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QUALIFIED OPPORTUNITY ZONES

WHAT EVERY TRUSTS AND ESTATES LAWYER SHOULD KNOW

Knoxville Estate Planning Council

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Sentiment

*Too many communities in our great nation feel passed over by economic growth and forgotten by our political leaders. We need a new formula for the public and private sectors to work together to generate new investments, new businesses, and new good paying jobs in places that have fallen behind**

* The Honorable Andrew Young, Chair of the Andrew J. Young Foundation, former U.S. ambassador to the United Nations, and former U.S. Congressman

Genesis

- Sean Parker – Co-founder of Napster, past president of Facebook, current board member Spotify and billionaire philanthropist
- Steve Glickman – Former Obama advisor and Venture Capitalist
- Economic Innovation Group - founded in 2013, combining innovative research and data-driven advocacy to address America's most pressing economic challenges. Conceived and promoted *Investing in Opportunity Act* (IIOA)
- "Aimed" at unlocking a portion of the estimated $6 trillion dollars in unrealized capital gains held by US taxpayers

What is the Opportunity Zone program?

- Potential tax deferral, reduction and elimination of capital gains tax

HISTORY

In 2015, a little known policy organization, the Economic Innovation Group, developed a program that became known as the Investing in Opportunities Act. A bi-partisan group of senators sponsored the bill but few people knew about it or expected it to become policy.

WHAT

New community development tool created by the Tax Cuts and Jobs Act (TCJA) of 2017 to incentivize investments in designated low-income communities ("Qualified Opportunity Zones").

GOAL

Unlock existing capital gains to invest in economically distressed communities. Reportedly, there is $6 trillion dollars of unrealized capital gains in the capital markets.

WHERE

Each state designated 25% of its low-income census tracts as Qualified Opportunity Zones (QOZs) based upon their individual needs and priorities. All low-income census tracts in Puerto Rico are QOZs.

Source: Novogradac Consulting LLP, March 2018

Principals of QOZ Program

Access untapped/locked-up capital

Direct equity investment in low-income census tracts

Reward long-term investors

Minimize government regulation

Maximize scalability

Investment Premise - QOFs

- QOFs are long-term special purpose investment vehicles that can result in certain Federal income tax benefits
- QOFs are generally expected to be deployed into real estate projects within QOZs - thus QOFs may be suitable for investors with asset allocations that include real estate
- QOFs can invest in non-real estate assets as well (any business in QOZ … so taxpayers should have a good understanding of how the QOZ intends to deploy capital). See next slide
- May also be suitable for "Socially Responsible Investors"
- QOFs that are established as private equity funds will be illiquid
- QOFs might not make a dividend or partnership distribution other then when liquidating
- QOFs established as private equity funds will be subject to the Accredited Investor and Qualified Purchaser rules as set for by the SEC

Potential fund investment opportunities

Most businesses other than “sin” businesses permitted*

- Real estate
- Operating businesses
- Neighborhood-based approaches
- Multifamily housing
- Tech companies
- Co-working spaces
- Charter schools
- Location agnostic companies
- Medical Office
- Renewable energy firms
- Low-Capital Enterprises

* Sin businesses include golf courses, country clubs, massage parlors, hot tub facilities, liquor stores, etc.

Excluded from QOZ Business

Pursuant to section 1400Z-2(d)(3)(A)(iii), the following trades or businesses described in section 144(c)(6)(B) cannot qualify as a qualified opportunity zone business:

(i) Any private or commercial golf course

(ii) Country club

(iii) Massage parlor

(iv) Hot tub facility

(v) Suntan facility

(vi) Racetrack or other facility used for gambling, or

(vii) Any store the principal business of which is the sale of alcoholic beverages for consumption off premises

General Tax Benefits

- Income tax deferral - of pre-contribution gain (taxpayer must elect) under §1400Z-2(a)(1)

- Discounted capital gain rate - 10% after year 5; another 5% year after 7

  - Five Year Rule - §1400Z-2(b)(B)(iii)
  - Seven year Rule - §1400Z-2(b)(B)(iv)

- Forgiveness of post-contribution gain – after year 10; said forgiveness only applies to post-contribution gains attributable to previously deferred gain invested in a QOF

Note: *The QOF income tax benefits are not available to investors who invest fresh/new capital (i.e., rather than make investment from a sale of exchange).*

Deferral and potential reduction

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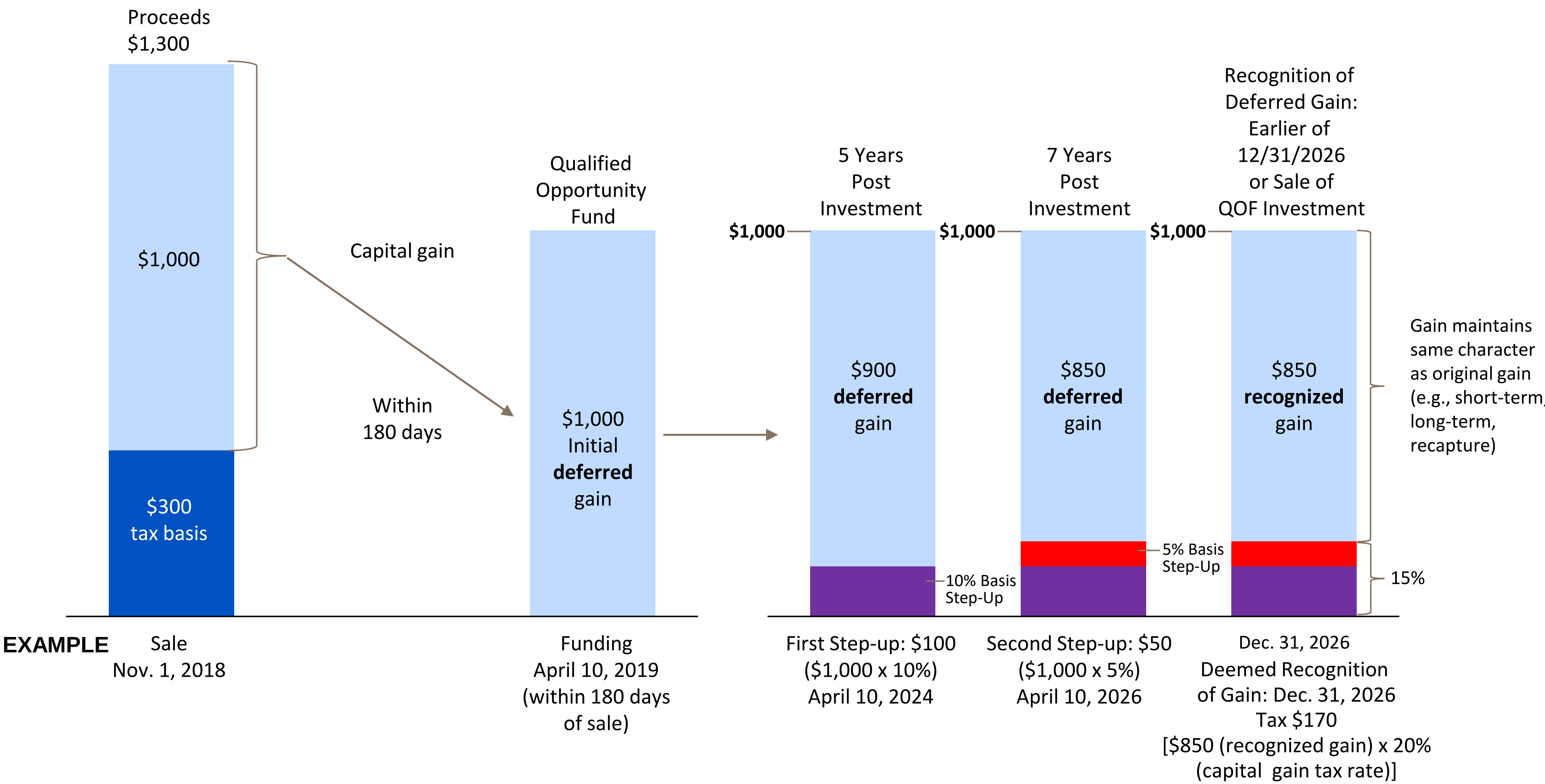
Deferred gain cannot exceed amount which taxpayer invests in a Qualified Opportunity Fund within 180 days of original date of sale.*

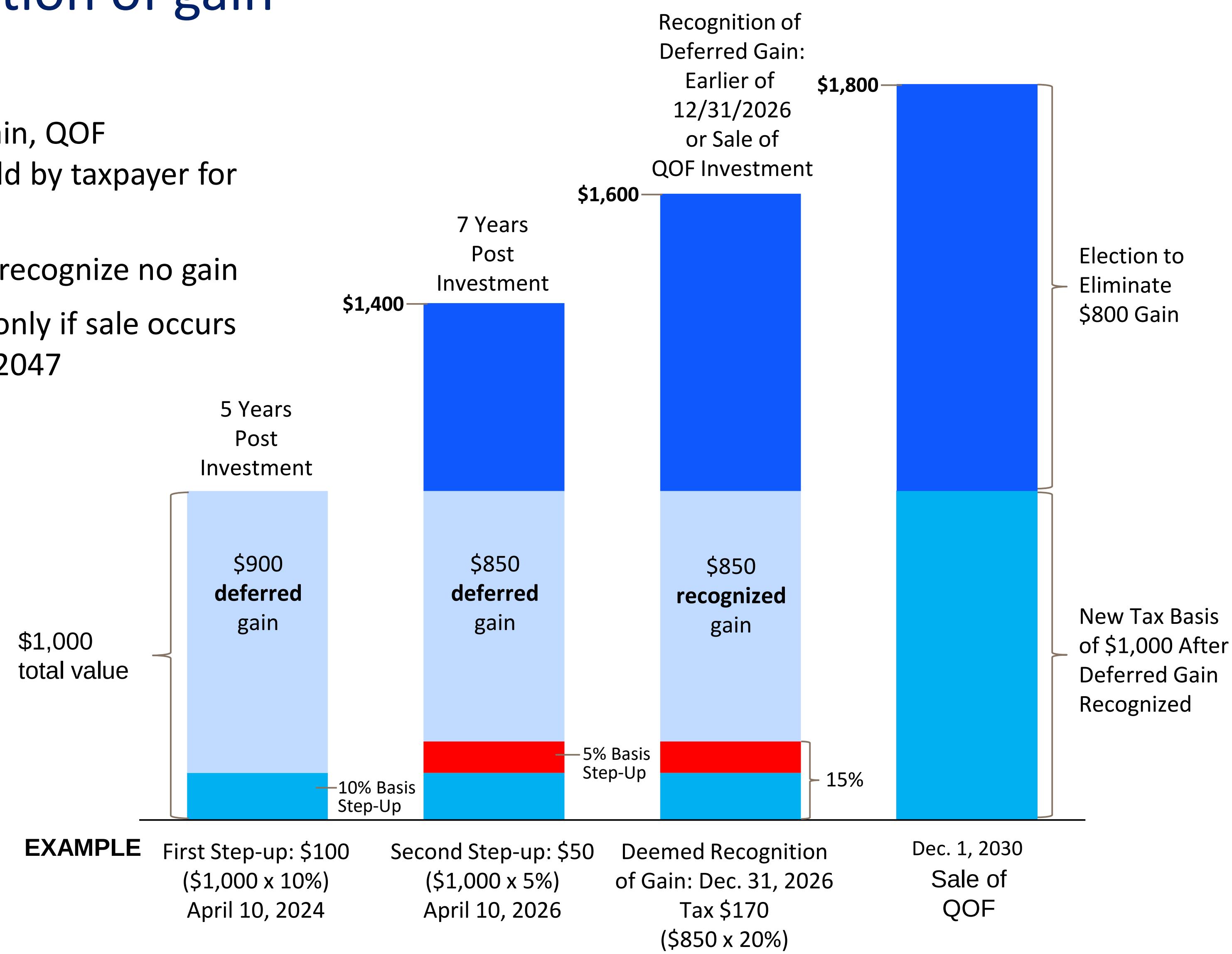
Taxpayer's original deferred gain reduced when Qualified Opportunity Fund investment held for appropriate time.



The projections or other information shown regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. Results may vary over time. For illustrated purposes only. Source: U.S. Trust, October, 2018

Potential elimination of gain

- In order to eliminate gain, QOF investment must be held by taxpayer for at least 10 years
- Taxpayer must elect to recognize no gain
- Ability to elect applies only if sale occurs prior to December 31, 2047



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Source: U.S. Trust, October, 2018

Opportunity Zones

8,762

DESIGNATED OPORTUNITY ZONES

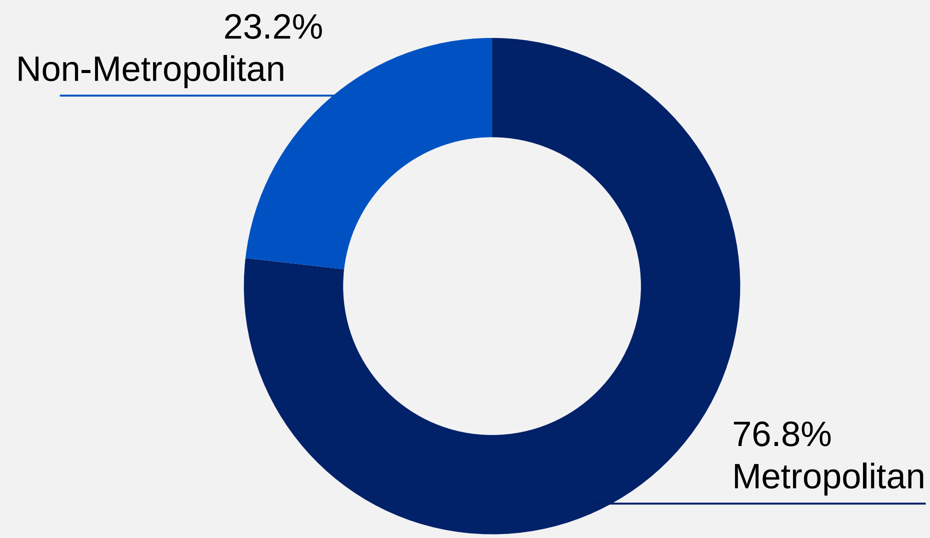
all 50 states

AND PUERTO RICO

$33,345 MEDIAN HOUSEHOLD INCOME

31.75% POVERTY RATE

13.41% UNEMPLOYMENT RATE



Source: EIG analysis of America Community Survey data, June 2018

Opportunity Zones – Cont.

- There are over 8,700 designated opportunity zones, covering all 50 states and Puerto Rico. These are economically-distressed communities that were nominated by governors and certified by the Treasury Department.

- In the average Opportunity Zone, the median household income is $33,345, the poverty rate is 31.75%, and the unemployment rate is 13.41%.

- The zones are Concentrated in Metro Areas: 75%+ QOZ are in metro areas, but zones are nearly evenly split between high density (urban) zip codes and low density (rural) ones, with remaining 22% in medium density (suburban).

- Many states included set-asides for tribal areas, resulting in 294 zones on Native American lands - this is proportional to eligible low income communities

Investor Profile

- Deferred Accounts – Investing in a QOZ within an IRA or other qualified plan adds illiquidity but no tax efficiency. If intent is for such account to have an allocation to real estate there are many other options. Also, IRD should apply if account owner dies while holding QOZ in such retirement vehicles.

- Private Foundations and Charitable Remainder Trusts - Investing in a QOZ within an IRA or other qualified plan adds illiquidity (if PE format) but no tax efficiency. If intent is for such account to have an allocation to real estate there are many other options. Also, QOZ are generally expected to use debt and thereby create UBTI. Note that CRTs pay a 100% tax on items of UBTI.

  - **Query**: Whether a PF's QOF investment can be applied to its 5% qualifying distribution requirement as a program-related investment (PRI)?

  - **Query**: Whether a PF's QOF investment can be applied towards its mission related investment (MRI) policy?

QOZ: General requirements

- Eligible taxpayers can invest capital gains in QOF
- Enumerated eligible taxpayers include individuals, corporations, RICS, REITs, partnerships, S Corporations, trusts, settlement funds and estates are enumerated.
- Must invest realized gain within 180 days of sale or exchange
- Exchange must be with non-related persons. §§267(b) and 707(b)(1) modified by substituting 20% for 50%
- Investment must cannot be made via debt as defined in §1275(a)(1) and §1.1275-1(d)

Code & Proposed Treasury Regulations

- 2017 TCJA - on December 22, 2017 added §§1400Z-1 and 1400Z-2.
- First zones - designated by Department of Treasury and the IRS on April 9, 2018.
- List of QOZs - updated on December 14, 2018 to include all 50 States, the District of Columbia and five U.S. Territories. IRB 2008-48 with a downloadable and sortable spreadsheet.
- Proposed Regs. - IR-2018-206 (October 19, 2018)
- Public hearing on Proposed Regs. - January 10, 2019 at 10:00am

Note: The Treasury Department and the IRS are working on additional published guidance, including additional proposed regulations expected to be published in the near future

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Additional Guidance Imminent

- The Treasury Department and the IRS are working on additional published guidance, including additional proposed regulations expected to be published in the near future

- The forthcoming proposed regulations are expected to address other issues under section 1400Z-2 such as:

  - The meaning of “substantially all” in each of the various places where it appears in section 1400Z-2;

  - The transactions that may trigger the inclusion of gain that has been deferred under a section 1400Z-2(a) election;

  - The “reasonable period” (see section 1400Z-2(e)(4)(B)) for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty; administrative rules applicable under section 1400Z-2(f) when a QOF fails to maintain the required 90 percent investment standard; and information-reporting requirements under § 1400Z-2.

Fund Manager Considerations

- Reputation, experience in real estate, balance sheet, fee structure and administrative fee infrastructure
- Organizational structure (e.g., corporation, partnership, LLC …) with common and/or preferred interests
- Size of fund
- Capital calls (if any)
- Geographic diversification of underlying QOF investments
- Investment Policy

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General Market Considerations

- Too much capital chasing deals – Congress expects huge amounts of capital expected to flow into QOFs may change the financial calculus for fund managers due to rising prices from an increase in demand fueled by such funds

- QOFs will deploy capital in low income census tracks, distressed geographies where the success of the fund can be dampened by the local struggling economy

- Rising interest rates may dampened a QOF's ROI

- May be too flexible according to the Urban-Brookings Tax Policy Center. "Neither the statute nor the guidance ensure that investments will benefit low and moderate-income residents of these communities."*

* https://www.brookings.edu/blog/up-front/2018/02/26/will-opportunity-zones-help-distressed-residents-or-be-a-tax-cut-for-gentrification/

May Not Produce Desired Social Results

- Rising housing costs
- Rising labor costs
- Not all of the eligible tracts are comprehensively disadvantaged - some tracts may contain a high-income population or significant economic activity alongside a large low-income population
- Investment can simply displace existing investments in the community – benefiting owners (who may not be residents themselves) who sell to QOFs … but not necessarily the local residents
- Governors may have not properly designated low-income and undercapitalized communities

Timing Considerations in addition to 180 Days

- The 5-year basis adjustment will be of benefit only if it occursbefore the December 31, 2026 deadline by which all remainingdeferred gain must be recognized. This means that in orderto receive the 5-year basis adjustment, you must invest in aQualified Opportunity Fund before December 31, 2021.

- Similarly, the 7-year basis adjustment will be of benefit only if it occurs before the December 31, 2026 deadline by which all remaining deferred gain must be recognized. This means that in order to receive the 7-year basis adjustment, you must invest in a Qualified Opportunity Fund before December 31, 2019.

- If taxpayer dies before December 31, 2026, the deferred gain would not receive a step-up in basis but would remain eligible for the 10-year rule that allows all post-rollover appreciation to be permanently excluded.

Opportunity Zone timeline

Dec. 22, 2017

Enactment of TCJA and IRC 1400Z-1 and 1400Z-2

Dec. 22, 2017

Sales on or after Dec. 22, 2017, eligible for OZ tax benefits

Dec. 31, 2019

Last day to invest in QOF for both the 5% and 10% basis step-up

Dec. 31, 2021

Last day to invest in QOF for 10% step-up

Dec. 31, 2026

Last day for sale eligible for OZ tax benefits

Dec. 31, 2026

Deemed recognition of deferred gain (unless previously sold)

Lesser of:

- Deferred gain minus basis step-up

  or

- FMV of QOF investment less basis step-up

Dec. 31, 2028

OZ designation expires

Dec. 31, 2047

Last day to sell QOF investment and eliminate gain

2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2028 | 2047

Information as of the date of this presentation and is subject to change.

Source: U.S. Trust, October, 2018

TCJA – Tax Cuts and Jobs Act **QOF** – Qualified Opportunity Fund **OZ** – Opportunity Zone **FMV** – Fair market value

Private Opportunities

- Taxpayers such as family offices and those with considerable investment expertise may consider setting up their own special purpose Qualified Opportunity Fund to make investments in Qualified Opportunity Zone Property

Tax Burdens

- IRD – no step-up of tax basis at owner's death (only applies to pre-contribution gains)
- Gift tax consequences not addressed in Proposed Regs.
- QOF may generate annual income for fund investors without making distributions to cover investors' resulting tax bill
- Partners and trust beneficiaries may not receive K-1s in time to make election

Sampling of Alternatives to QOZ

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	Like-Kind Exchange	Qualified Opportunity Zone Funds	Exchange Funds	Installment Sales	ESOP Sales
Capital Gain Rollover	An owner of real estate held for use in a trade or business or an "investor" in real estate has 45 days from the date they sell the relinquished property to identify potential replacement properties. The identification must be in writing, signed by seller and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary. The replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier. The replacement property received must be substantially the same as property identified within the 45-day limit described above.	A taxpayer must reinvest capital gains in a qualified opportunity fund or a qualified opportunity zone business within 180 days of sale of an asset to qualify for capital gains in a qualified opportunity fund or a qualified opportunity zone business tax advantages. An investor is not required to roll over the entire gain, but only the rolled over portion is eligible for tax advantages. If the investment is held for five years the basis receives a 10% step-up, if held for seven years it receives another 5% basis step-up. Capital gains tax is due upon sale of the investment or on December 31, 2026, whichever is earlier. Investments held for at least 10 years are eligible for a basis step-up to fair market value upon sale.	An investor can contribute stock (usually a concentrated stock position) to a limited partnership or limited liability company that will hold a diverse portfolio of stocks and other assets in return for an interest in the fund. After seven years the investor can withdraw a diversified basket of stocks from the fund without triggering capital gains. A possible gain event will occur, however, when the investor sells a stock that was received from the exchange fund.	Generally, applies if a taxpayer sells property and receives at least one payment after the tax year of the sale. Installment rules do not apply if the taxpayer elects not to use the installment method or if the transaction does not qualify to use the method.	A shareholder of a closely held C corporation can defer long-term capital gain by selling shares to the company's ESOP and reinvesting the proceeds into qualified replacement property. Gain is recognized when the qualified replacement property is sold.
Specifically Authorized	IRC §1031	IRC §1400Z-2	IRC §704, IRC §721 and IRC §731	IRC §453	IRC §1042
Qualified Assets	For tax years 2018–2025 only real estate can qualify for a 1031 tax deferred exchange. Primary residences are excluded.	Any *gain* treated as capital gain	Stocks that are acceptable to the fund manager	Any capital asset but excludes inventory, dealer sales and publicly traded property	Stock in a domestic closely held C corporation that has been owned for at least three years where the ESOP will own at least 30% of the stock immediately following the purchase. Section 83 stock does not qualify. Selling shareholder generally must be an individual, trust, underwriter or partnership.
Investment Structure	Typically designed for single property swaps	Private equity investment in low-income, economically distressed communities	Exchange funds are limited partnerships or limited liability companies that provide qualified investors with the opportunity to exchange a stock (without triggering gain) for an interest in the diversified fund. The fund will hold no more than 80% in stocks with the remaining amount held in illiquid investments like real estate.	None — although special rules apply when selling property under installment method to a related person/party	Reinvest the proceeds in qualified replacement property (QRP) within 12 months after the ESOP stock purchase (or during the three-month period preceding the ESOP stock purchase)
Capital Gains Tax *Deferral*	Yes — generally deferred until the property received in the swap is sold	Taxpayer can elect to defer capital gains tax which can also be reduced or eliminated depending on how long investor holds fund. QOZ funds held for over five years receive a 10% increase in basis, funds held for seven years receive another 5% increase in basis. Pre-contribution gain must be recognized no later than December 31, 2026. Post-contribution gain can be exempt if fund held past year ten.	Yes — no capital gain recognition at funding and if held for seven years no capital gain recognition when taxpayer receives a diversified basket of stock. Gain should only be recognized when investor sells the stocks received from the fund.	Yes — Each payment on an installment sale usually consists of the following three parts: (i) Interest income, (ii) return of adjusted basis in the property and (iii) gain on the sale. In each year a payment is received the taxpayer must include in income both the interest part and the part that's gain on the sale. Taxpayers do not include return of basis in income. In certain instances, there may be an interest charge associated with the deferral.	Yes
Capital Gains Tax *Reduction*	No — although gains can be eliminated by step-up at death	If the investor holds the investment in the Opportunity Fund for at least 10 years, the investor would be eligible for an increase in basis equal to the fair market value of the investment on the date that the investment is sold or exchanged. Basis will also step up (or down) if taxpayer dies at any time holding the fund.	No	No	No — although gains can be eliminated by step-up at death
Capital Gains Tax at Final Sale	Yes — gain may have to be recognized when exchanged property eventually sold	No —none on post-investment gain if held at least 10 years	Yes — when securities that are received from fund after year seven are eventually sold	N/A	Yes — when qualified replacement property is eventually sold

* Each of these strategies is complex, and this chart provides only a very high-level overview. Consult tax advisor for more information

Open Questions after Proposed Regulations

IRD – 1400Z-2(e)(3) provides that, "[i]n the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be includible in gross income as provided by section 691."

- IRC §691(a)(3) – character of IRD is the same as it would have been had investor survived
- IRC §691(c) provides the beneficiary with an income tax deduction for estate tax attributable to IRD. The deduction is not a miscellaneous itemized deduction impacted by §67(g)
- But … note that IRD is not reportable on the decedent's final income tax return … it's reportable by the recipient of the IRD? ACTEC has requested further clarification in comments dated December 27, 2018

Sampling of Open Questions after Proposed Regulations

Grantor trusts - ACTEC has requested further clarification in comments dated December 27, 2018 to clarify that under Rev. Rul. 85-13 a sale to a grantor trust should not be considered a sale or exchange and that such sale does not restart the 5, 7 or 10 holding periods

Sale of entire QOF and reinvestment in same QOF or another QOF – Does the sale restart the 5, 7 and 10 year holding periods

Limited Liability Companies – Can a taxpayer purchase an interest in a QOF through an entity such as an LLC? Only individuals, corporations, RICS, REITs, partnerships, S Corporations, trusts and estates enumerated.

Gift tax consequences under §1400Z-2(b) - ACTEC has requested further clarification in comments dated December 27, 2018 to clarify that a inter vivos gift should not be treated as a sale or exchange.

Open Questions after Proposed Regulations

How to make the election? – Proposed Regs. silent as to which form will be used to make the election. Some practitioners are anticipating that IRS Form 8949 (Sales & Dispositions of Capital Assets) will be used.

What tax rate should apply? – Proposed Regs. did not address what rate to use when the deferred capital gain is recognized. Tax rate on date of sale or exchange or the rate on the date the deferred capital gain is recognized?

FIFO – IRC §1400Z-2)b)(2)(B) – provides rules for 5 and 7 year holding periods to step-up basis but is silent as to the 10 year holding period.

QOF failure to satisfy QOF requirement during life of fund – Proposed Regs. set forth financial penalties for fund but is silent as to whether such failure affects taxpayers' deferral

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Open Questions after Proposed Regulations

180 day relief for partners or trust beneficiary that do not receive K-1s - ACTEC has requested further clarification in comments dated December 27, 2018 to request a relief provision for taxpayers without sufficient information to make a timely election.

NOTE: After the Proposed Regs. there remains many unanswered questions … especially from a QOF's point of view