OPPORTUNITY ZONES AND NON-PROFITS

With Hamang Patel, Partner, Co-Leader, Transactions at Michael Best

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OPPORTUNITY ZONES AND NON-PROFITS

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Opportunity Zones

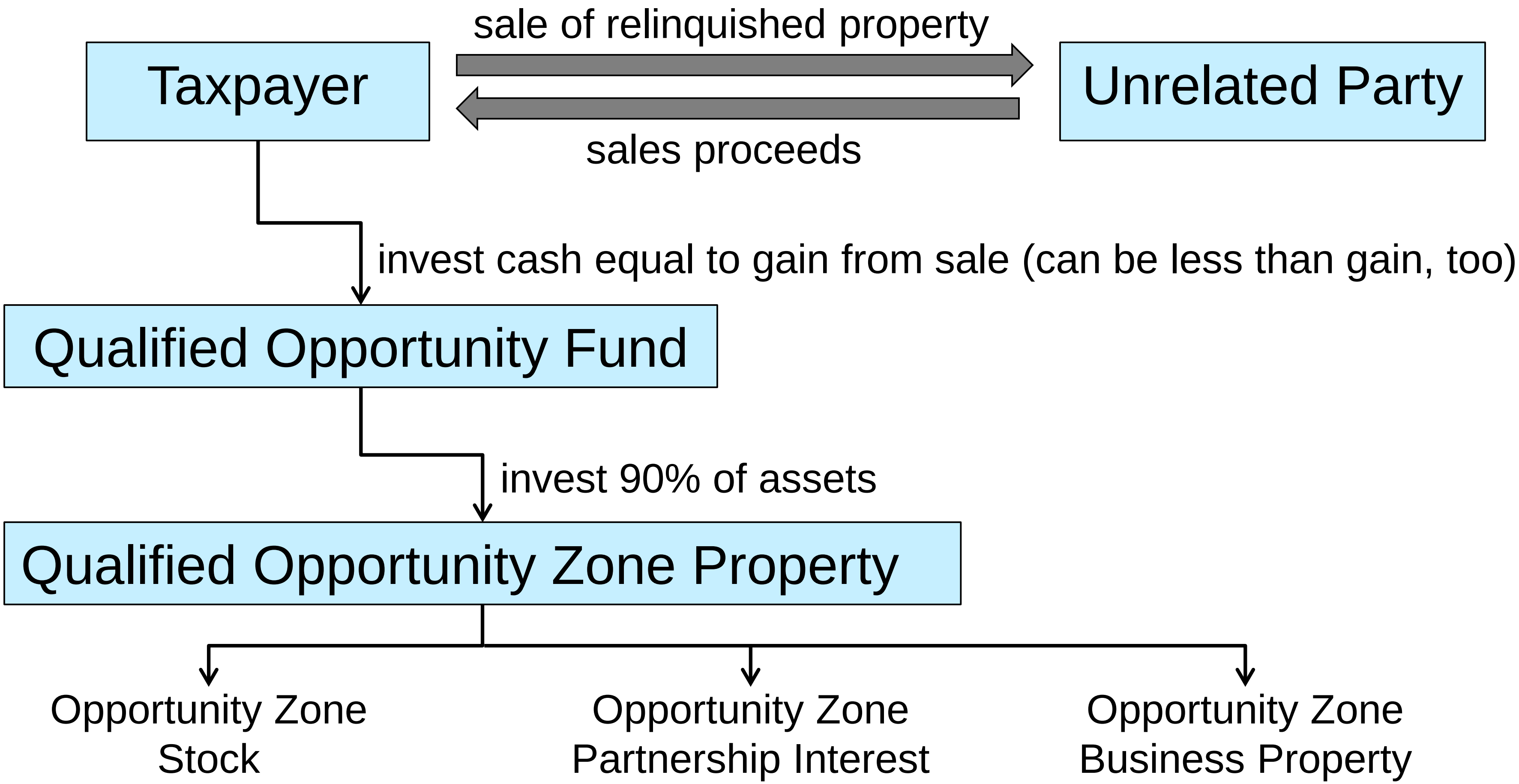
1. Creation

A. Created by Tax Cuts & Jobs Act (PL 115-97) on December 22, 2017.

B. New IRC §1400Z.

C. Purpose is to spur private investment in distressed communities by providing tax benefits to investors.

2. Overall Structure



3. Income Tax Benefits

A. Gains

1. Applies to capital gains from sale or exchange of property.
2. Sale must be to an unrelated party (80% standard).

3. Income Tax Benefits

B. Reinvestment

1. An amount equal to (or less than) the gain from sale of relinquished property invested in a Fund within 180 days of the date on which gain would be recognized upon the relinquished property.
2. The investment must be common or preferred equity (not debt).
3. No minimum or maximum limits.
4. To benefit from IRC §1400Z, only an amount equal to (or less than) the gain needs to be invested in the Fund (not the entire amount of proceeds).

3. Income Tax Benefits

C. Deferral of Gain

1. Deferral of gain from relinquished property until earlier of (i) the sale of the Fund investment (subject to reinvestment) or (ii) December 31, 2026.
2. Deferred gain recognized equal to difference between (i) the lesser of (x) excluded gain or (y) FMV of Fund investment and (ii) basis in the Fund.
   a. The taxpayer's initial basis in the Fund is $0.
   b. If the taxpayer holds the Opportunity Zone investment for at least five (5) years, the basis of such investment stepped-up by 10% of the gain deferred.
   c. If the taxpayer holds the Opportunity Zone investment for at least seven (7) years, the basis of such investment stepped-up by additional 5% of the gain deferred (i.e., 15% aggregate step-up).

3. Income Tax Benefits

D. Exclusion of Gain

1. Opportunity Zone investment held for at least ten (10) years.
   a. Latest potential holding period must start within 180 days from sale <u>and</u> by June 2027 (i.e., 180 days after December 31, 2026).
2. Step-up of basis in Opportunity Zone investment to FMV on the date the investment is sold or exchanged.
   a. The sale must be on or before December 31, 2047 per proposed regs (i.e., 20 ½ years after the latest date an election may be made – 10 years after June 2027 plus an extra 10 years).
   b. In order to enjoy the benefits of this exclusion, the taxpayer would need to sell the investment in the Fund.
   c. The proposed regulations clarify an ambiguity in the statute regarding the exclusion after the zone designations expire on December 31, 2028.

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3. Income Tax Benefits

E. Deferral Election Details

1. Taxpayers may elect to defer the tax on some or all of the gain from sale of relinquished property.
2. Election to defer gains made when filing the taxpayer's income tax return in the year of the sale of the relinquished property.
3. Information about the relinquished property to be identified on IRS Form 8949, *with instructions on how to use that Form to come*.
4. Sales of relinquished property in 2017 can become eligible for IRC §1400Z, even if the taxpayer filed a 2017 return by filing an amended return.

3. Income Tax Benefits

E. Deferral Election Details (cont.)

5. No double dipping.
   a. No election may be made with respect to a sale if an election previously made is in effect.
   b. Multiple Fund investments are permissible, as long as the aggregate deferral does not exceed the gain recognized upon the sale.

3. Income Tax Benefits

F. Deferral Election by Pass-through

1. A partnership may make the election, if the partnership makes an eligible investment in a Fund.
2. If a partnership fails to elect, then the gain is passed through per IRC 705, and a partner may make the election with respect to the partner's eligible investment in a Fund (to the extent of the allocable share of the gain).
   a. The partner's 180 day period starts on the last day of the partnership's tax year.
   b. Special rules allow the partner's 180 day period to commence sooner if notice is given.
3. Similar rules apply to other pass-throughs (e.g., S-corps, decedent's estates, and trusts).

3. Income Tax Benefits

G. Additional Investments in Funds

1. The exclusion only applies to the equity interest attributed to the reinvestment of relinquished property proceeds.
2. Additional investments or subsequent investments need to be separately tracked and are not eligible for the exclusion.
3. Deemed contributions under IRC section 752 do not constitute a Fund investment.

3. Income Tax Benefits

H. Sale of Fund Equity

1. If a sale of the Fund equity triggers an inclusion of the deferred gain, may make a qualifying new investment in a Fund, and make a new election to defer inclusion of the previously deferred gain.
2. This concept only works if the taxpayer disposes of the ENTIRE original Fund equity (i.e., it doesn’t apply to partial redemptions).

4. Investors

- Individual
- C Corporation
- S Corporation
- Partnership
- LLC
- Trust

Don’t need to live,

Work, or have a business

in an Opportunity Zone.

5. Opportunity Zone

A. A “low-income community” census tract (as defined for new market tax credit purposes with some exceptions).

B. Nominated by each state governor and designated by U.S. Department of Treasury.

   1. Limited to 25% of the number of low-income census tracts in the state, but if the state has less than 100, it is permitted to designate 25 tracts as Opportunity Zones.

5. Opportunity Zone

C. First set of Opportunity Zones designated on April 9, 2018 covering 18 states and all zones approved as of June 15, 2018 in all 50 states, 5 territories, and the District of Columbia.

D. Approximately 8,767 low-income areas deemed to qualify as of October, 2018.

E. A list of eligible Opportunity Zones by state available at the following link: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

F. A mapping feature available at the following link: https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml

6. Qualified Fund

A. Can be a corporation or LLC.

B. Must be organized in one of the 50 states, D.C., or a U.S. possession.

C. Can be an existing or a new entity.

D. Must have a purpose of investing in qualified Opportunity Zone Property (other than another Fund).

6. Qualified Fund

E. Must hold at least 90% of its assets in Qualified Opportunity Zone Property.

1. Determined by the average of the % of Qualified Opportunity Zone Property held in the Fund.

2. Use asset values reported on the Fund's "applicable financial statement" as defined in §1.475(a)-4(h) (e.g., financials filed with SEC, federal agency, or certified audited financial statements prepared in accordance with US GAAP and given to 3rd parties). If no such financials, then use cost of assets.

6. Qualified Fund

E. Must hold at least 90% of its assets in Qualified Opportunity Zone Property (cont.)

    3. Test measured on the last date of the first 6-month period of the tax year of the Fund and on the last day of the tax year of the Fund.

6. Qualified Fund

F. Certification Generally.

1. A Fund can be self-certified.
2. No approval or action by the IRS is required.
3. Certify using IRS Form 8996.

<u>6. Qualified Fund</u>

G. <u>Certification Timing</u>.

1. The Fund should identify the tax year in which it becomes a Qualified Opportunity Fund and choose the first month in that year to be treated as such.

2. The timing is important because a taxpayer’s deferral election may not be made for an otherwise qualifying investment before the entity is a Qualified Opportunity Fund.

3. The timing is also important because the 90% test starts measurement in the first 6-month period after the entity is a Qualified Opportunity Fund or the end of the first taxable year, whichever is first.

6. Qualified Fund

H. Management.

1. No limits.
2. Can be public or private.

7. Qualified Opportunity Zone Property

A. Property which is:

- Qualified Opportunity Zone Stock;
- Qualified Opportunity Zone Partnership Interest; or
- Qualified Opportunity Zone Business Property.

Note: Qualifying property does not include equity of another Fund.

7. Qualified Opportunity Zone Property

B. Stock or Partnership Interest.

1. New or existing domestic corporation, partnership, or LLC.
2. Acquired by Fund after December 31, 2017.
3. Acquired for cash by Fund (i.e., no contributions of businesses to Fund).
4. Issued at original issue (either directly or through an underwriter).
5. Qualifies as “Opportunity Zone Business” during substantially all of the Fund’s holding period.

7. Qualified Opportunity Zone Property

C. Opportunity Zone Business Property.

1. Tangible property (either real or personal) used in trade or business.
2. Purchased by the Fund after December 31, 2017.
3. Original use of property in the Opportunity Zone commences with the Fund.

   OR

   Fund substantially improves the property.

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7. Qualified Opportunity Zone Property

C. Opportunity Zone Business Property. (cont.)

4. Substantially all of the use of the property must be in an Opportunity Zone Business for substantially all of the Fund's holding period.
   a. Proposed regulations created a safe harbor to measure this test.
   b. Under the safe harbor, at least 70% of the tangible property must be owned or leased by a trade or business must be Qualified Opportunity Zone Business Property.

7. Qualified Opportunity Zone Property

C. Opportunity Zone Business Property. (cont.)

5. Substantial Improvement.

a. Treated as substantially improved if during any thirty (30) month period beginning after the date of acquisition, additions to basis by the Fund exceed an amount equal to the adjusted basis of such property at the beginning of such thirty (30) month period in the hands of the Fund.

- Rev. Rul. 2018-29 provides that basis attributable to land on which a building sits isn't taken into account.

b. Allows real estate developers/investors to purchase existing buildings or used property and rehabilitate/improve it without having to meet the original use requirement.

c. Intent is not to allow investors to buy buildings or land simply to be held for long-term investment.

7. Qualified Opportunity Zone Property

C. Opportunity Zone Business Property. (cont.)

6. Cash.

a. Cash can be treated as Opportunity Zone Business Property for purpose of the 90% asset test if the cash is held with the intent of investing in Qualified Opportunity Zone Property.

b. Safe harbor of 31 months included in proposed regulations.

c. The safe harbor requires evidence of a written plan identifying the cash as towards acquisition, construction, or substantial improvement of tangible property in the Opportunity Zone, along with a schedule.

7. Qualified Opportunity Zone Property

C. Opportunity Zone Business Property. (cont.)

7. Entity.

   a. If an entity qualifies as a Qualified Opportunity Zone Business, the value of the Fund's entire interest in the entity counts towards the 90% asset test.

   b. A Fund can operate multiple trades or businesses through multiple entities and satisfy the 90% test if each of the entities qualifies as a Qualified Opportunity Zone Business.

7. Qualified Opportunity Zone Property

D. Open Items.

1. Need further guidance regarding how to measure where tangible property is used (e.g., based on physical presence in zone or other measure, how to address vehicles, how to address abandonment, etc.).

2. Need guidance about qualifying as an active trade or business during construction or redevelopment of an existing project.

8. Qualified Opportunity Zone Business

A. Generally.

1. Trade or business following the requirements described in IRC §1397(C) as follows:
   a. At least 50% of the total gross income derived from the active conduct of the business.
   b. A substantial portion of the use of the intangible property is used in the active conduct of such business.
   c. Less than 5% of the average of the aggregate unadjusted basis of the property is attributable to nonqualified financial property.
      i. Debt, stock, partnership interests, options futures, forwards, options, etc.
      ii. Exception for reasonable working capital held in cash, cash equivalents or debt instruments with a term of eighteen (18) months or less. The exception also applies to accounts or notes receivable in the ordinary course of a trade or business for services rendered, or from the sale of inventory.

8. Qualified Opportunity Zone Business

A. Generally. (cont.)

2. No “sin business”:
   a. Private or commercial golf course;
   b. Country club;
   c. Massage parlor;
   d. Hot tub facility;
   e. Suntan facility;
   f. Racetrack or other facility used for gambling; or
   g. Store the principal purpose of which is the sale of alcoholic beverages for consumption off premises.

9. Qualified Fund – Alternative Structures

A. Number of Investments by Funds.

1. Possible for a Fund to be single-investment and single-purpose.
2. In a September 28, 2018 letter to the Secretary of the Treasury, Senator Scott contemplated that most Funds would have multiple portfolio investments.
   a. Need IRS guidance on how to address “churn” from Funds disposing of investments prior to the disposition of investors’ equity interests in the Fund.
   b. Senator Scott asked Treasury to address reinvestments by Funds.
   c. Reinvestments by a Fund were not addressed by the initial proposed regulations.

9. Qualified Fund – Alternative Structures

B. Number of Investors in Fund.

1. No floor or ceiling on the number of investors in a Fund.
2. Any non-corporate entity must be treated as a partnership.
3. In the September 28, 2018 letter, Senator Scott mentioned the drafters envisioned the pooling of capital and risk among a wide array of investors.

10. Penalty for Compliance Failure

A. If Fund fails to meet the 90% asset requirement, it will be assessed a penalty for each month the failure continues.

B. Penalty equals (i) 90% of its aggregate assets minus the aggregate amount of Qualified Opportunity Zone Property held by the Fund multiplied by (ii) underpayment rate under IRC 6621(a)(2) for such month.

C. Reasonable cause exception.

11. Qualified Fund – Securities Laws

A. Under federal securities laws, a company that offers or sells its securities must register the securities with the SEC or find an exemption from the registration requirements.

B. No exemption from federal and state securities laws for Funds.

C. Federal securities laws provide a number of exemptions. A major exemption includes sales to "accredited investors."
See https://www.sec.gov/fast-answers/answers-accredhtm.html

D. Single-owner Fund owned by the sponsor likely to sidestep securities laws regarding disclosure.

12. Proposed Regulations

A. Proposed regulations were issued on Friday October 19, 2018 and available at the following link: https://www.irs.gov/pub/irs-drop/reg-115420-18.pdf.

B. Initial IRS guidance in the form of frequently asked questions issued at the following link: https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.

C. Additional proposed regulations are expected.

13. Interaction with Other Tax Incentives

A. NMTC

1. Overlap with low-income census tracts.

2. Acquisition of QALICB equity does not interfere with the pass-through of the NMTC to an investor.

3. IRC §1400Z benefits would be held by the QALICB owners.

13. Interaction with Other Tax Incentives

B. LIHTC

1. Many affordable housing developments are located in Opportunity Zones.
2. Parallel between the ten (10) year holding period of an investment in a Fund and the holding period of a low-income housing tax credit (LIHTC) investor in a LIHTC partnership.
3. Could certify the LIHTC partnership as a Fund.
4. Benefits to investors investing in limited partner equity through reduction of tax on gain from disposing of such interest in a high loss deal after ten (10) years.
5. Need to invest fully within 180 days of a sale of relinquished property to receive full benefit of the deferral and exclusion. However, LIHTC investors typically fund over an extended period during construction, which may limit benefits.

13. Interaction with Other Tax Incentives

C. HTC

1. Similar issues to LIHTC.
2. Put after five (5) years by investor may limit ability to benefit from exclusion (which requires at least ten (10) years of holding period).
3. Consider master tenant structure to permit issuance of Qualified Opportunity Zone Partnership Interest of the landlord.
4. May have difficulty causing a master tenant to qualify as a Fund.

13. Interaction with Other Tax Incentives

D. Other Deferral/Exclusions Provisions

1. IRC §1202.
   a. 100% exclusion.
   b. Need to meet five (5) year holding period.
   c. C-corporation.
2. IRC § 1045.
   a. Rollover of gain from qualified small business stock if other such stock purchased during sixty (60) day period.
   b. Not available for C-corporation taxpayers.
   c. Requires reinvestment of relinquished property proceeds, not just gain.
   d. Elective.

13. Interaction with Other Tax Incentives

D. Other Deferral/Exclusions Provisions (cont.)

3. IRC §1031.
   a. No longer available for tangible personal property.
   b. No constructive receipt of relinquished property proceeds.
   c. Requires reinvestment of relinquished property proceeds, not just gain.
4. IRC §1033.
   a. Requires reinvestment of relinquished property proceeds, not just gain.
   b. Elective.

14. Opportunities for Nonprofits

A. Nonprofit as Fund Manager

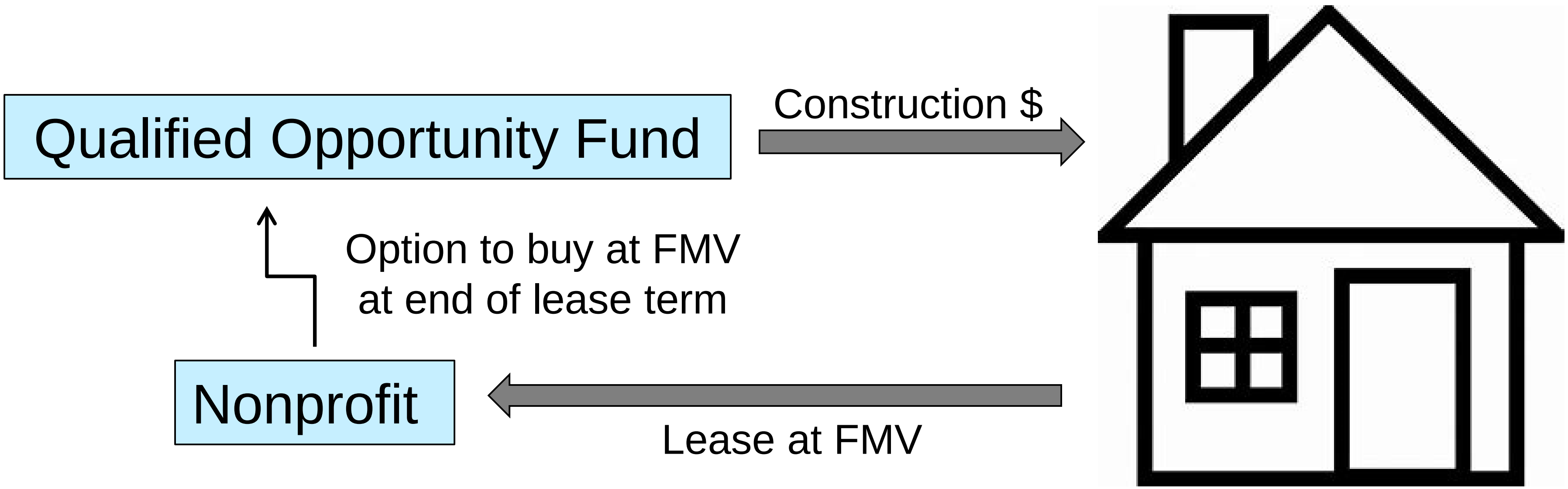
1. Must comply with all requirements of §501
2. How does the investment fit with the tax-exempt mission?
3. Potential unrelated business issues
    a. Unrelated Business Taxable Income (“UBTI”)
    b. Potential to jeopardize tax exemption if substantial

14. Opportunities for Nonprofits

B. Nonprofit as Project Owner/Beneficiary - Example: New build facility

1. Steps:
   a. Qualified Opportunity Fund builds facility
   b. Qualified Opportunity Fund leases facility to Nonprofit at fair market value
   c. At the end of the lease term (e.g.,10 years), Nonprofit has option to purchase facility from Qualified Opportunity Fund at fair market value
2. Gives the Nonprofit time to do a capital fund drive
3. Not a bargain for the Nonprofit
   1. Must be structured as a true lease, not a capital lease
   2. Must be sold at fair market value

Example: New build facility



14. Opportunities for Nonprofits

B. Nonprofit as Project Owner/Beneficiary (cont.)

4. Elements of a True Lease - All of the following criteria must be satisfied:
   a. Lessor must have made a minimum unconditional “at risk” investment (“Minimum Investment”) when lease begins, and must maintain Minimum Investment through end of lease term
      a. Must be an equity investment
      b. Must be equal to at least 20% of the cost of the property throughout the lease term
      c. Must be unconditional (i.e., Lessor must not be entitled a return of any portion of the Minimum Investment from L:essee or any party related to lessee)
   b. Lessee may not have a contractual right to purchase the property at a price that is less than fair market value at the time the right is exercised
   c. Subject to certain exceptions, Lessee must not make substantial improvements to the property
   d. Lessee must not lend money to, or guarantee any indebtedness of, the Lessor that is used to purchase the property
   e. Lessor must intend to receive a profit from the transaction
   f. The property must not be “limited use property” (i.e., at the end of the lease term, it must be probable that there will be potential lessees or buyers other than the Lessee)

14. Opportunities for Nonprofits

C. Nonprofit as Lender

1. Contribute to the total funding for a project through a low-interest loan along side a Qualified Opportunity Fund investment

2. Could add mission-aligned parameters

3. Must comply with all requirements of §501 and further the Nonprofit's charitable mission

14. Opportunities for Nonprofits

D. Nonprofit as Investor

1. Invest in a Qualified Opportunity Zone Business
2. Must comply with all requirements of §501 and further the charitable mission
3. IRS will likely look at such an investment skeptically

Opportunity Zones

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