

NEXT CHALLENGE. NEXT LEVEL.
NEXSEN | **PRUET**

MYRTLE BEACH OPPORTUNITY ZONE
INVESTOR FORUM

Burnet R. Maybank, III bmaybank@nexsenpruet.com

UPDATED: OCTOBER 19, 2018



OPPORTUNITY ZONES CREATION

- ▶ The Opportunity Zone Program was created as part of the Federal Tax Bill
- ▶ It was co-sponsored by Senators Tim Scott and Cory Booker
- ▶ Purpose
 - ▶ Combat geographical inequality:
 - ▶ In the 1990s, half or more of all counties grew at the national rate. None only 25% do
 - ▶ More than half of the country's distressed zip codes contained fewer jobs and places of business in 2015 than they had in 2010
 - ▶ This bill should expand the geography of economic growth

OPPORTUNITY ZONES PROGRAM INTENT

- ▶ The program provides incentives to investors to invest in new businesses and development in particular geographies
 - ▶ There is no public money as part of this program
 - ▶ The incentive is market based: investments must provide an attractive return on investment in order to attract investors
- ▶ The program is scalable and flexible
 - ▶ (Although rules are still being written) We do not expect there to be investment minimums or maximums required
 - ▶ Investors can invest in new businesses, new real estate, or substantial redevelopment of real estate (more than 100% of the acquisition cost spent on redevelopment)
 - ▶ Investors can NOT invest in so called sin businesses, defined as: golf courses, country clubs, massage parlors, hot tub facilities, tanning facilities, racetracks or gambling venues, or stores where the principal business is sale of alcoholic beverages for consumption off premises

OPPORTUNITY ZONES

HOW ARE OZs DETERMINED?

Governors of each state (and territory) were allowed to designate up to 25% of their low income census tracts

- ▶ Two approaches to designate:

- ▶ Data

- ▶ Population

- ▶ Income

- ▶ Urban/Rural

- ▶ Local Input

OPPORTUNITY ZONES

HOW ARE OZs DETERMINED?

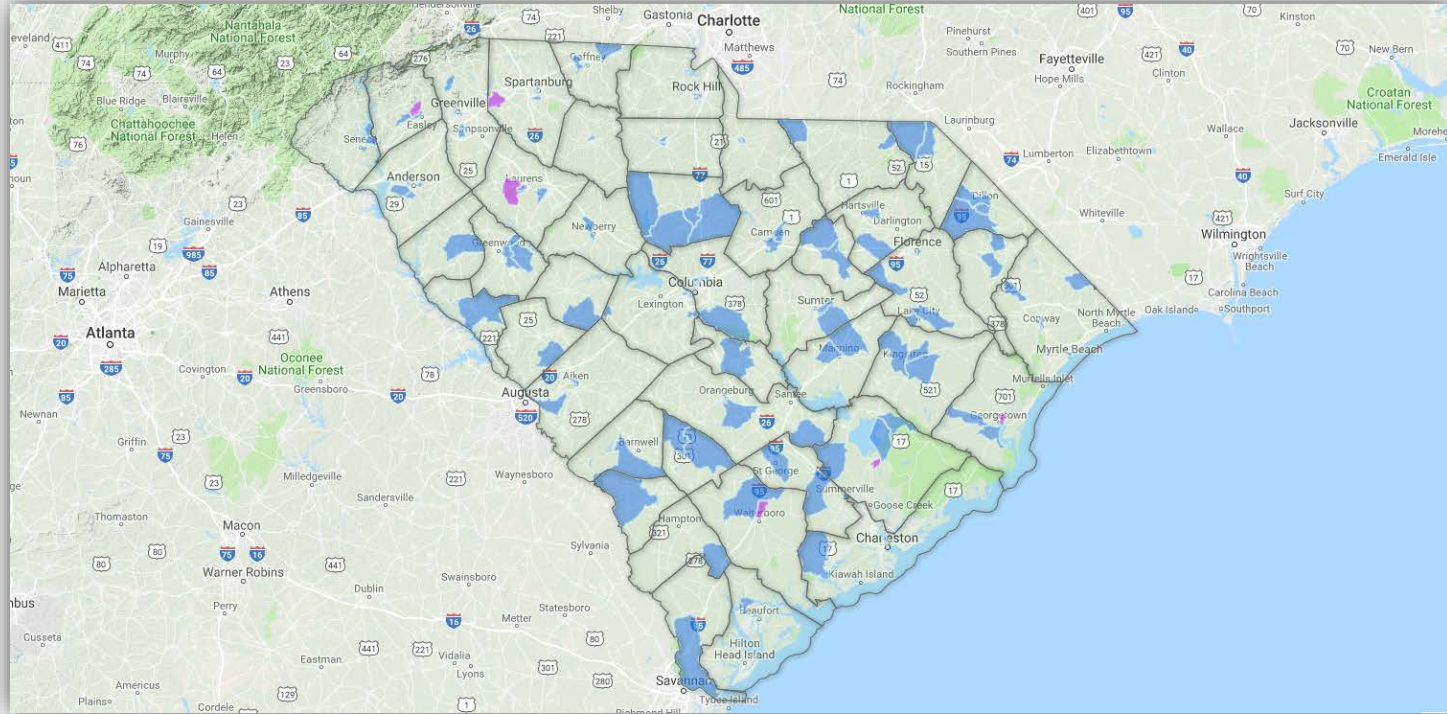
In South Carolina, we have 1,097 census tracts

- ▶ 538 were eligible to be submitted
- ▶ Submitted 135 tracts
 - ▶ 128 Low Income Community tracts were submitted
 - ▶ 7 eligible contiguous tracts were submitted

Focus Areas:

- ▶ Promoting economic vitality in parts of the state that have not shared in the general prosperity over the past few years
- ▶ Funding the development of workforce and affordable housing in areas with escalating prices and inventory shortages
- ▶ Investing in startup businesses who have potential for rapid increases in scale
- ▶ Upgrading the capability of existing underutilized assets through capital improvement investments

OPPORTUNITY ZONES WHERE ARE THEY?



www.scopportunityzone.com

OPPORTUNITY ZONES

On Friday, October 19, 2018, the U.S. Treasury Department issued its first set of guidelines for opportunity zones. That guidance included 74 pages of proposed regulations, a five page revenue ruling, an updated Q&A document and a draft of Form 8996 for qualified opportunity funds.

While the regulations are proposed, taxpayers and opportunity funds may rely on the proposed regulations, presuming they apply the rules in their entirety and do so in a consistent manner.

The IRS has indicated they will issue a second or third set of Regulations.

OPPORTUNITY ZONES REQUIREMENTS

There are three requirements:

- A. A **Capital Gain** must be invested in a
- B. Qualified **Opportunity Fund** which invests in a
- C. Qualified **Opportunity Zone**
- D. Where such occurs, substantial **Federal Income Tax Incentives** are generated

TAX INCENTIVES

Natch, I will go out of order and start with the tax incentives.

There are two forms of federal income tax incentives:

- (1) A deferral and possible reduction of the ORIGINAL capital gain; and
- (2) Elimination of the SECOND capital gain (if any) from the subsequent sale of the investment in the Opportunity Fund.

TAX INCENTIVES

ORIGINAL CAPITAL GAIN

The Opportunity Zones program offers two Income Tax Incentives for the underlying capital gain:

- 1) A deferral of inclusion in taxable income for capital gains reinvested in an Opportunity Fund. The deferred gain must be recognized on the earlier of the date on which the opportunity zone investment is disposed of or December 31, 2026; and
- 2) A capital gain reduction resulting from a step-up in basis for capital gains reinvested in an Opportunity Fund. The basis is increased by 10% if the investment in the Opportunity Fund is held by the taxpayer for at least 5 years and by an additional 5% if held for at least 7 years, thereby excluding up to 15% of the original gain from taxation.
- 3) The equity investment must be made by the end of 2019 in order to get the full 15% tax basis step-up.

TAX INCENTIVES

SECOND CAPITAL GAIN (IF ANY)

The Act provides a second tax incentive:

A permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in an Opportunity Fund if the investment is held for at least 10 years, i.e. no tax will be due on the appreciation of the Qualified Opportunity fund other than the original deferred gain that must be recognized by December 31, 2026.

QUALIFYING CAPITAL GAIN

The first Requirement above requires a capital gain.

The Legislation allows taxpayers to defer short or long-term capital gains due on the sale of any investment (stocks, bonds, real estate) if the capital gain portion of the sale is reinvested within 180 days in a Qualified Opportunity Fund.

If the capital gain results from the sale or exchange of real estate it must be with an unrelated party.

TRACING: Arguably, the taxpayer that owns the Opportunity Fund Investment must be the same individual or entity that recognized the gain. So, the eligible taxpayer must directly invest into a Opportunity Fund, rather than investing the proceeds into another entity (even a pass-through) which would then invest into the Opportunity Fund.

QUALIFYING CAPITAL GAIN RELATED PARTY SALE

The gain must not arise from a sale or exchange with a related person as defined in section 1400Z-2(e)(2). Section 1400Z-2(e)(2) incorporates the related person definition in sections 267(b) and 707(b)(1) but substitutes “20 percent” in place of “50 percent” each place it occurs in section 267(b) or section 707(b)(1).

QUALIFYING CAPITAL GAIN

The Proposed Regulations provide that any person that recognizes capital gain for U.S. federal income tax purposes (including any individual, "C" corporation (including a regulated investment company, commonly known as a mutual fund ("RIC")), or a real estate investment trust ("REIT")), partnership, "S" corporation, trust or estate) is eligible to defer all or a portion of such gain by investing in an Opportunity Fund.

QUALIFYING CAPITAL GAIN

Any gain that is not treated as capital gain is not eligible to be deferred. In addition, any gain that is realized but not recognized for U.S. federal income tax purposes, such as gain in corporate reorganizations, certain partnership transactions and Section 1031 “like-kind” exchanges, is not eligible to be deferred.

The Proposed Regulations allow a taxpayer to “split” the gain derived from a single transaction into multiple Opportunity Fund investments. For example, if a taxpayer realized a \$100,000 capital gain on January 1, 2019 and invested \$80,000 of the gain into an Opportunity Fund on February 1, 2019, the remaining \$20,000 portion of the gain could be invested into an Opportunity Fund prior to the expiration of the 180-day period beginning on January 1, 2019. However, to the extent that the second investment exceeded \$20,000, the excess amount would not qualify for the Opportunity Fund tax benefits.

QUALIFYING CAPITAL GAIN

The Proposed Regulations provide special rules for the deferral of capital gain by a partnership and/or its partners. Where a partnership recognizes a capital gain and invests the gain into an Opportunity Fund, the rules provide that the deferred partnership-level gain will not be taxed at the partner level in the year of deferral. When the gain is later recognized (e.g., upon the earlier of the sale of the Opportunity Fund interest or December 31, 2026), the partnership's partners will be taxed on the recognized gain at such later time.

To the extent that a partnership does not elect to defer its eligible gain, each partner may elect to defer its allocable share of the gain. Several special rules allow the individual partner to defer its capital gain where the partnership declines to do so.

QUALIFYING CAPITAL GAIN

HOW DOES THE TAXPAYER DEFER THE GAIN

The proposed Regs state that it is anticipated that taxpayers will defer the gain by making a deferral election on Form 8949 which will be attached to their Federal Income Tax Return for the taxable year in which the gain would have been recognized but for the deferral.

TAX INCENTIVES

STACKING OF THE CREDITS

The Opportunity Zone tax incentive can be stacked with both federal:

NMTC

Historic Rehabilitation

And state tax incentives:

Fee-in-Lieu/MCBP

Bailey Bill

Abandoned Building/Textile

Revitalization Acts

Infrastructure Credit

QUALIFIED OPPORTUNITY FUNDS

The second requirement is that the capital gain must be invested within 180 days in a qualified Opportunity Fund.

Corporate and partnership investments must be made in cash – i.e., in-kind contributions or promissory notes issued to a qualified opportunity zone business are not qualified investments.

The gain must be invested in an Opportunity Fund within the 180-day period that begins on the date on which the taxpayer would otherwise be required to recognize that gain (the “Recognition Date”). In the case of a stock sale effected on an exchange, the Recognition Date is the trade date. In the case of a capital gain dividend received from a RIC or REIT, the Recognition Date is the date that the dividend is paid. In the case of a taxpayer that is a partner (or “S” corporation shareholder or beneficiary), seeking to defer its share of gain realized by the partnership (or “S” corporation or trust or estate), the Recognition Date is the last day of the entity’s tax year.

QUALIFIED OPPORTUNITY FUNDS

The Proposed Regulations provide that any entity classified as a domestic corporation or a domestic partnership for U.S. federal income tax purposes, which should presumably include a limited liability company (LLC) or business trust, is eligible to be an Opportunity Fund. Opportunity Funds may be organized as REITs and "S" corporations.

The Proposed Regulations clarify that an eligible interest in an Opportunity Fund includes preferred stock and a partnership interest with special allocations, but not a debt instrument. Deemed contributions under section 752(a) do not qualify.

The eligible interest can be used as collateral for a loan, whether purchase money borrowing or otherwise.

QUALIFIED OPPORTUNITY FUNDS

“Qualified Opportunity Funds” were determined by the Community Development Institutions Fund of the Treasury Department. It was originally thought that this would be in a process similar to allocation of New Markets Tax Credits to “community development entities,” and that only CDE type organizations would qualify.

This was a substantial negative for many real estate developers, who would be reluctant to make investments in a CDE with limited real estate experience, and the process to qualify as a CDE was lengthy.

QUALIFIED OPPORTUNITY FUNDS SELF CERTIFICATION

The IRS recently issued a FAQ which states in part:

Q. How does a taxpayer become certified as a Qualified Opportunity Fund?

A. To become a Qualified Opportunity Fund, an eligible taxpayer self certifies. (Thus, no approval or action by the IRS is required.) To self-certify, a taxpayer merely completes a form (Form 8996) and attaches that form to the taxpayer's federal income tax return for the taxable year. (The return must be filed timely, taking extensions into account.)

The proposed Regs confirmed the self-certification.

QUALIFIED OPPORTUNITY FUNDS SELF CERTIFICATION

On October 19, 2018, the IRS issued a Draft IRS Form 8996 for qualifying as an Opportunity Fund. The draft form implies that the Opportunity Fund must own the Opportunity Zone Business Property directly. The draft Regs say that it is expected that taxpayers will use Form 8996, Qualified Opportunity Fund, both for initial self-certification and for annual reporting of compliance with the 90-Percent Asset Test. It is expected that the Form 8996 would be attached to the taxpayer's Federal income tax return for the relevant tax years.

QUALIFIED OPPORTUNITY FUNDS

The statute outlines two requirements:

(1) The entity must be organized as a corporation or partnership; and (2) must maintain at least 90 percent of assets in “Qualified Opportunity zone property,” including investments in “Qualified Opportunity zone stock,” “Qualified Opportunity zone partnership interest,” and “Qualified Opportunity business property.”

Business Property is covered below.

QUALIFIED OPPORTUNITY FUNDS

QUALIFYING OPPORTUNITY ZONE BUSINESS PROPERTY

The qualifications as “Qualified Opportunity zone stock,” “Qualified Opportunity zone partnership interest,” and “Qualified Opportunity zone business property” encompass investments in (1) new or (2) substantially improved tangible property, including commercial buildings, equipment, and multi-family complexes.

QUALIFIED OPPORTUNITY ZONE BUSINESS

In IRS Information Letter 2018-0018, the IRS stated:

“A qualified opportunity zone business is a trade or business in which the taxpayer owns or leases substantially all the tangible property as qualified opportunity zone business property (Section 1400Z-2(d)(3)). The qualified opportunity zone business must meet the requirements of paragraphs (2), (4) and (8) of Section 1397C(b), and not be of the type described in Section 144(c)(6)(B).

This is explained below.

QUALIFIED OPPORTUNITY ZONE BUSINESS

A qualified opportunity zone business is a trade or business:

- ▶ In which *substantially all* of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property;
- ▶ At least 50 percent 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;
- ▶ In which less than five percent of the average of the aggregate unadjusted bases of its property is attributable to nonqualified financial property; and
- ▶ Which 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.

QUALIFIED OPPORTUNITY ZONE BUSINESS SUBSTANTIALLY ALL REQUIREMENT

In order for an entity to be treated as an Opportunity Zone Business (and therefore count towards an Opportunity Fund's 90% Asset Test), "substantially all" of the tangible personal property owned or leased by the entity must be Opportunity Zone Business Property. The Proposed Regulations provide a bright-line rule that, if at least 70% of the entity's tangible property is Opportunity Zone Business Property, the entity satisfies this "substantially all" test (the "70% Safe Harbor").

QUALIFIED OPPORTUNITY ZONE BUSINESS

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

- ▶ The property was acquired by the qualified opportunity fund by purchase after 2017;
- ▶ The original use in the qualified opportunity zone commenced with the qualified opportunity fund or the qualified opportunity fund substantially improves the property; and
- ▶ During substantially all of the qualified opportunity fund's holding period, substantially all of the use of the property was in a qualified opportunity zone.

90% QUALIFIED PROPERTY ALLOCATION TEST

The law states that an Opportunity Fund must hold at least 90 percent of its assets in Qualified Opportunity Zone Property “Qualified Property,” which is measured as the average holding over two periods: (A) “on the last day of the first 6-month period of the taxable year of the fund, and” (B) “on the last day of the taxable year of the fund.”

The proposed Regs say, “For example, if a calendar-year entity that was created in February chooses April as its first month as a QOF, then the 90-Percent-Asset-Test testing dates for the QOF are the end of September and the end of December. Moreover, if the calendar-year QOF chooses a month after June as its first month as a QOF, then the only testing date for the taxable year is the last day of the QOF’s taxable year. Regardless of when an entity becomes a QOF, the last day of the taxable year is a testing date.

90% QUALIFIED PROPERTY ALLOCATION TEST

For this purpose, the Opportunity Fund is required to use the “book” value of its assets as shown in its financial statements filed with the U.S. Securities and Exchange Commission (or another U.S. federal agency), or the value of its assets as prepared in accordance with U.S. GAAP. If the Opportunity Fund does not have applicable financial statements, it must use the cost of its assets.

90% QUALIFIED PROPERTY ALLOCATION TEST

Does this mean there is a strict requirement that, in just the Opportunity Fund must invest 90 percent of the fund in real estate construction or improvement six months? Construction and rehabilitation of real property typically takes longer than six months. As stated above, the Fund can hold only a maximum of 5% of its assets in non-qualified Financial Property.

90% QUALIFIED PROPERTY ALLOCATION TEST

The Proposed Regulations adopt a working capital safe harbor that applies to cash as well as other “financial property” (including stock, bonds and other debt, partnership interests, options and certain derivatives). Under this safe harbor, such cash and financial property counts toward the 90% Asset Test, if for a period of up to 31 months: (1) if there is a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone, (2) there is written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months, and (3) the business substantially complies with the schedule. (4) Taxpayers are required to retain any written plan in their records.

DEFINITION OF SUBSTANTIAL IMPROVEMENT

Qualified Business Property must be either constructed by the Fund or “substantially improved.” Substantial improvement is more complicated, but the new Revenue Ruling and proposed Regs provide a very pro-taxpayer treatment to real estate developers.

The definition of “substantial improvement” to Qualified Opportunity Zone Business Property “Qualified Business Property” is met only if “additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the qualified opportunity fund,” i.e., the cost of the property improvements must exceed the tax basis of the property at the time of acquisition.

DEFINITION OF SUBSTANTIAL IMPROVEMENT

The Proposed Regulation and Revenue Ruling provides a pro-taxpayer view that with respect to an acquisition of land with an existing building, located within an Opportunity Zone, the tax basis of the land is not taken into account in determining whether the building has been substantially improved, and that there is no separate requirement to improve the land, so long as the existing building itself is substantially improved.

SUBSTANTIAL IMPROVEMENT REV. RUL. 2018-29

In September 2018, QOF A purchases for \$800x Property X, which is located wholly within the boundaries of a QOZ. Property X consists of a building previously used as a factory erected prior to 2018 and land on which the factory building is located. QOF A intends to convert the factory building to residential rental property. Sixty percent (\$480x) of the \$800x purchase price for Property X is attributable to the value of the land and forty percent (\$320x) is attributable to the value of the building. Within 24 months after the date of QOF A's acquisition of Property X, QOF A invests an additional \$400x in converting the building to residential rental property.

SUBSTANTIAL IMPROVEMENT REV. RUL. 2018-29

Under § 1400Z-2(d)(2)(D)(ii), tangible property used in a QOF's trade or business is treated as substantially improved by the QOF only if, during any 30-month period beginning after the date of acquisition of such tangible property, additions to basis with respect to such tangible property in the hands of the QOF exceed an amount equal to the adjusted basis of such tangible property at the beginning of such 30-month period in the hands of the QOF.

SUBSTANTIAL IMPROVEMENT REV. RUL. 2018-29

Because the factory building existed on land within the QOZ prior to QOF A's purchase of Property X, the building's original use within the QOZ did not commence with QOF A. However, under § 1400Z-2(d)(2)(D)(ii) QOF A substantially improved Property X because during the 30-month period beginning after the date of QOF A's acquisition of Property X QOF A's additions to the basis of the factory building (\$400x) exceed an amount equal to QOF A's adjusted basis of the building at the beginning of the 30-month period (#320x).

ADDITIONAL PROPOSED REGULATIONS

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 Treasury Department and the IRS expect the forthcoming proposed regulations to incorporate the guidance contained in the revenue ruling to facilitate additional public comment. The forthcoming proposed regulations are expected to address other issues under section 1400Z-2 that are not addressed in these proposed regulations. Issues expected to be address include: 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 section 1400Z-2.