EVERSHEDS SUTHERLAND

Holy Grail: Opportunity Zones and Section 199A

November 14, 2018

The Basics on QOZs

The What, Who, Where, When, Why & How of the Qualified Opportunity Zone (“**QOZ**”) Program

- ***What*** is the QOZ program and its U.S. income tax benefits?
  - The QOZ program was introduced as part of the Tax Cuts & Job Act of 2017 and offers significant opportunities to businesses and investors to defer, and potentially reduce, gains from sales or exchanges of property to unrelated parties. It requires a reinvestment of gains (and only gains) from a sale or exchange of certain assets in a Qualified Opportunity Zone Fund (“**QOZ Fund**”).
  - The principal benefits of the program can include:
    - Up to 15% of gains from the sale or exchange of certain assets is permanently excluded from gross income (“**Deferred Gain**”) if certain holding periods are met;
    - Recognition of the remaining 85% of the remaining original gain can potentially be deferred until the end of 2026; and
    - A complete exclusion of the gain from a sale or disposition of the QOZ Fund (“**QOZ Fund Gain**”) if such property is held for 10 years.

- ***Who*** can use the QOZ program?
  - Any taxpayer (foreign and U.S., corporate and non-corporate) with certain U.S. gains can benefit from the program.

- ***Where*** are QOZs located?
  - QOZs are located throughout the U.S., the District of Columbia, Puerto Rico, and U.S. territories and possessions.
  - An interactive map of all QOZs can be found through the Community Development Financial Institutions Fund’s website found at https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml

The Basics on QOZs

The What, Who, Where, When, Why & How of QOZs *(continued)*

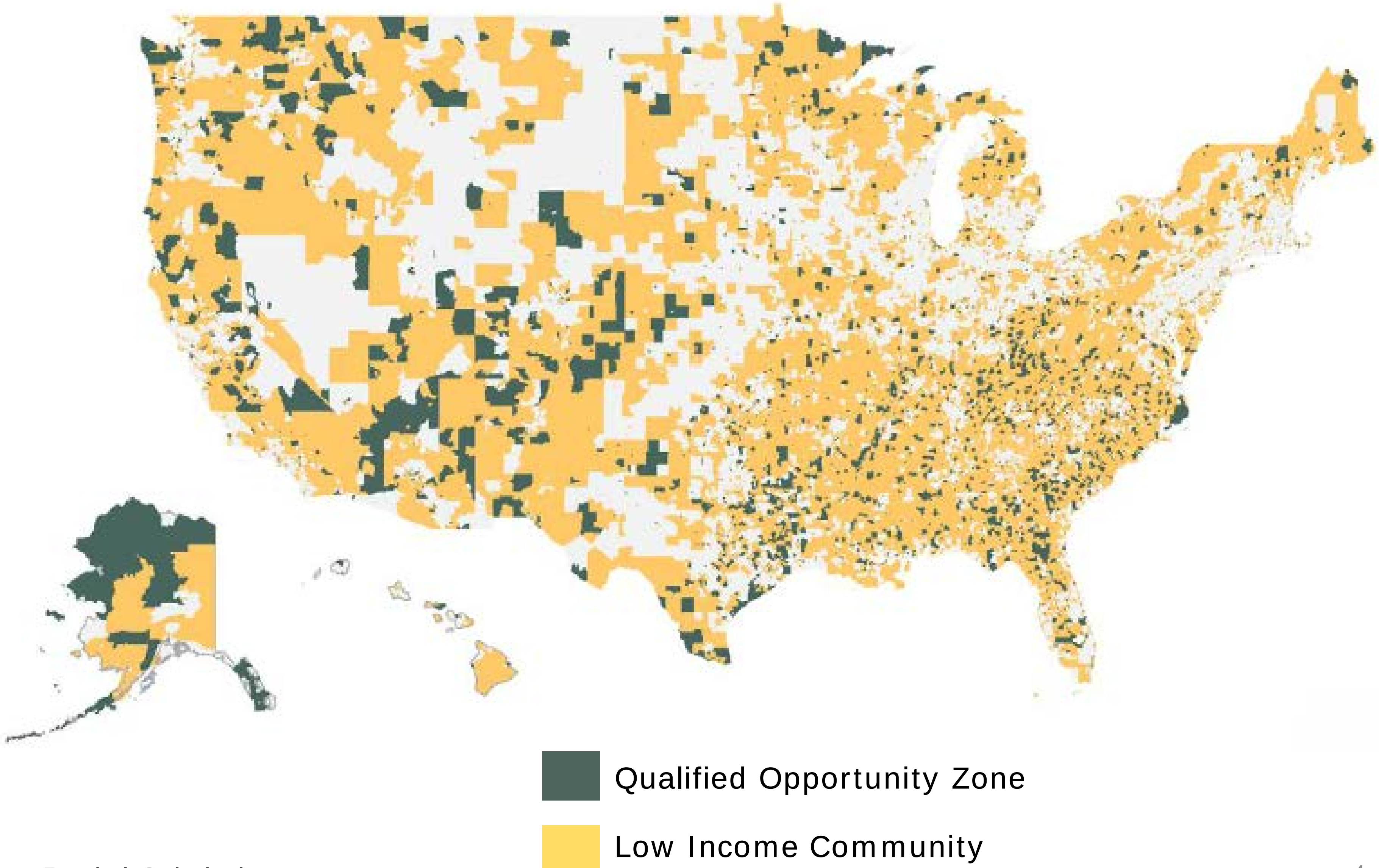
– ***When*** can a taxpayer utilize the QOZ program?
  - The QOZ program is elective and can apply when the applicable taxpayer has certain U.S. gains from the sale or exchange of certain property, and those gains are generally reinvested in a QOZ Fund within 180 days.

– ***Why*** was the QOZ program enacted?
  - QOZs are an economic development tool that were designed to spur economic development and job creation in distressed communities throughout the U.S. and its territories and possessions.

– ***How*** can a taxpayer make an investment?
  - Investments must be made through a QOZ Fund which is a U.S. corporation or partnership (and in certain cases an entity formed in a U.S. territory) formed for the purpose of investing in QOZ property.

The Basics on QOZs

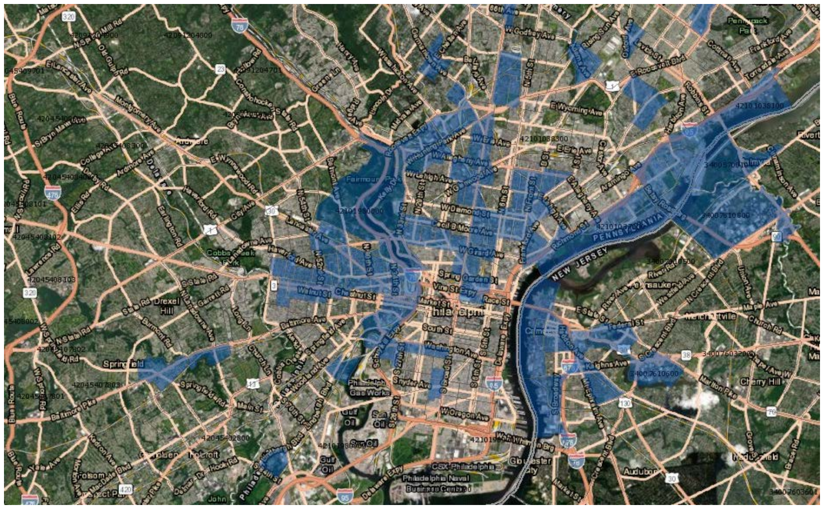
Map of Qualified Opportunity Zones in the United States



The Basics on QOZs

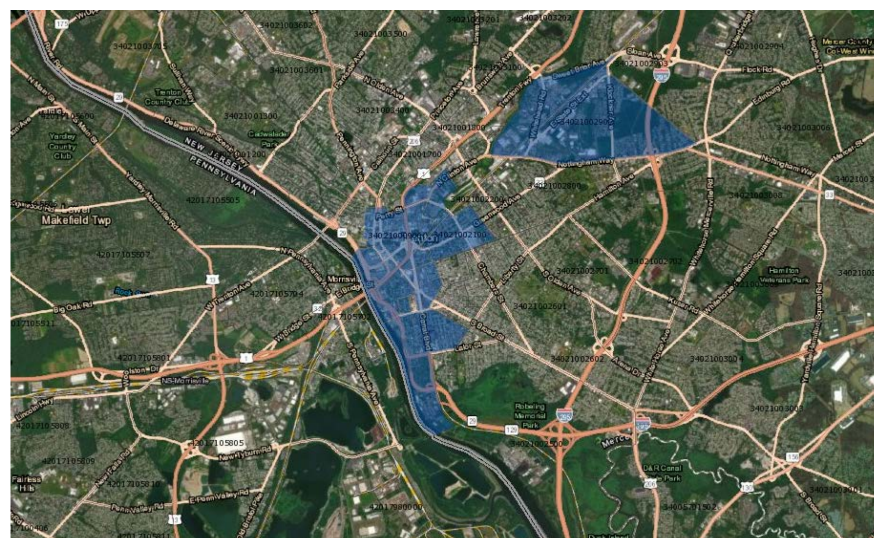
Examples of QOZs in the Greater Philadelphia & Trenton Metropolitan Areas

Greater Philadelphia Area Map



- The eligible QOZs in the Greater Philadelphia metropolitan area.
- Portions of New Jersey which ring the outside of Philadelphia can also qualify for the QOZ program.
- It appears that the Commonwealth of Pennsylvania will also be participating in the QOZ program and will have conforming Pennsylvania income tax treatment.
- It does not appear that Pennsylvania will be offering any additional incentives as part of the program.

Greater Trenton Area Map



- The eligible QOZs in the Trenton and Camden areas.
- It appears that the State of New Jersey will also be participating in the QOZ program and will have conforming New Jersey income tax treatment.
- It does not appear that New Jersey will be offering any additional incentives as part of the program.

The Basics on QOZs

Gain Deferral & Basis Increase Rules

- Deferred Gain is *deferred* until the *earlier* of (i) a disposition of all or a portion of the investment in the QOZ Fund, or (ii) December 31, 2026.

- The amount of Deferred Gain recognized equals:
  - the lesser of
    - The Deferred Gain or
    - The fair market value of the investment in the QOZ Fund on the applicable date;
  - minus the taxpayer's tax basis in the QOZ Fund.

- QOZ Basis Rules:
  - Taxpayer's starting tax basis in its interest in the QOZ Fund is <u>$0</u>.
  - If the investment in the QOZ Fund is held for at least *5 years*, taxpayer's tax basis in its interest in the QOZ Fund is <u>increased to 10%</u> of the Deferred Gain.
  - If the investment in the QOZ Fund is held for at least *7 years*, the taxpayer's tax basis in its interest in the QOZ Fund is <u>increased by another 5%</u> of the Deferred Gain.
  - If the investment in the QOZ Fund is held for <u>at least 10 years</u>, the taxpayer's tax basis in its interest in the QOZ Fund is <u>increased to fair market value</u> on a subsequent disposition of the QOZ Fund.

- The above calculation can result in at least 15% of the Deferred Gain being exempted from U.S. tax if the 7 year holding period is met.

- Proposed regulations indicate that only <u>gains treated as capital gains</u> can qualify for deferral.
  - Recharacterized items like section 1245 recapture appear to be excluded under the proposed regulations.

- Income derived by or through a QOZ Fund is still subject to U.S. federal income tax but can be combined with a tax credit or reduced taxed items like pass-through payments.

The Basics on QOZs

Example Gain Deferral & Basis Increase Rules of a QOZ

- For example:
  - Taxpayer sells capital gain assets with a tax basis of $0 for $100 million to an unrelated party and reinvests all $100 million of the gain in a QOZ Fund which otherwise qualifies for the QOZ program.
  - The taxpayer holds the interest in the QOZ Fund for seven years increasing its tax basis in the QOZ Fund from $0 to $15 million.
  - **Alternative #1 (Increase in QOZ Fund Value)**
    - The QOZ Fund investment has increased in value from $100 million to $150 million, and the taxpayer sells in the 7th year.
    - The amount of the Deferred Gain recognized would be $85 million (i.e., $100 million minus $15 million in tax basis in the QOZ Fund).
  - **Alternative #2 (Decrease in QOZ Fund Value)**
    - The QOZ Fund investment has decreased in value to $90 million, and the taxpayer also sells in the 7th year.
    - The amount of the Deferred Gain recognized would be $75 million (i.e., $90 million fair market value of the QOZ Fund minus the $15 million in tax basis in the QOZ Fund).

The Basics on QOZs

Qualifying as a QOZ Fund

- A QOZ Fund is an investment vehicle organized as a U.S. corporation or partnership; in certain circumstances an entity formed in a U.S. possession can qualify.
- 90% of the QOZ Fund's assets must be qualified opportunity zone property ("**QOZ Property**") which cannot generally include another QOZ Fund.
- The 90% threshold is tested by averaging percentages of the QOZ Property (defined below) held by the QOZ Fund at six month intervals.
- The underlying business property must be acquired from an unrelated party, which is determined using a relatively low 20% threshold.
- A QOZ Fund self certifies on an IRS Form 8996 that is to be attached to its U.S. federal income tax return. A draft of such form and the instructions attributable to such form have been released.
- QOZ Property is comprised of three items:
  - Qualified opportunity zone stock ("**QOZ Stock**");
  - Qualified opportunity zone partnership interest ("**QOZ Partnership Interest**"); or
  - Qualified zone business property ("**QOZ Business Property**").

The Basics on QOZs

Qualifying as a QOZ Fund

- QOZ Stock is generally a U.S. corporation (or a possession corporation) that:
  - Has its stock acquired after 2017 for cash;
  - Was in a qualified opportunity zone business ("**QOZ Business**") or formed for the purpose of investing in a QOZ Business; and
  - During substantially all of the QOZ Fund's holding period, the corporation qualified as a QOZ Business.

- QOZ Partnership Interest is generally a U.S. partnership (or a possession partnership) that:
  - Has its interests acquired after 2017 for cash;
  - Was in a QOZ Business or formed for the purpose of investing in a QOZ Business; and
  - During substantially all of the QOZ Fund's holding period, the partnership qualified as a QOZ Business.

- QOZ Business Property is tangible business property used in a trade or business of the QOZ Fund if:
  - The property was acquired by purchase from an unrelated party after 2017;
  - The original use in a QOZ begins with the QOZ Fund or the QOZ Fund substantially improves the property; and
  - During substantially all of the QOZ Fund's holding period, substantially all of the use of the QOZ Business Property was in a QOZ.

The Basics on QOZs

Qualifying as a QOZ Fund *(continued)*

- A QOZ Business is a trade or business in which:
  - Substantially all of the tangible property owned or leased is QOZ Business Property;
  - At least 50% of the gross income is derived from the active conduct of such trade or business;
  - A substantial portion of the QOZ Business' intangible property is used in the active conduct of that trade or business;
  - Less than 5% of the QOZ Business Property is financial property (i.e., stock, debt, options, etc.), although reasonable working capital is allowed; and
  - Is not a specified "sin" business.
- "Substantially all" is defined as 70% solely with respect to the amount of a QOZ Business an entity may have to qualify as QOZ Stock or a QOZ Partnership Interest.
  - Note: If a QOZ Fund invests directly in QOZ Business Property, its assets must meet the 90% threshold.
  - However, if a QOZ Fund invests indirectly through QOZ Stock or QOZ Partnership Interests, it must indirectly have only 63% qualifying assets (i.e., 90% x 70% = 63%).
- "Substantial Improvement" is met if within 30 months "additions to basis with respect to the property" exceeds the adjusted basis of the property at the beginning of the 30-month period.
  - The IRS has clarified in a ruling that where both land and a building are acquired, only the amounts attributable to the building are counted for the basis increase, and the land does not need to be separately improved.
- The IRS has further clarified in a ruling that land and a pre-existing building cannot have an original use.

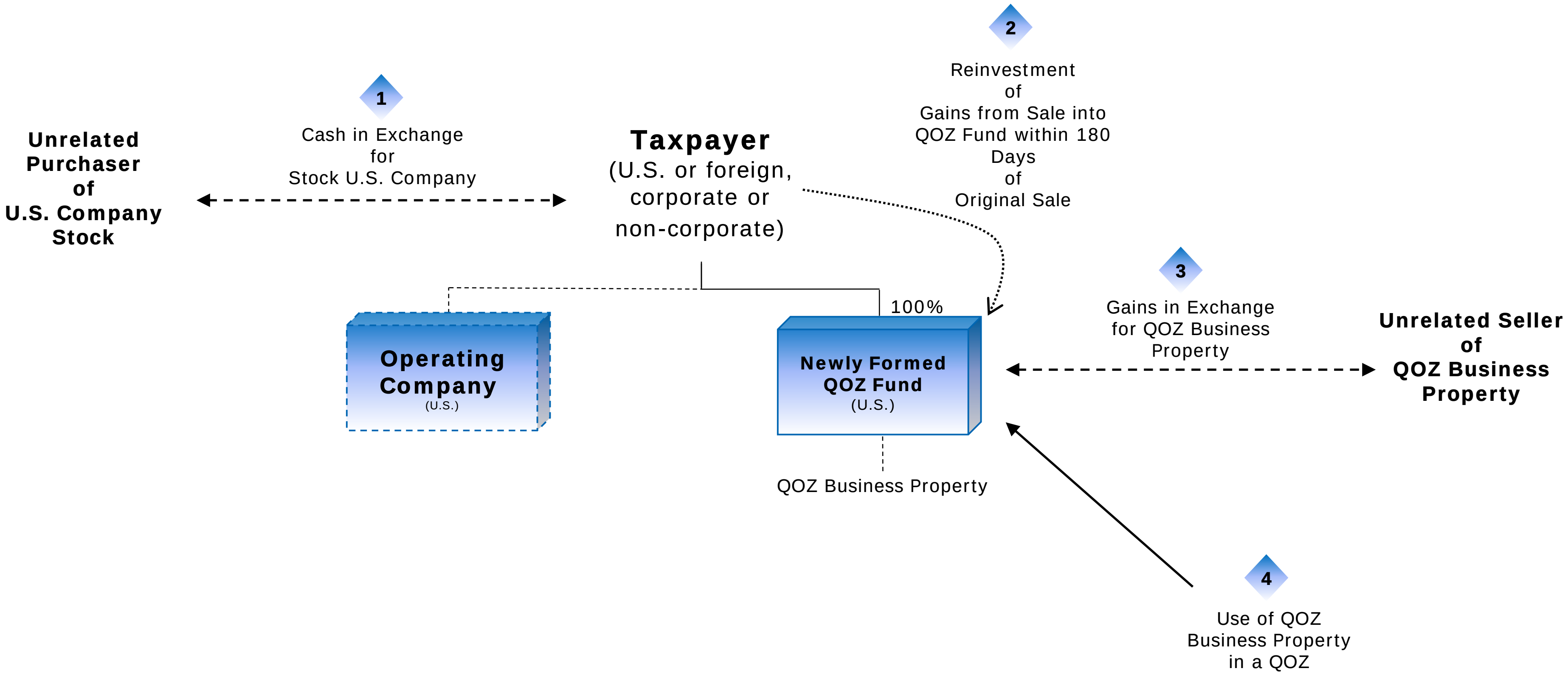
The Basics on QOZs

So Many Questions Remain.....

- Proposed regulations have been promulgated, but many questions remain and additional guidance is expected.
- What is the tax rate to which the Deferred Gain is subject at the end of the deferral period (i.e., tax rate in effect at time of original sale or at end of deferral period)?
  - Note: Proposed regulations indicate the original character of the Deferred Gain (e.g., long-term or short-term capital gain) is preserved.
- Is only a sale of a taxpayer's interest in a QOZ Fund eligible?
  - The language of the statute appears to reference only a sale or exchange of a taxpayer's interest in the QOZ Fund.
- How is debt treated in a QOZ Fund that is a partnership for U.S. federal tax purposes?
  - Because of the way partnership debt rules work, a reduction in liabilities is treated as cash received, potentially creating gain on a disposition of a QOZ Fund treated as a partnership.
  - Is a refinancing a disposition of an interest in a QOZ Fund?
- How is the disparity between the tax basis a taxpayer has in its interest in a QOZ Fund that is a partnership and the tax basis that such QOZ Fund has in its property addressed?
  - Are the events that increase the tax basis a taxpayer has in its interest in the QOZ Fund partnership also reflected in an increase in the tax basis of such QOZ Fund's property?
- How are construction costs treated if related parties are engaged (e.g., related general partner in a QOZ Fund provides construction services that are capitalized)?
- Can carried or profits interests qualify for the basis step-up on disposition of an interest in a QOZ Fund treated as a partnership for U.S. federal income tax purposes?
- What is active conduct of a business in a QOZ?

The Basics on QOZ

Possible QOZ Structure (Direct)



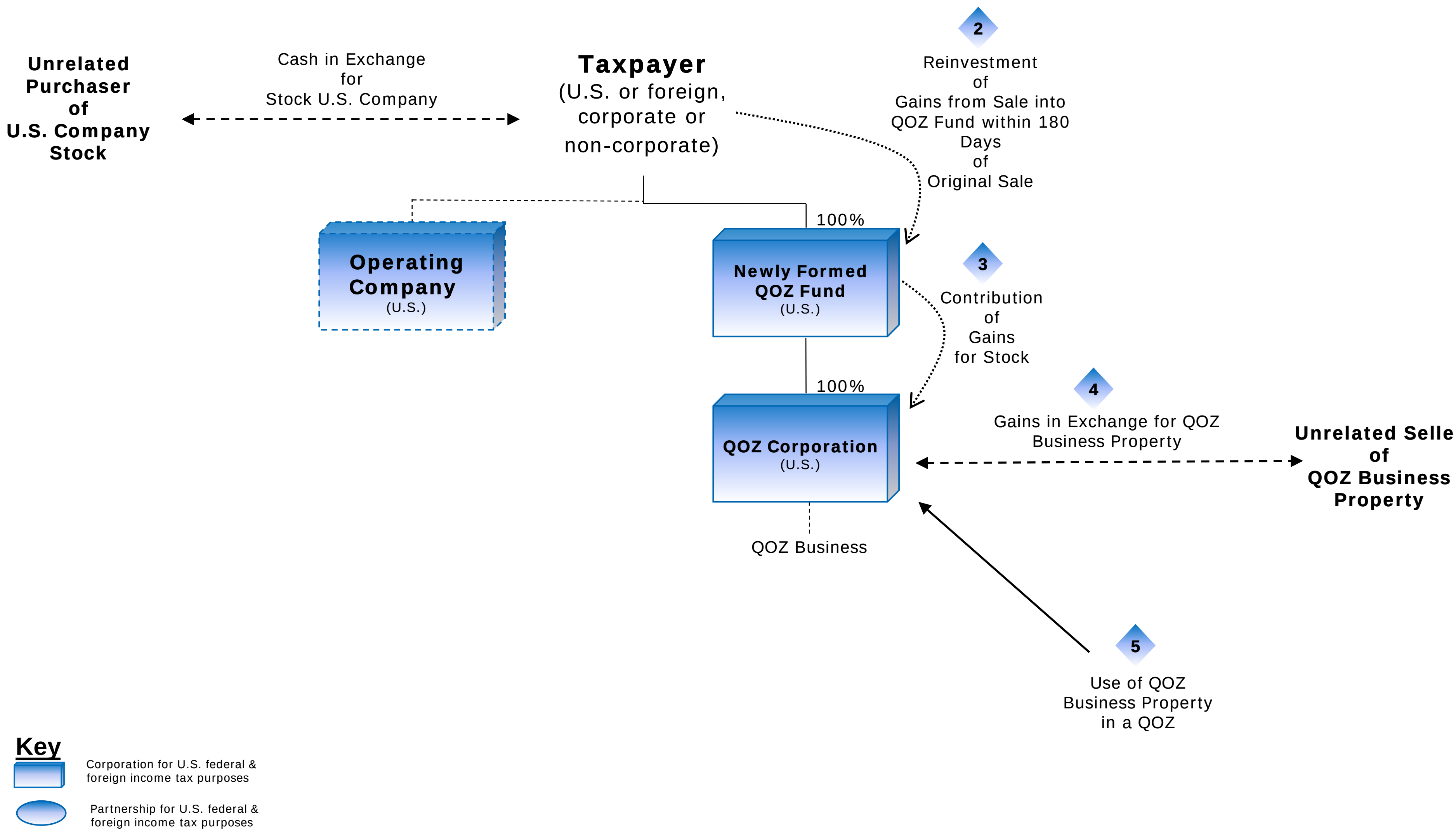
Key

Corporation for U.S. federal & foreign income tax purposes

Partnership for U.S. federal & foreign income tax purposes

The Basics on QOZ

Possible QOZ Structure (Indirect)



The Basics on QOZs

Dates & Confusing QOZ Terminology Cheat Sheet

- **Qualified Opportunity Zone Fund or "QOZ Fund"** – Generally a U.S. partnership or corporation formed to invest, directly or indirectly, in QOZs. A taxpayer with gains *can only* participate in the QOZ program through a QOZ Fund.
- **December 31, 2026** – The last possible date that a taxpayer can defer gains under the QOZ Program.
- **Qualified Opportunity Zone Property or "QOZ Property"** – What 90% of the QOZ Fund's assets must contain. QOZ Property can include (i) QOZ Stock; (ii) QOZ Partnership Interests; or (iii) QOZ Business Property.
- **Qualified Opportunity Zone Stock or "QOZ Stock"** – A U.S. corporation that generally (i) has its stock acquired for cash in 2018 or after, (ii) operates or plans to operate a QOZ Business; and (iii) throughout substantially all of the QOZ Fund's holding period, the corporation qualified as a QOZ Business. An "indirect investment" for QOZ purposes is through QOZ Stock or QOZ Partnership Interests.
- **Qualified Opportunity Zone Partnership Interest or "QOZ Partnership Interest"** – A U.S. partnership that generally (i) has its interests acquired for cash in 2018 or after; (ii) operates or plans to operate a QOZ Business; and (iii) throughout substantially all of the QOZ Fund's holding period, the partnership qualified as a QOZ Business. An "indirect investment" for QOZ purposes is through QOZ Partnership Interests or QOZ Stock.
- **Qualified Opportunity Zone Business Property or "QOZ Business Property"** – Is generally tangible business property used in a trade or business of the QOZ Fund if (i) the property was acquired from an unrelated party in 2018 or after; (ii) the original use begins with the QOZ Fund or the QOZ Fund substantially improves the property; and (iii) substantially all of the use of the QOZ Business Property was in a QOZ.
- **Qualified Opportunity Zone Business of "QOZ Business"** – Is generally a trade or business where (i) substantially all the business's tangible property owned or leased is QOZ Business Property; (ii) at least 50% of the income is from that active trade or business; (iii) a substantial portion of the business's intangible property is used in that trade or business; (iv) less than 5% of the property is certain financial property; and (v) the business is not a "sin" business (e.g., golf club, country club, massage parlor, hot tub or suntan facility, racetrack or gambling facility, or business where sale of alcohol for consumption off premise). QOZ Business is only relevant in an "indirect" investment (i.e., through QOZ Stock or a QOZ Partnership Interest).
- **Substantial Improvement** – Is additions over a 30-month period that equal or exceed the adjusted basis of property. Most likely relevant with respect to U.S. real estate investments under the QOZ program.

Section 199A – Qualified Business Income Deduction

Overview

- Generally, Section 199A provides a 20% deduction computed based on:
  - Qualified business income
    - Partnerships, S corporations, and sole proprietorships
  - Qualified REIT dividends
  - Qualified publicly traded partnership income
  - Qualified cooperative dividends
- Service businesses are generally disfavored
  - Does not apply to the business of being an employee
  - Limited applicability to specified services businesses
  - Compensation-type income (i.e., “reasonable compensation” and guaranteed payments for services) and investment income (i.e., investment interest, capital gain or loss, dividends) are generally ineligible
- The highest effective rate on income to which the deduction applies is reduced from 37% to 29.6%
- Proposed regulations issued on August 16, 2018.

Section 199A – Qualified Business Income Deduction

Calculation of the Deduction Amount

- The total deduction available is the sum of:
  - (i) the lesser of
    - (1) the taxpayer's **combined qualified business income amount** and
    - (2) 20% of the taxpayer's taxable income, excluding net capital gains and aggregate qualified cooperative dividends; plus
  - (ii) the lesser of
    - (1) 20% of the taxpayer's aggregate qualified cooperative dividends and
    - (2) the taxpayer's taxable income, excluding net capital gains

  The total deduction amount may not exceed the taxpayer's taxable income for the year

- The combined qualified business income amount is generally the sum of:
  - (i) 20% of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income, plus
  - (ii) the **separate deduction amounts** for each **qualified trade or business** of the taxpayer

Section 199A – Qualified Business Income Deduction

Separate Deduction Amounts – Qualified Trade or Business

- A qualified trade or business is any trade or business of the taxpayer except
  (i) the business of providing services as an employee, and
  (ii) certain **specified service trades or businesses**
    - NOTE: The term "trade or business" is not defined in this Section

- Specified service trades or businesses are
  (i) businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, and
  (ii) businesses which involve the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities

Section 199A – Qualified Business Income Deduction

Separate Deduction Amounts – Qualified Trade or Business

- The exclusion of businesses listed in (i) in the prior slide is phased in based on the taxpayer's taxable income
  - For married couples filing jointly, the phase in begins at a threshold taxable income of $315,000 and ends at $415,000
  - For all other taxpayers, the phase-in begins at a threshold taxable income amount of $157,500 and ends at $207,500
- If the taxpayer's income falls between these amounts, the taxpayer must take an applicable percentage of the partnership items attributable to the specified service trade or business into account in calculating the separate deduction amount
  - The applicable percentage equals 100% minus the ratio of the amount by which the taxpayer's income exceeds the threshold amount over $50,000 ($100,000 for joint filing couples)
  - Each additional $500 of taxable income reduces the amount of the items attributable to such trade or business taken into account by 1% ($1,000 per 1% reduction for joint filing couples)

Section 199A – Qualified Business Income Deduction

Separate Deduction Amounts – Qualified Business Income

- For each qualified trade or business of the taxpayer, the separate deduction amount is the lesser of:
  - (i) 20% of the taxpayer's **qualified business income** with the respect to the qualified trade or business, or
  - (ii) the **wage / basis limitation**
- For a qualified trade or business conducted through a partnership or S corporation, qualified business income is calculated at the partner or shareholder level

Section 199A – Qualified Business Income Deduction

Separate Deduction Amounts – Qualified Business Income

- Qualified business income is the net amount of **qualified items of income, gain, deduction and loss** with respect to any qualified trade or business of the taxpayer
  - Qualified items of income, gain, deduction and loss are items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a U.S. trade or business and includable in determining the taxpayer's taxable income
  - Qualified business income excludes items taken into account in computing qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income
  - If the net amount of the taxpayer's qualified business income with respect to a qualified trade of business in a year is negative, such amount is carried forward as a loss from such qualified trade or business to the next year

Section 199A – Qualified Business Income Deduction

Separate Deduction Amounts – Wage/Basis Limitation

- For each qualified trade or business, the separate deduction amount cannot exceed the greater of:
  - (i) 50% of the taxpayer's share of the entity's **W-2 wages** attributable to the qualified trade or business, or
  - (ii) 25% of the W-2 wages plus 2.5% of the unadjusted basis immediately after acquisition of all **qualified property**
- W-2 Wages
  - The amount paid by a person as wages and certain other compensation with respect to the employment of employees by such person and allocable to qualified business income
- Qualified Property
  - Generally includes depreciable property held by and used in the trade or business in the production of qualified business income
- Phase-In
  - The wage/basis limitation is subject to a phase-in that is similar to the phase-in of the exclusion of specified service trades or businesses

Section 199A – Qualified Business Income Deduction

Other Important Terms

- Qualified REIT dividends
  - All REIT dividends except capital gain dividends and dividends that result in qualified dividend income under section 1(h)(11)
- Qualified publicly traded partnership income
  - For each qualified trade or business, (i) the net amount of the taxpayer's allocable share of the items of income, gain, deduction and loss from a PTP, plus (ii) any gain recognized by the taxpayer upon disposition of an interest in a PTP to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset
  - Includes only interests in PTPs that are not treated as corporations
- Qualified cooperative dividends
  - Any patronage dividends, per-unit retain allocations, qualified written notices of allocations, and similar amounts includable in gross income and received from cooperatives.
- Limitations
  - The deduction amounts based on qualified REIT dividends and qualified cooperative dividends are **not** subject to the wage/basis limitation or the specified services limitation, while qualified publicly traded partnership income is subject to the specified services trade or business exclusion, though it is not clear how this exclusion would apply to PTPs

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