QUALIFIED OPPORTUNITY ZONE FUNDS

Increasing After-Tax Financial Returns for Community-Related Investments

As part of the 2017 Tax Cuts and Jobs Act, an unlikely group of conservatives, liberals, capitalists and philanthropists created one of the greatest tax-minimization opportunities in American history, Qualified Opportunity Zone Funds (OZ Funds).

OZ Funds are designed to spur economic development and job creation by investing in businesses located in economically-distressed communities. In return for these investments, investors can receive tax deferrals and possible elimination of capital gains taxes.

This article is written for two audiences, (i) potential investors; and, (ii) tax geeks.

If you are an investor, Section One of this article explains the tax benefits of investing in an OZ Fund.

If you are a tax geek, we have licensed counselors available to take your call. However, while you're on-hold, you'll enjoy reading the technical summary contained in Section Two. Our therapists claim it is both informative and calming.

With this background, let's get started.

SECTION ONE – INVESTOR TAX BENEFITS OF OPPORTUNITY ZONE INVESTMENTS

Before taxing our minds with technical jargon, let's discuss two important non-tax factors you should consider when evaluating if an OZ Fund investment is right for you:

1 Social Impact Returns

Many investors are looking for more than economic returns... they want their investments to have a positive social impact. For example, we have several clients who invest heavily in early childhood education centers because of the long-term benefits of early childhood education on employment and health in economically disadvantaged communities. If the centers are in designated low-income areas[1], future investments in such centers could qualify for the OZ Fund tax benefits. So, if you're interested in investments that generate positive social and economic returns, an OZ Fund might make sense.

2 Risk-Adjusted Rate of Return

As investors, we expect lower economic returns for lower risk. For example, we will accept lower yields on AAA rated versus "junk" bonds. A few OZ Funds are working with foundations and Community Reinvestment Act investors to make grants, zero-or-low interest loans, PRI investments (and a bunch of other technical stuff that is beyond the scope of this article) to lower the risk of these investments. Funds with lower risk make your investment look more like an AAA versus a "junk" bond. In tech-speak, these funds are offering an enhanced "risk-adjusted rate of return".

[1]Visit micpa.org/taxteam for the full Tax Reform Toolkit and a searchable list of qualified opportunity zones.

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SECTION ONE – INVESTOR TAX BENEFITS OF OPPORTUNITY ZONE INVESTMENTS – CONTINUED

Let's assume you sold a bunch of stock and have a $100,000 of capital gain you'd like to reinvest. If, within 6-months of selling this stock[2], you invest the capital gains (but apparently not the basis of the stock sold) into an OZ Fund, you could receive the following tax benefits:

1 Temporary Deferral on Gain Invested in an Opportunity Fund

You can defer paying taxes on the capital gains (short or long-term) from the sale of your stock to the extent you invest these gains in an OZ Fund. The $100,000 gain from the sale of your stock will become taxable on the earlier of: (i) December 31, 2026; or, (ii) the date on which you sell your OZ Fund investment.

2 Basis Step-Up in Opportunity Zone Fund Investment

If the OZ Fund investment is held for at least 5 years, your basis in this fund will be increased by 10% of your deferred capital gain. If the investment is held for 7 or more years, this basis step-up is increased to 15%. In our example, this means you'll be able to exclude $10,000 or $15,000 of the capital gains when you sell your OZ Fund investment.

3 Permanent Exclusion for Qualified Opportunity Fund Gains

If you hold the OZ Fund for 10 years or more, you won't be taxed on any capital gains from this investment.[3]

Before getting into the technical details, let's look at a couple of examples to see how this works. (See Scenario One)

[2]The capital gain must be invested in a Qualified Opportunity Zone Fund within 6-months to qualify for any of the three tax benefits.

[3]This exclusion must be elected and only applies to gains accrued after an investment in a Qualified Opportunity Fund. If your basis in the Opportunity Fund exceeds its fair market value at the time of sale, you would not make this 1400Z-2(c) election so that the loss could be recognized.

[4]The new law can be interpreted to allow our investors to, not only defer, but reduce or eliminate the capital gains taxes from their 2018 stock sale. However, we are waiting for IRS regulations for clarification.

SCENARIO ONE: OPPORTUNITY FUND INVESTMENT

Meet Ichabod and Griselda. They are a married couple with ordinary income (e.g. wages and interest) of $300,000 and capital gains of $100,000 from the sale of stock. They have decided to invest this capital gain into an OZ Fund which, to simplify our analysis, appreciates at a constant annual rate of 4%. Furthermore, they will hold their OZ Fund for 11 years, selling it in 2029 for $154,000. Let's review the after-tax impacts of this investment.

Temporary Deferral on Capital Gains

Ichabod and Griselda will defer paying taxes on their $100,000 stock capital gain until 2026. (Remember, the deferred capital gains taxes must be paid by the *earlier* of 2026 or the year they sell their OZ Fund investment, 2029.) This tax deferral saves our investors $18,800 ($15,000 capital gain tax + $3,800 net investment income tax) on their 2018 income taxes, allowing them to use these tax dollars to partially fund their OZ Fund investment.

Permanent Exclusion of Opportunity Fund Gain in 2029

As noted above, at 4% annual growth, the OZ Fund will appreciate to approximately $154,000; however, because Ichabod and Griselda held their Opportunity Zone investment for 11 years, none of the appreciation is taxable.

In summary, our investors receive:

(i) An eight-year deferral on their 2018 capital gains (i.e. the 2018 stock gain of $100,000 is taxed in 2026)[4]; and,

(ii) An exclusion of all capital gains taxes on the appreciated OZ Fund investment.

The 4% annual appreciation plus the tax benefits generates an after-tax return on investment of 4.5%.

Qualified Opportunity Zone Funds – Continued

SCENARIO TWO – ALTERNATIVE INVESTMENT:

Rather than investing in an OZ Fund, Ichabod and Griselda reinvest their 2018 capital gains in an investment that is not an OZ Fund. Let's call this the "alternative investment". If this alternative investment appreciates at the same 4% , their after-tax return on investment will be 3.4%. The OZ Fund investment generates a better after-tax return because of two factors:

1. Deferring the tax payment of the 2018 capital gain of $100,000 until 2026; and,
2. Exclusion of capital gains taxes on the sale of the OZ Fund.

TAXES

CASH INVESTMENT

LESS DEFERRED TAXES

INVESTMENT RETURNS

Does this mean everyone should invest in OZ Funds? For two simple reasons, "no".

1. It is unlikely that the OZ Fund and alternative investment will appreciate at identical rates. Rather, it's probable you'll find alternative investments with greater appreciation potential. However, using the facts from our example, your alternative investment would need to appreciate at an annual rate exceeding 5.4% to outperform an OZ Fund with a 4% appreciation rate.
2. The number of years you plan to hold the OZ Fund and your tax bracket in the year of sale will significantly impact your after-tax returns. If you are planning on liquidating your investment in less than ten years, an OZ Fund investment is probably not a good fit.

Nevertheless, the potential tax benefits from OZ Fund investments justifies investigating this new investment class.

Let's summarize what we have learned:

The 2017 Tax Act created Opportunity Zone Funds.

If you invest in a qualified O-Zone Fund (sorry, I've been dying to use this this abbreviation and finally gave in to the temptation) you get a deferral on your current year's capital gains taxes PLUS a potential reduction or elimination of capital gains taxes on the sale of the OZ Fund.

OZ Funds can be a valuable tool for enhancing after-tax returns AND creating a positive social impact.

Look for an OZ Fund that has institutional investors such as foundations (making grants or program related investments) and banks (investing under the Community Reinvestment Act) that reduce the fund's risk.

We have created an OZ Fund Investment Calculator that estimates after-tax returns from equivalent OZ Funds and Non-Opportunity Fund investments. **Visit micpa.org/taxteam to download a simple comparison calculator.**

If you want to learn about the technical aspects of the new law, read on. Otherwise, thanks for your attention and I hope our discussion will be beneficial. Please feel free to write us at bweins@insights3.com if you have any questions. We'll be glad to help.

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SECTION TWO – TECHNICAL SUMMARY OF IRC SECTION 1400Z

WHAT IS A QUALIFIED OPPORTUNITY ZONE FUND?

A Qualified Opportunity Fund (OZ Fund) is any investment vehicle organized as a corporation or partnership that invests 90% of its assets in "Qualified Opportunity Zone Property" (which we will define below). An OZ Fund can be of any size and can invest in a single project or multiple projects.

OZ Funds can be used to create new businesses, new commercial real estate or new residential real estate developments. They can invest in an existing business if the fund doubles its investment basis in such business over thirty months. An OZ Fund cannot engage in any of the following "sin" businesses: private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, facilities used for gambling (including racetracks) or any store where the principal business purpose is the sale of alcoholic beverages for consumption off premises.

OZ Fund tax benefits can be combined with other incentives such as renewable energy credits, historic rehabilitation credits, New Market Tax Credits (NMTC), or Low-Income Housing Tax Credit (LIHTC), adding a valuable tool for economic and community development.[5]

OPPORTUNITY ZONE TAX INCENTIVES

As noted in Section One, Opportunity Zones offer investors three potential tax benefits:

Temporary Deferral on Gain Invested in an OZ Fund

Capital gains (short or long-term) invested in an OZ Fund receive a temporary income tax deferral. This deferred gain must be recognized on the earlier of the date on which the opportunity zone investment is disposed of or December 31, 2026 (1400Z-2 (b)(1)). The taxpayer includes in income the lesser of: (i) the deferred gain; or, (ii) the fair market value of the OZ Fund investment less the taxpayer's basis in this fund. Hence, if the investment: (i) declines in value; or, (ii) appreciates less than the investor's step-up in basis for holding the OZ Fund for 5 or 7 years (discussed below), the taxpayer is taxed on only a portion of the deferred gain.6

Basis Step-Up in OZ Fund Investment

If the OZ Fund is held for at least 5 years, the investor's basis in this investment is increased by 10% of the deferred gain. If the investment is held for 7 but less than 10 years, the taxpayer receives a basis step-up equal to 15% of the deferred gain (1400Z-2 (b)(2)(B)).

Permanent Exclusion for OZ Fund Gains

A permanent exclusion from taxable income of capital gains from sale or exchange of an investment in a Qualified Opportunity Fund if the investment is held for at least 10 years. This exclusion must be elected and only applies to gains accrued after an investment in a Qualified Opportunity Fund (1400Z-2(c))[7]

Below is a summary of these basis step-up rules:

OZ FUND HOLDING PERIOD (YEARS)	OZ FUND INVESTMENT BASIS STEP (AS % OF DEFERRED GAIN)
At least 5 but less than 7	10%
At least 7 but less than 10	15%
10 or more years	100% exclusion of capital gain

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[5] *NMTC financing may not be combined with LIHTC.*

[6] *If the Opportunity Fund investment is held beyond 2026, it is unclear if a taxpayer could claim a refund for payment of deferred capital gain taxes in 2026 . For example, a taxpayer who holds the OZ Fund investment for at least 10-years would receive an OZ Fund basis adjustment equal to the its fair market value. Hence, the tax on the deferred gain would be zero as the taxable amount of deferred gain is the lesser of the: (i) deferred gain; or, (ii) the FMV of the OZ Fund less its basis. We'll need guidance from IRS regulations.*

[7] *If the taxpayer's basis in the Opportunity Fund exceeds its fair market value at the time of sale, the taxpayer would not make a 1400Z-2(c) election so that the loss could be recognized.*

Qualified Opportunity Zone Funds – Continued

SECTION TWO – TECHNICAL SUMMARY OF IRC SECTION 1400Z – Continued

To receive the tax deferral and basis step-up benefits, the investor and OZ Fund must comply with the following requirement:

Investor Requirements:

There are three basic investor requirements:

1. Deferred gain is generated from a sale of property to an unrelated person (1400Z-2(a)(1)(A))[8];
2. Deferred gain is invested in an OZ Fund within 180 days of sale (1400Z-2(a)(1)(A)); and,
3. An Opportunity Zone election is made by taxpayer (1400Z-2(a)(1)).

Fund Requirements:

An OZ Fund must:

1. Be a qualified entity; and,
2. Invest in Qualified Opportunity Zone Property.

Qualified Entity Requirements:

As noted above, an OZ Fund must be an investment vehicle organized as a corporation or a partnership for investing in and holding at least 90% of its assets in qualified opportunity zone property. The 90% test is measured at the fund's mid-year and year-end tax year.[9]

On April 25, 2018, the IRS published FAQs explaining that eligible taxpayers will self-certify as an OZ Fund by attaching a form to the taxpayer's timely filed federal income tax return, including extensions. As of the publication date of this article, this form has not been released[10]

Investment in Qualified Opportunity Zone Property Requirements:

Qualified Opportunity Property includes investments in: (i) qualified stock or partnership interests; or, (ii) qualified opportunity zone business property.

(i) Qualified stock or partnership interests must be:

- Purchased for cash by the OZ Fund after December 31, 2017;
- A corporation or partnership must be:
  - Organized for the purpose of being a Qualified Opportunity Zone Business; or, at the time the OZ Fund purchased such equity, the corporation or partnership qualified as an opportunity zone business; and,
  - A Qualified Opportunity Zone Business for substantially all of the OZ Fund's holding period.

A Qualified Opportunity Zone Business is a trade or business in which:

- Substantially all the tangible property owned or leased by the taxpayer is qualified opportunity zone business property[11];
- 50% or more of the business' total gross income is derived from the active conduct of the trade or business;
- A substantial portion of the business' intangible property is used in the active conduct of the trade or business;

[8]The title to the statute and the conference reports uses the term "capital gains" but the body to the statute only refers to "gains." We are awaiting IRS guidance to confirm which types of gains are eligible including short-term and long-term capital gains, 1231, 1245 and 1250 gain. Sales must be to an unrelated party as defined under Sections 267(b) or 707(b)(1), applying a 20% (versus a 50%) threshold.

[9]An OZ Fund that fails to meet the 90% test, is subject to a penalty based upon the shortfall times the Short Term AFR + 3%. Currently around 5.5%

[10]https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

[11]Clarification of the definition of "substantially all" has been requested of the IRS. Similar "substantially all" standards in other tax statues have been interpreted to mean a range of 70-85%. For example, for the New Markets Tax Credits it is 85%.

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- Less than 5% of the average of the aggregate unadjusted bases of its property is attributable to nonqualified financial property[12]; and
- Is not a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

(ii) Qualified opportunity zone business property means any tangible property used in a trade or business if:

- The property was purchased for cash by the OZ Fund after 2017 for cash;
- The original use in the qualified opportunity zone commenced with the OZ Fund or the fund "substantially improves" the property (property is substantially improved if investment in the property (i.e. basis adjustments) during any 30-month period equals or exceeds the adjusted basis of the property at the beginning of such period); and
- During substantially all of the OZ Fund's holding period, substantially all of the use of the property was in a qualified opportunity zone.

Miscellaneous Observations

Here are few observations that can be beneficial when advising clients:

OZ Fund investments will be income in respect to a decedent (IRD)

OZ Funds are treated as IRD and thus will not receive a basis step-up at the death of the taxpayer (1400Z-2(e)(3)). Hence, whomever inherits an OZ Fund interest will be taxed on its income.

Investor's basis in OZ Funds starts at zero

The taxpayer will have an initial basis of zero in an OZ Fund investment (1400Z-2(b)(2)(B))(i)); however, the fund itself will have a different "inside basis" for the assets it purchases. This can create interesting tax considerations regarding basis, at-risk, and passive activity limitations.

OZ Fund versus Section 1031 like-kind exchanges

An investor should consider if it is better to defer a capital gain using a Section 1031 like-kind exchange versus an OZ Fund. When making this analysis, don't forget, the 2017 Tax Act limited the application of section 1031 to real property.

We are likely to see lots of small OZ Funds

1400Z-2(f) assesses a penalty if less than 90% of an OZ Fund's assets are invested in qualified opportunity zone property. This penalty will promote single asset and small funds.

Conclusions

OZ Funds aren't for everyone (but nothing is except, arguably, chocolate). An OZ Fund investment should be considered by investors who:

- Want their investment to have a social impact in an identified community;
- Plan to hold their investment for at least 10 years; and,
- Will not be negatively impacted by IRD, at-risk and passive activity rules.

We will be following IRS 1400Z announcements and regulations. Feel free to contact us with comments and questions.

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[12]*Nonqualified financial property is debt, stocks, partnership interests, options, futures/forward contracts, warrants, notional principal contracts, annuities and other similar property with exceptions for working capital and debt instruments of 18 months or less.*

Qualified Opportunity Zone Funds – Continued

Executive Summary

INVESTOR TAX BENEFITS	
Temporary deferral on capital gains	An investor can defer capital gains taxes by investing the gains in an OZ Fund. Deferred until earlier of 2026 or date of sale.
Basis step-up on Opportunity Zone Fund investment	If the OZ Fund investment is held for at least 5 years, investor's basis in the OZ Fund is increased by 10% of the deferred capital gain. If the investment is held for 7 or more years, this basis step-up is increased to 15%.
Permanent exclusion of capital gains	If an investor holds an OZ Fund investment for 10 years or more, s/he can exclude all capital gains from the OZ Fund investment.
Can be combined with other tax incentives	OZ funds can share in New Market Tax Credits, Historic, Energy and Low-Income Housing Tax.
INVESTOR POTENTIAL NON-TAX BENEFITS	
Social Impact returns	Many investors are looking for more than economic returns... they want their investments to have a positive social impact. For such investors, an OZ Fund investment should be considered.
Risk reduction	A few OZ funds are being structured with organizations like foundations and CRA investors to make grants and reduce fund risk, enhancing the Fund's risk-adjusted rate of return. (AAA bonds versus "junk" bonds).