Opportunity Zones
Overview and Guidance

February 6, 2019
Agenda

• Opportunity Zone Overview
• Benefits of the Opportunity Zone Incentive
• Qualified Opportunity Zones
• Qualified Opportunity Funds
• Qualified Opportunity Zone Property
• Combining with Other Incentives
• Next Steps and Takeaways
Opportunity Zone Overview
“Opportunity Funds are private sector investment vehicles that invest at least 90 percent of their capital in Opportunity Zones. U.S. investors currently hold trillions of dollars in unrealized capital gains in stocks and mutual funds alone—a significant untapped resource for economic development. Opportunity Funds provide investors the chance to put that money to work rebuilding the nation’s left-behind communities. The fund model will enable a broad array of investors to pool their resources in Opportunity Zones, increasing the scale of investments going to underserved areas.”  
https://eig.org/opportunityzones/about
Benefits of the Opportunity Zone Incentive
Taxpayers can get capital gains tax deferral (& more) for making timely investments in Qualified Opportunity Funds (QOFs) which invest in Qualified Opportunity Zone Property.
3 Tax Incentive Benefits

1. Gain Deferral
2. Partial forgiveness
3. Forgiveness of additional gains
Period of Deferral & Amount Recognized

- Deferral period ends upon the earlier of:
  - Sale of QOF interest or
  - December 31, 2026

- Amount of capital gain tax recognized:
  - Lesser of:
    - Amount of gain deferred or
    - The fair market value of the investment in the QOF interest
  - Minus
    - Taxpayer’s basis in the QOF interest (basis in QOF interest initial is deemed to be zero)
Partial Forgiveness and Forgiveness of Additional Gains

- **SALE INVESTMENT**

  - **HELD FOR 5 YEARS**
    - Basis increased by 10% of the deferred gain
    - Up to 90% taxed

  - **HELD FOR 7 YEARS**
    - Basis increased by 5% of the deferred gain
    - Up to 85% taxed

  - **HELD FOR 10 YEARS**
    - Basis is equal to Fair Market Value
    - Forgiveness of gains on appreciation of investment
    - Requires an election

<table>
<thead>
<tr>
<th>Year</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
<th>2025</th>
<th>2026</th>
<th>2027</th>
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<td>SALE</td>
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Jan. 2, 2018
Taxpayer enters into a sale that generates $1M of capital gain

June 30, 2018
(Within 180 days), Taxpayer contributes entire $1M of capital gain to a Qualified Opportunity Fund

- Taxpayer is deemed to have a $0 basis in its QOF investment
- QOF Invests the $1MM in Qualified Opportunity Zone Property
June 30, 2023 (After 5 years), Taxpayer’s basis in investment in QOF increases from $0 to $100k

June 30, 2025 (After 7 years), Taxpayer’s basis in investment in QOF increases from $100k to $150k

Dec. 31, 2026 $850K of the 1MM of deferred capital gains are taxed and the basis in QOF investment increases to $1MM.

June 30, 2028 (after 10 years), Taxpayer sells its investment for $2.0MM. Basis in the investment is deemed to be FMV. The effect is no tax on appreciation in investment.
Mixed Investments

Day 1
Disposition of Asset results in $2,000,000 of proceeds – return of capital of $1,000,000 and capital gain of $1,000,000
All proceeds are invested in QOZF.

$1,000,000 Capital Return

$1,000,000 Capital Gain

Day 3,653 (10 years, 1 day)
Disposition of OZ Fund interest results in proceeds of $4,000,000 – return of original $1,000,000 investment; $1,000,000 of “original” capital gains, and $2,000,000 of new capital gain. All proceeds are held by investor.

$1,000,000 Capital Return
No Tax

$1,000,000 new gain on original capital
Taxed at Capital Gains Rate

$1,000,000 “original” capital gain. Tax due in 2027, so no tax on disposition of OZ Fund interest

$1,000,000 new gain on OZ Fund investment.
Basis = FMV, so not taxed

Total Tax\(^1\) = $212,500 on invested capital gain
$250,000 on non-Opportunity Zone new gain
$462,500

Instead of $750,000 without Opportunity Zone treatment

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\(^1\) Assuming no changes in rates.
Qualified Opportunity Zones
Opportunity Zones in La Crosse

• Census Tract 2 and Census Tract 4 are the approved Opportunity Zones in La Crosse, Wisconsin. The following table gives a glimpse as to how these census tracts compare to the regional average.

<table>
<thead>
<tr>
<th>Category</th>
<th>Census Tract 2</th>
<th>Census Tract 4</th>
<th>Regional Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poverty Rate</td>
<td>36%</td>
<td>65%</td>
<td>14%</td>
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<tr>
<td>Household Income</td>
<td>$30,814</td>
<td>$19,748</td>
<td>$52,004</td>
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<tr>
<td>Homeownership</td>
<td>30%</td>
<td>7%</td>
<td>67%</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>10%</td>
<td>8%</td>
<td>5%</td>
</tr>
<tr>
<td>Adults that have a high school diploma</td>
<td>84%</td>
<td>93%</td>
<td>94%</td>
</tr>
<tr>
<td>Adults that have a bachelor’s degree or higher</td>
<td>16%</td>
<td>43%</td>
<td>31%</td>
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</tbody>
</table>
Qualified Opportunity Funds
Taxpayers can get capital gains tax deferral (& more) for making timely investments in Qualified Opportunity Funds (QOFs) which invest in Qualified Opportunity Zone Property.
Qualified Opportunity Fund

• Statutory definition:
  • An investment vehicle organized as a corporation or a partnership for the purpose of investing in Qualified Opportunity Zone Property (QOZP).

• Opportunity Funds self certify

• Noncompliance Penalty
  • 90% asset test
  • Per month penalty equal to % of shortfall x underpayment rate
  • No penalty for reasonable cause
Types of Funds

• Self directed
  • Investing into the next project
• Targeted
  • Small groups/identified projects
• Large Funds
  • May be specialized; add management talent
Securities Laws

- OZ Funds are investments and are subject to securities laws
  - Accredited vs. unaccredited investors
  - Crowdsourcing
  - In-state exemptions from federal acts
- Consult securities counsel!
Qualified Opportunity Zone Property
Taxpayers can get capital gains tax deferral (& more) for making timely investments in Qualified Opportunity Funds (QOFs) which invest in Qualified Opportunity Zone Property.
Qualified Opportunity Zone Stock and Partnership Interests

- The investment must be acquired after December 31, 2017 in exchange for cash;
- Must be a qualified opportunity zone business, or is being organized for the purpose of being a qualified opportunity zone business;
- Must remain a qualified opportunity zone business for substantially all of the qualified opportunity fund’s holding period
Qualified Opportunity Zone Businesses (QOZB)

A trade or business in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property (QOZBP) and:

• At least 50% of income derived from Active Conduct
• Substantial portion of intangible property used in active conduct of business
• < 5 percent unadjusted basis of property is nonqualified financial property

No “sin businesses” permitted

• 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.
Qualified Opportunity Zone Business Property (QOZBP)

✓ Tangible property used in a trade or business
✓ Acquired by purchase from an unrelated party (20% standard) after December 31, 2017
✓ During substantially all of holding period, substantially all the use is in a QOZ
✓ Original use in the QOZ commences with the taxpayer

OR
✓ Taxpayer substantially improves the property
  ✓ during any 30-month period after acquisition, additions to basis exceed an amount equal to the adjusted basis of such property at the beginning of such period
Readily Identifiable Investment Types in Opportunity Zones

- Commercial Real Estate Development and Renovation in Opportunity Zones
- Opening New Businesses in Opportunity Zones
- Expansion of Existing Businesses into Opportunity Zones
- Large Expansions of Businesses already within Opportunity Zones
5 QOZB Tests

✓ Organized as a partnership or corporation for tax purposes
✓ 70% of tangible assets are QOZ Property
  ✓ Acquired after 1/31/17
  ✓ Used in an Opportunity Zone
  ✓ Original Use or Substantial Improvement
✓ 50% of active gross income from OZ
✓ <5% NQFP
✓ Ineligible businesses
1031 Comparison

- No “like kind” requirement
- No qualified intermediary necessary
- 180 days to reinvest
- No initial property identification necessary
- Benefits to tax payer in addition to deferral
- No continuous deferral - taxes on original gain must be paid in April 2027
- Potential cash flow issues when taxes are due
Takeaways for Real Estate Developers

- New construction in an OZ works well
- Renovations of existing structures must meet substantial improvement test
- Potential that “original use” test could be applied to vacant structures
- If the QOZB is an operating company, the company may only need to locate in an OZ but not construct or substantially improve a structure
- OZ capital can be layered with other financing incentives
Takeaways for Municipalities

• Know your Opportunity Zones and the assets in them

• Add OZ notifications on any marketing materials for city-owned real estate in OZs

• Consider alignment with Tax Increment Districts

• Communicate with core developers and corporate stakeholders about OZ benefits

• Consider facilitating a local fund for local projects

• Consider creating a dedicated OZ webpage
Takeaways for Investors

- Timing of investment
- Don’t forget to file elections!
- Ability of Fund to change or restrict investments
- Exit strategies
- Experience of Fund manager
Takeaways for Fund Managers

- Private Placement Memorandum/Offering materials
- Tax services offered to investors
- Fiduciary duty to investors
- Exit strategies
- Mixed fund issues/accounting
- Good legal and accounting counsel
Takeaways for Small Business

- Source of capital for expansion/relocation
  - Patient Capital
  - Lower Cost
- Be mindful of the 5 tests
- Active conduct
- Must remain in OZ for substantially all of the holding period
- How to attract OZ investment
- Issues with selling equity interests
Takeaways for Lenders

- Tax due in 2027 with no corresponding cash event = lending opportunity
- Guidance for bank customers
- Pair with OZ funds to provide complete package
Questions?

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