O-Zone property;
  - At least 50% of the total gross income is derived from the active conduct of the business;
  - A substantial portion of the intangible property is used in the active conduct of the business;
  - Less than 5% of the average of the aggregate unadjusted bases of the property is attributable to nonqualified financial property; and
  - Not what the IRS deems "sin" businesses

"Sin" Businesses Prohibited

- Private or commercial golf course
- Country club
- Massage parlor
- Hot tub facility
- Suntan facility
- Racetrack or other gambling facility
- Liquor/beer store – potentially grocery store if significant sales are from alcohol

Opportunity Zone Business Property

- Tangible property used in the trade or business if:
  - Acquired by purchase after 12/31/17 from an unrelated party;
  - The *original use* of the property in the O-Zone commences with the O-Zone Fund or the O-Zone Fund *substantially improves* the property; **and**
  - During substantially all of the O-Zone Fund's holding period, substantially all of the property's use is in the O-Zone

Substantial improvement of property

- Substantial improvement
  - During any 30-month period, the Fund must have additions to basis equal to the property's adjusted basis at the beginning of the 30-month period
    - You have to double your basis in the property
  - Only additions to the adjusted basis of the building are required (land is not subject to the "original use" test)
- Shuttered property

Issues to Watch For

- Overlays Existing Tax Code
  - Depreciation Recapture
- Direct vs. Indirect Structuring
- Restrictions on Distributions of Interim Gain
- Restrictions on Redeployment of Capital
- Further Guidance on Recapture of Depreciation
- Imposition of Reporting Requirements

Philanthropic Community

- Connect investors with projects
- Manage O-Zone Funds
  - Due diligence
  - Compliance
- Provide seed capital
- Make program-related investments
- Make donations
- Help establish industry standards for reporting community impact requirements

Current Focus

- Proposed Statutory Changes
- Possible Third Round of Regulations
- Matching OZ Investors with Projects
  - Local vs. National
  - What projects are “shovel ready”?
- Opportunity for Okla State OZ credit
- Continuing Education and Outreach

Not so easy after all …

Good Resources

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Economic Innovation Group – www.eig.org

Novogradac & Company – www.novoco.com

Federal Government – www.cdfifund.gov