Navigating Opportunity Zone Client Representation

Dannielle Lewis, CPA, WIPFLI, LLP – CPAs and Consultants

Emily Chad, Tax Lawyer, Fredrikson & Byron

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Taking Advantage of Opportunity Zone Investing

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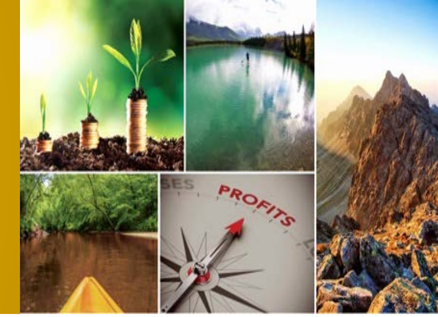
Opportunity Zones 101

- Taxpayer has “capital gain” from an actual or deemed sale or exchange of property or any other gain included in the calculation of capital gain for federal income tax purposes
- The sale or exchange of property must be with an unrelated third party (20% standard applies rather than normal 50%)
- Gain can be from personal, business, or investment property
- Taxpayer reinvests that capital gain into a Qualified Opportunity Fund (QOF) within 180 days of the transaction triggering the gain

Opportunity Zones 101



Federal tax benefits for investor:

- Deferral
  - Investors can make an election for their reinvested capital gain to be deferred until *earlier* of:
    - When they sell their QOF investment
    - December 31, 2026
- Basis Step Up
  - Five years, their *original deferred capital gain* is reduced by 10%
  - Seven years, their *original deferred capital gain* is reduced by another 5%
- Exclusion
  - Ten years = If taxpayers elect, no taxable gain is recognized on the sale of their *QOF investment* (their tax basis in the QOF investment is deemed to be equal to its FMV as of the date of sale), but a taxable loss can still be recognized
    - This 10-year hold benefit is not impaired solely because the designation of opportunity zones ceases to be in effect on December 31, 2027
    - The taxpayer remains eligible for the 10-year hold benefit until December 31, 2047

Opportunity Zones 101

- A fund can be a:
  - Corporation (C or S),
  - Partnership, or
  - LLC that is taxed as either a corporation or partnership
- The fund entity must hold at least 90% of its assets in Qualified Opportunity Zone Property (QOZP) which is the following:
  - Qualified Opportunity Zone Stock or Qualified Opportunity Zone Partnership Interest
    - Equity interest must be in a new or existing partnership/corporation
    - Equity interest must be acquired by fund after December 31, 2017
    - Equity interest must be acquired for cash
    - Stock or partnership interest must be original issue, not acquired from another investor in the corporation, partnership or LLC
    - Must be a QOZ Business at the time the interest is issued and for 90% of the QOF’s holding period of the interest.

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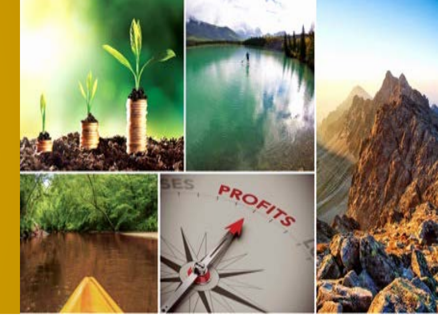
Opportunity Zones 101

- The fund entity must hold at least 90% of its assets in Qualified Opportunity Zone Property (QOZP) which is the following:
  - Direct investment in Qualified Opportunity Zone Business Property (QOZBP)
    - Tangible property that is used in the trade or business of the QOF or QOZ business
    - The property must be acquired by purchase from an unrelated party (20% standard applies rather than normal 50%)
    - Property must be acquired after December 31, 2017
    - The “original use” of the property within the QOZ must commence with the QOF or Substantial” improvements must be made to the property
    - *70% of the use must be in an opportunity zone during 90% of the holding period*

Qualified Opportunity Zone Business

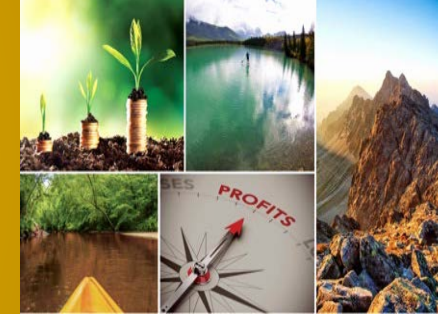
- Substantially all (70%) of the trade or business's tangible property, owned or leased, is QOZB Property
- A substantial portion of its intangible property is used in the active conduct of the trade or business *(40%)*
- Less than 5% of the average of the aggregate unadjusted basis of its property is attributable to nonqualified financial property
    - An exception is made for reasonable amounts of working capital held as cash, cash equivalents or debt for 18 months or less
- A least 50% of its total gross income is derived from the active conduct of its trade or business in the qualified opportunity zone
    - *Safe harbor #1: 50%* of the services performed for the business by its employees and independent contractors (and employees of independent contractors) are performed in the qualified opportunity zone, based on amounts paid for the services performed
    - *Safe harbor #2: 50%* of the services performed (based on hours) for such business by its employees and independent contractors (and employees of independent contractors) are performed within the qualified opportunity zone
    - *Safe harbor #3: 50%* of the gross income requirement is met if (1) the tangible property of the business that is in a qualified opportunity zone and (2) the management or operational functions performed for the business in the qualified opportunity zone are each necessary to generate 50 percent of the gross income of the trade or business.

Qualified Opportunity Zone Business



- No “Sin” businesses
- Working-capital safe-harbor is expanded to include development of a trade or business
  - An exception is made for reasonable amounts of working capital held as cash, cash equivalents or debt for 18 months or less
- Safe harbor for inventory in transit
  - Inventory (including raw materials) of a trade or business does not fail to be used in a qualified opportunity zone solely because the inventory is in transit--
    - From a vendor to a facility of the trade or business that is in a qualified opportunity zone, or
    - From a facility of the trade or business that is in a qualified opportunity zone to customers of the trade or business that are not located in a qualified opportunity zone

Leased Property



- In order for leased property to meet the definition of QOZBP they must meet the following criteria:
  - Lease must have been entered into after 12/31/2017
  - 70% of the use of the leased property must be in an opportunity zone 90% of the time of the lease
- The proposed regulations provide that improvements made by a lessee to leased property satisfy the original use requirement and are considered purchased property
- The proposed regulations impose an original use requirement with respect to leased tangible property or impose a requirement for a lessee to “substantially improve” leased tangible property
- The proposed regulations do not require leased tangible property to be acquired from a lessor that is unrelated
- Lease needs to be at market rate
  - The proposed regulations also issue guidance on valuing the lease
- If the lessor and lessee are related, the proposed regulations do not permit leased tangible property to be treated as qualified opportunity zone business property if, in connection with the lease, a QOF or qualified opportunity zone business at any time makes a prepayment to the lessor relating to a period of use of the leased tangible property that exceeds 12 months.
- Leased tangible personal property is not treated as qualified OZ business property unless the lessee becomes the owner of tangible property that is qualified OZ business property and that has a value not less than the value of the leased personal property.

Real Estate Updates

- Tangible Property & Original Use
  - If real property, other than land, that is acquired by purchase had been placed in service in the qualified opportunity zone by a person other than the QOF or qualified opportunity zone business in a means that would allow the tangible property to be depreciated or amortized, then it needs to be substantially improved to be considered qualified opportunity zone business property
- Land & Original Use
  - The original use requirements do not apply to land that is improved or unimproved, nor does it need to be substantially improved. However, the land must still be used in a trade or business and cannot rely on the proposed regulations if the intent is to not improve the land by more than an insubstantial amount within 30 months after the date of purchase.
- Triple Net Leases
  - The ownership and operation (including leasing) of real property is the active conduct of a trade or business. However, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer.

Real Estate Updates

- Contiguous Property in an Opportunity Zone
  - If the amount of real property based on square footage located within the qualified opportunity zone is substantial as compared to the amount of real property based on square footage outside of the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to part or all of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone
- 31-Month Working Capital Safe Harbor Exceptions
  - Exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action the application for which is completed during the 31-month period.
- Vacant Property
  - If property has been unused or vacant for an uninterrupted period of at least 5 years, original use in the zone commences on the date after that period when any person first uses or places the property in service in the qualified opportunity zone

General Opportunity Zones Updates

- §1231 Gains
  - Because the capital gain income from §1231 property is determinable only as of the last day of the taxable year, these proposed regulations provide that the 180-day period for investing such capital gain income from section 1231 property in a QOF begins on the last day of the taxable years
- Carried Interest
  - Qualifying investment into QOF may be cash or property, but not <u>services</u>
  - The proposed regulations provides that only the portion of the investment in a QOF to which an election under section 1400Z-2(a) is in effect is treated as a qualifying investment. Under this rule, the share of gain attributable to the excess investment and/or the service component of the interest in the QOF partnership is not eligible for the various benefits afforded qualifying investments
- Reasonable Time to invest
  - Six months is given to invest capital received from investors. The assets must be cash/cash equivalents or debt <18 months
- Debt Financed Distributions (DFD)
  - Proposed regulations generally allow DFD with the following exceptions:
    - Distribution will be limited to the taxpayers basis (including liabilities)
    - If there is a distribution within the first two years of the investors contribution into the QOF there are additional disguised sale rules that could affect the characteristic of the fund investment

General Opportunity Zones Updates

- Step Up to basis
  - 5 & 7 year
    - Step up is a step up for all basis clarify that such basis is basis for all purposes and, for example, losses suspended under section 704(d) would be available to the extent of the basis step-up.
  - 10 Year
    - For the selling of partnership interest, the basis adjustment is made immediately *before* the taxpayer disposes of its QOF investment. This will permit basis adjustments to the QOF partnership's assets, including its inventory and unrealized receivables, and avoid the creation of capital losses and ordinary income on the sale
- Exit Strategy
    - A taxpayer that is the holder of a direct qualifying QOF partnership interest or qualifying QOF stock of a QOF S corporation may make an election to exclude from gross income some or all the capital gain from the disposition of qualified opportunity zone property reported on Schedule K-1 of such entity, provided the disposition occurs after the taxpayer's 10-year holding period. To the extent that such Schedule K-1 separately states capital gains arising from the sale or exchange of any particular capital asset, the taxpayer may make an election under section 1400Z-2(c) with respect to such separately stated itemunrealized receivables, and avoid the creation of capital losses and ordinary income on the sale

Inclusion Events & Other Transactions

- Regulations detail out eleven different inclusion events in proposed regulations that would cause the inclusion of deferred capital gain
  - Gifts
  - Sale/Disposition
  - Distributions
- Death – Not an inclusion event
- Secondary purchase of fund interest
- Interim Gains

What's the Deal? Representing Opportunity Zone Parties

Emily Chad

June 26, 2019

Fredrikson & BYRON, P.A.

What kind of deals are being done?

- Real Estate
  - Developer
  - Investor(s), through one or several funds
  - Multi-member project company
- Business Investments
  - Likely C corporation targets
  - Likely multi-asset, multi-investor funds to diversify risk
  - Still uncertain
- Direct Investments in Property
  - Fund buys property directly
  - Possibly single member LLCs to hold individual properties

What does your client need?

- OZ Investor
  - Legal:
    - Timing of initial investment
    - Creation and certification of the fund (maybe)
    - Investment documents in underlying QOZB equities
    - Structure liquidity event in 2027 to pay taxes
    - Structure exit after 10 years
  - Accounting:
    - Match tax basis with losses, cashflow
    - Model after-tax returns for investor
    - Assess appetite for bonus depreciation
    - Netting of 1231 gains

What does your client need?

- Fund (multi investor fund)
  - Legal:
    - Creation and certification of the fund
    - Operating Agreement/LLC Agreement for the fund
    - Securities advice
    - Investment documents in underlying equities
    - Structure liquidity event in 2027 for taxes
    - Structure exit after 10 years
  - Accounting:
    - Match basis with losses, cashflow
    - Model after-tax returns
    - Ensure 90% threshold met

What does your client need?

- Sponsor or Operating Business:
  - Legal:
    - Creation of project company
    - Operating Agreement/ LLC Agreement/Shareholder Control Agreement for project company
    - Possibly securities compliance
    - Structure liquidity event in 2027 for taxes
    - Structure exit after 10 year
  - Accounting:
    - Ensure 70% threshold is met
    - Watch for nonqualified financial property – reserves, equity in subsidiaries, debt instruments
    - Audit compliance with QOZB tests

What does your client need?

- Lender into an OZ project
  - Legal/Business
    - Standard debt documents
    - Review equity documents to ensure:
      - Financial projections based on reasonable assumptions
      - Remedies for failure to satisfy OZ requirements are not likely to render project company insolvent
      - Liquidity and exit event expectations realistic
    - Be open to “bottom dollar” guarantees for investor or fund to ensure sufficient basis

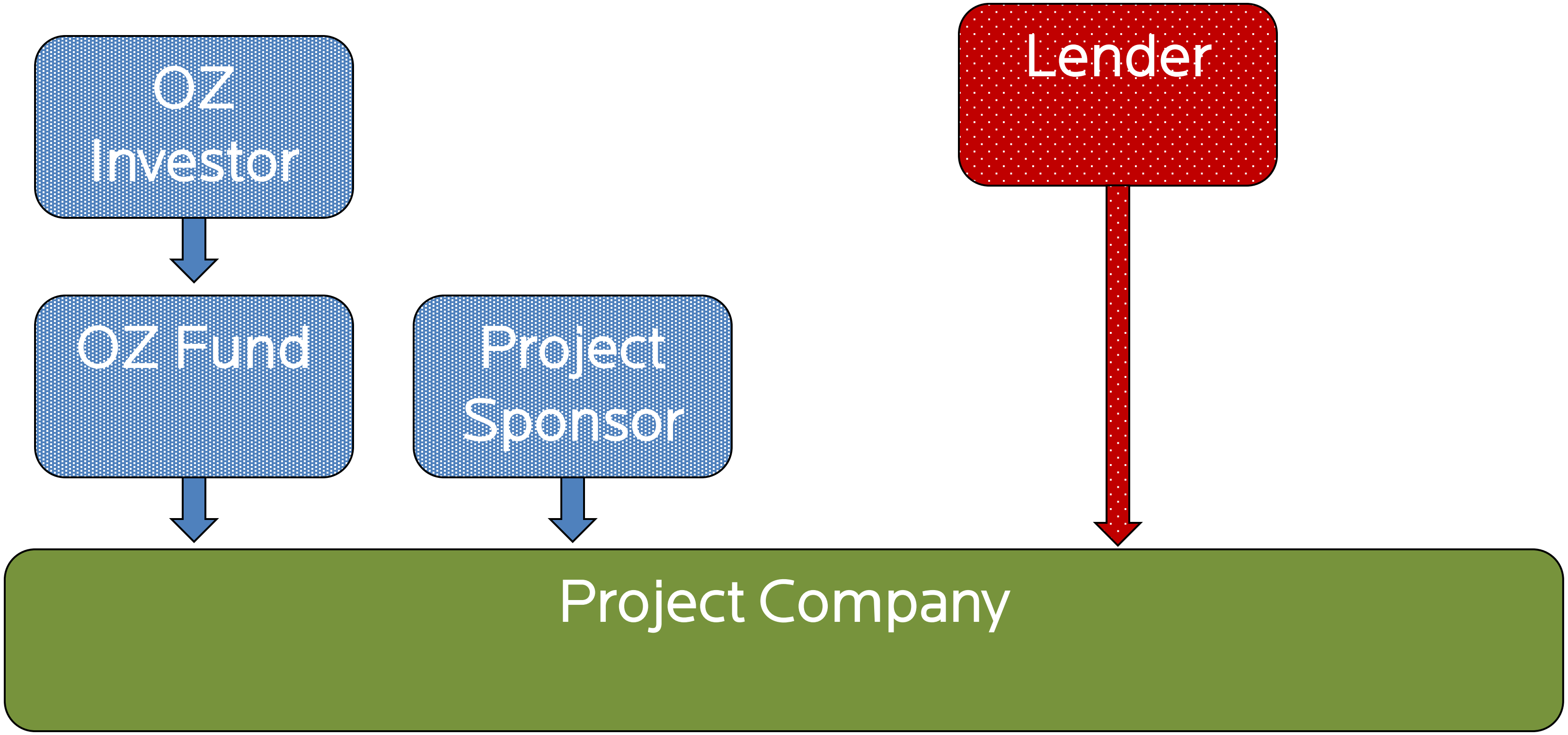
National Marketplace

- Single investor, single asset deals have been funding for a while
- Large multi-investor, multi-project funds formed; still in the early stages of funding projects
- Hot areas:
  - Low Income and Workforce Housing
  - Hotels
  - Solar
  - Social Impact Investing*
- Expected Expansion Areas:
  - Farming-adjacent businesses
  - Operating businesses

What projects are a good fit?

- **This depends heavily on your OZ investor**
- Third party OZ investors expect double-digit pre-tax IRRs; local or impact-motivated investors likely accept lower IRRs
- Shovel-ready project for real estate projects
- Source of debt financing available to cover 40-60% of the project costs if cash flow expected in first 10 years
- Projects with either steady, reliable appreciation, or the ability to hit a “home run” after year 10
- Although no government-mandated community benefit reporting, many investors want their money to create positive community impacts and will expect accountability

How Do These Deals Look? Simple Scenario:



Example: $10M Project

Sources (No OZ)	Sources (With OZ)	Uses
Sponsor Equity: $3M Debt Financing: $75M	OZ Investment: $4.5M Sponsor Equity: $1M Debt Financing: $5M	Legal and accounting fees: $50,000 Developer Fee: $400,000 Available for project: $10.05M
Total Sources: $10.5M	Total Sources: $10.5M	Total Uses: $10.5M

OZ reduced debt need, improved project returns by decreasing interest expense

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Simple Financial Model

	Year 0	Year 1	Year 2
	2019	2020	2021
Rent	$0.00	$3,000,000.00	$3,090,000.00
(Vacancy Allowance)	$0.00	-$50,000.00	-$50,000.00
Gross Revenue	$0.00	$2,950,000.00	$3,040,000.00
Operating Expenses			
Utilities	$75,000.00	$75,000.00	$77,250.00
Management Fee	$0.00	$200,000.00	$200,000.00
Marketing	$10,000.00	$10,000.00	$10,000.00
Admin	$50,000.00	$10,000.00	$10,000.00
Insurance	$50,000.00	$100,000.00	$103,000.00
Taxes	$0.00	$200,000.00	$206,000.00
Debt			
Interest	$0.00	$300,000.00	$300,000.00
Principal	$0.00	$166,666.67	$166,666.67
Construction Expense	$10,000,000.00	$0.00	$0.00
Reserve Expenses	$0.00	$200,000.00	$200,000.00
Net Revenue		$1,688,333.33	$1,767,083.33

Tax Model

*assumes no debt	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Investment	$5,000,000	0	0	0	0	0	0	0	0		0
Tax Basis	$0	0	0	0		$500,000		$750,000	$5,000,000	$5,000,000	FMV

Investment with no basis

10% step up

1. 5% step up
2. 85% of tax due; basis step up

Step up to FMV

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Tax Model

*assumes $5M debt	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
	2,019	2,020	2,021	2,022	2,023	2,024	2,025	2,026	2,027	2,028	2,029
Investment	5,000,000	0	0	0	0	0	0	0	0		0
Tax Basis	5,000,000	5,000,000	5,000,000	5,000,000	5,000,000	5,500,000	5,500,000	5,750,000	10,000,000	10,000,000	FMV

Investment with $5M debt basis

10% step up

1. 5% step up
2. 85% of tax due; basis step up

Step up to FMV

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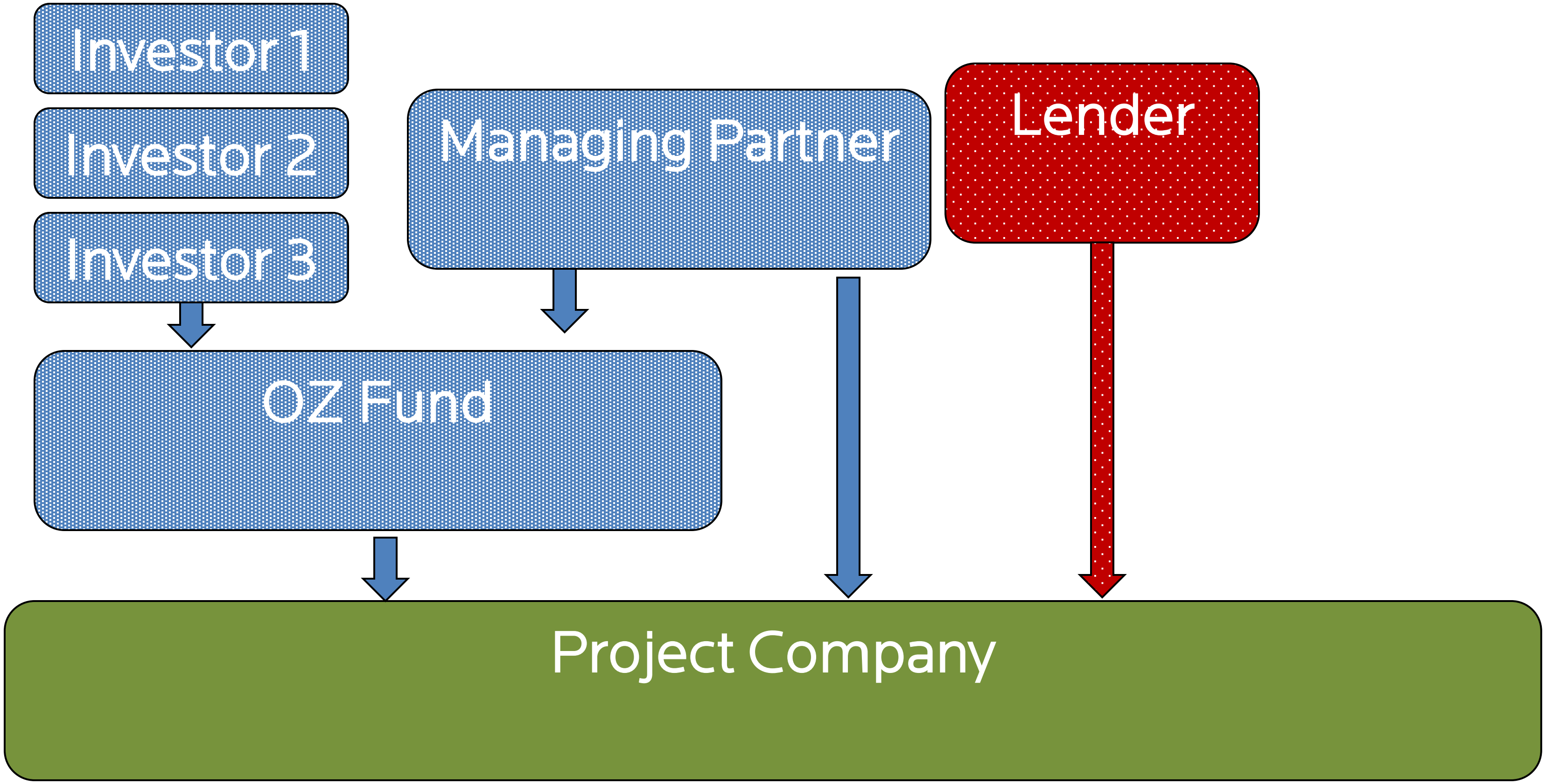
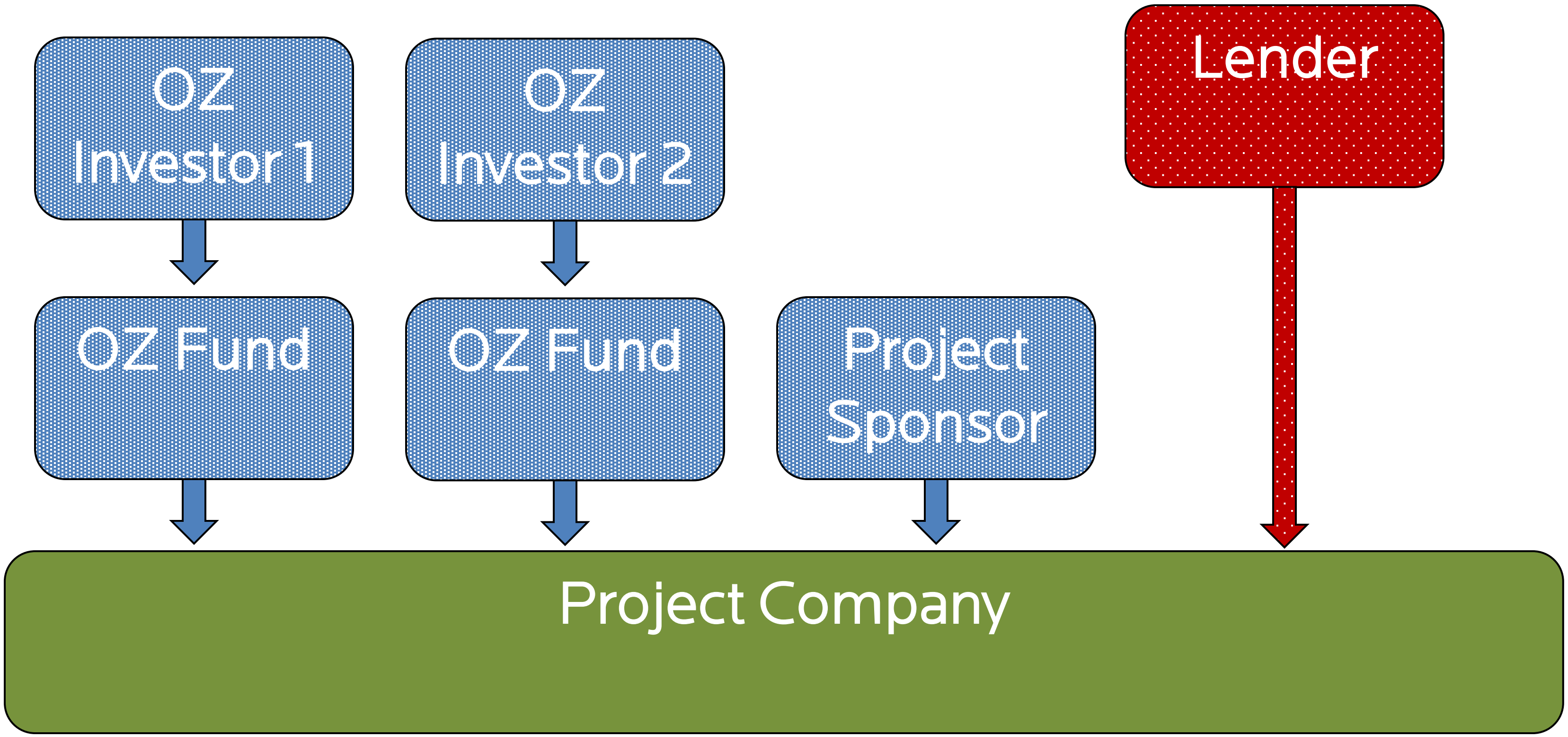
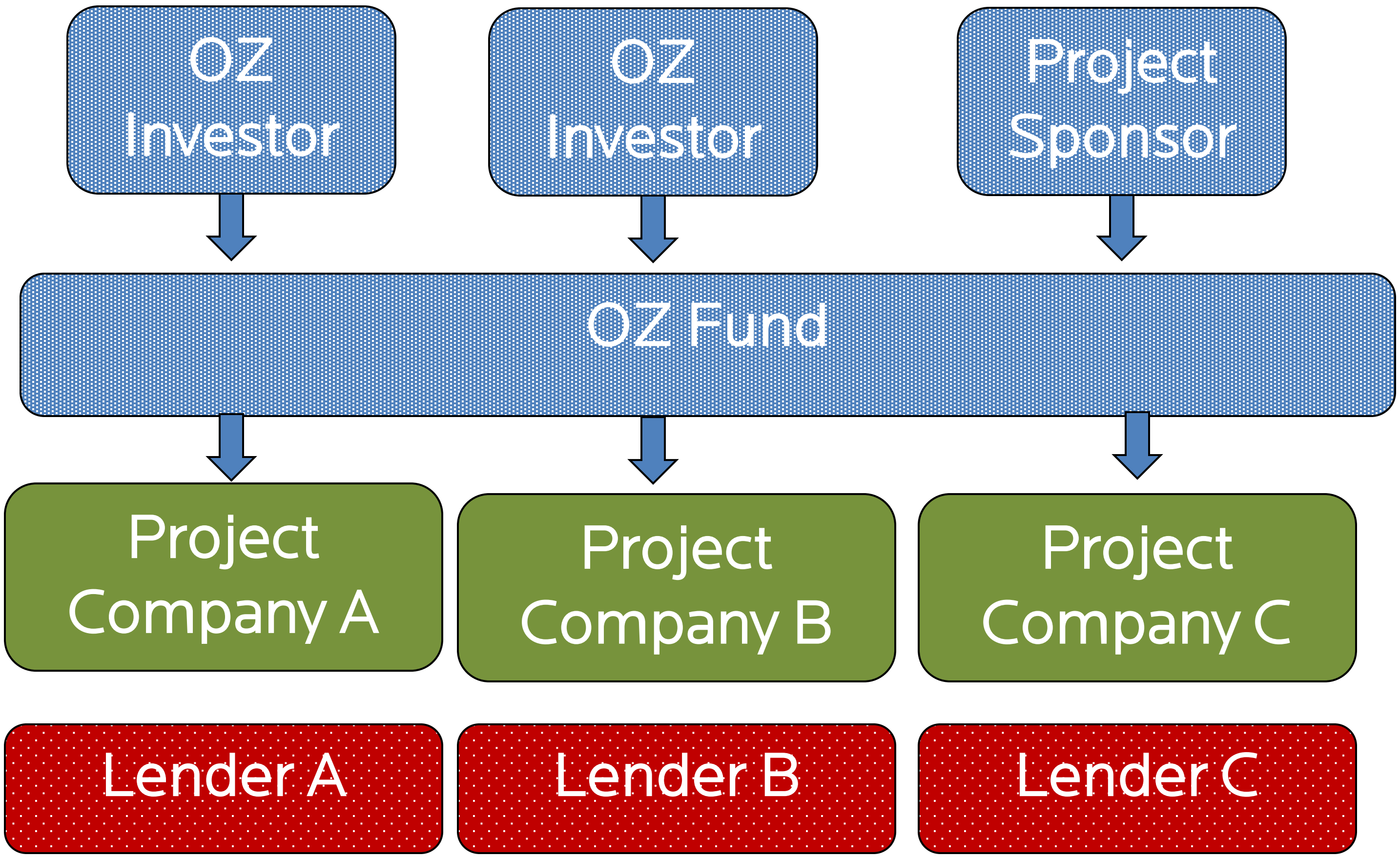
How Do These Deals Look?
Multi-Investor Fund:



How Do These Deals Look? Multiple Investors Scenario:



How Do These Deals Look? Multi-Investor, Multi-Asset:



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Common Issues #1:

- Developer already owns land in OZ
  - If developer owns >20% of project company:
    - Developer's gain from the sale to project company ineligible for OZ investment
    - Property (whether sold or contributed) is not eligible as 70% qualifying OZ property

Possible Fixes:

- Developer owns 20% or less of project company
- Developer keeps land, enters into ground lease to the project company
- Developer owns >20%, property value is less than 30% of total project value

Common Issues #2:

- Business in qualified zone wants to reinvest capital gains in own business
  - Existing business likely can't qualify for 70% qualified property requirement – must be newly deployed in zone
  - Business can't sell to itself to "launder" the assets

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Possible Fixes:

- Create a company to acquire new assets and lease to existing business
  - Manufacturing equipment
  - Solar panels
- Acquire a new property and substantially improve it; lease to existing business
- Highly unlikely: if existing assets can be "substantially improved" or will be less than 70% of final assets, might be able to make investment in existing company

Calendar of an OZ Deal

	Time Period	Responsible Parties	Task
CG – (2 months)	2-3 months prior to capital gain event (either sale or end of tax year if partnership or 1231 netting)	Investor	• Begin diligence on possible investments • Identify intended returns and liquidity needs during OZ Fund lifetime
CG	Shortly after capital gain event	• Investor • Either Fund Manager or Project Sponsor	• Begin negotiating investment documents in either the Fund (if multi-investor) or project company/operating business • Begin modeling expected returns

Calendar (cont.)

	Time Period	Responsible Party	Task
CG + 6 months	Within 6 months after capital gain event	Investor	• Make contribution(s) to Fund(s)
CG + 12 months	Within 6 months after Fund contribution	Investor or Fund Manager Project Sponsor	• Satisfy 90% test through purchase of property or equity in QOZB • Develop 31 month construction plan

Pitfalls

- No such thing as a "standard" OZ deal yet; each deal is custom and therefore expensive to negotiate
- Requires significant developer staff time to model returns and negotiate deal terms, and may require significant investor time to negotiate and understand models
- This will not make a bad project viable; third party investors are looking for long term project growth
- Even sophisticated accountants and lawyers are still coming up to speed; ongoing rule-making and interplay with other tax code sections require patient, collaborative efforts to model

Questions?

Emily Chad
Business and Tax Group

- Email: echad@fredlaw.com
- Phone: (612) 492-7397

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