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Chattanooga
Tax Practitioners
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Opportunity Zones Now Up and Jogging

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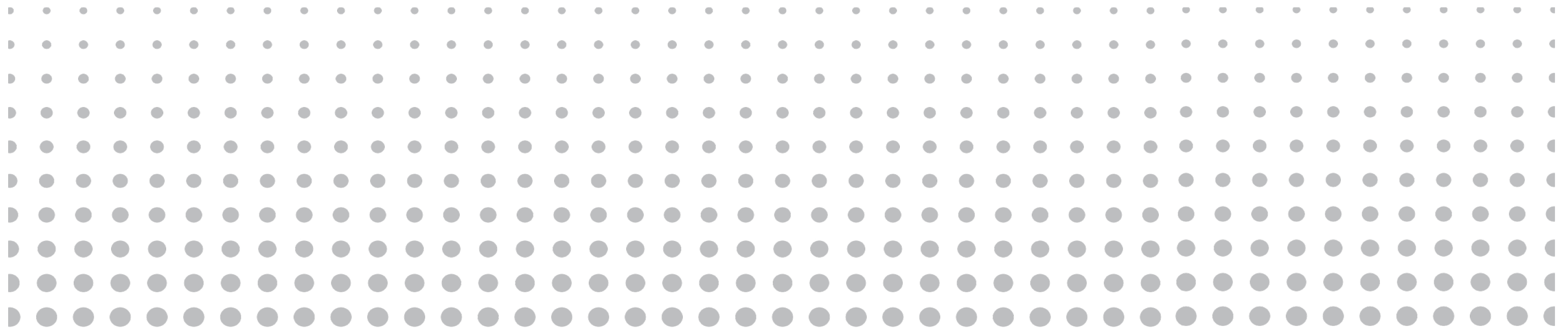

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Speaker Profile

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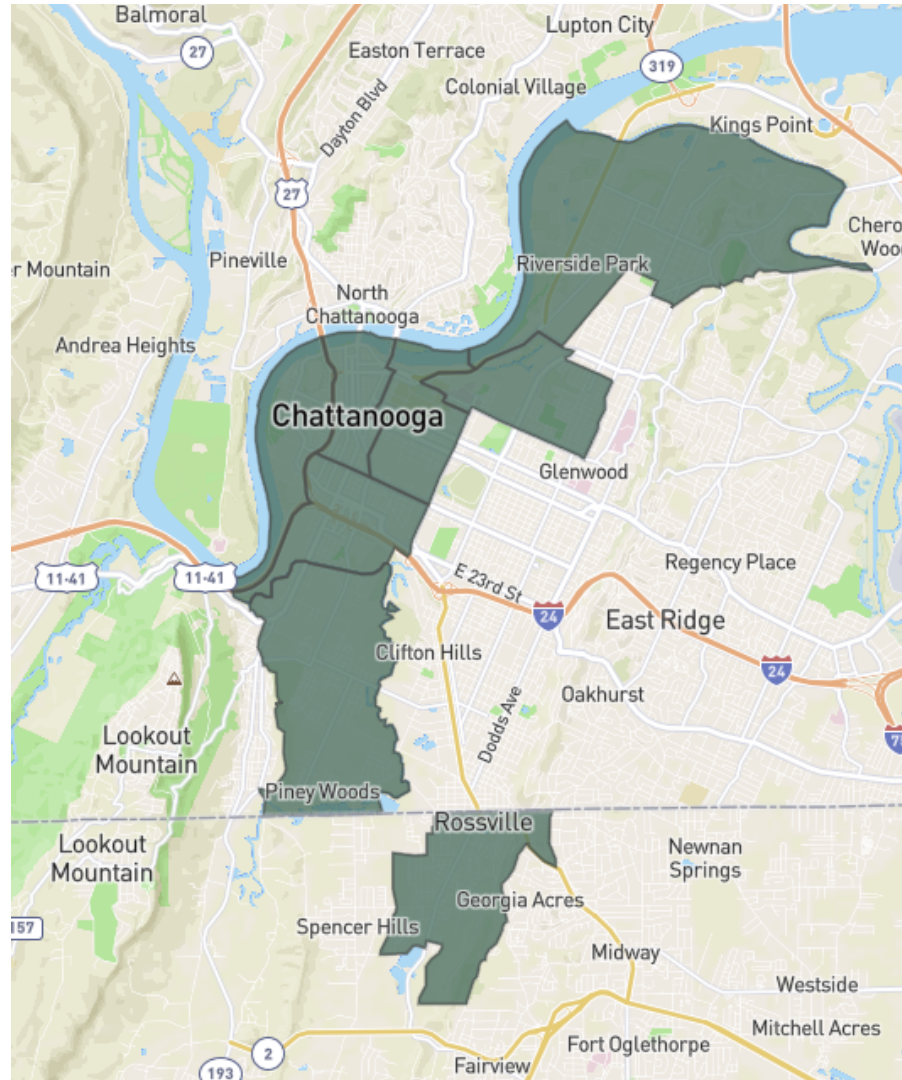
In his more than 35 years of practicing tax and business law, Leigh Griffith has helped clients grow their businesses from the start-up stage to billion-dollar corporations. Transaction-oriented businesses, healthcare companies, private equity firms, Limited Liability Companies (LLCs), and partnerships rely on Leigh's experience and counsel to structure their tax matters, which can range from a few million dollars to over $1 billion. Colleagues and clients regularly turn to him for his deep knowledge of tax at the state, national and global levels as well as the intersection of non-profit tax law, for-profit tax law and healthcare regulatory law. Leigh's background as a certified public accountant has contributed to groundbreaking legal work, including: creation of the first LLC in Tennessee; development of the Double Holdco LLC structure for the home healthcare industry; being named principal draftsman of the Tennessee LLC Act; participating in the first life insurance/annuity combination securitization, recognized by the rating agencies as a new security and a new asset class; American Bar Association Tax Section Advisor to National Conference of Commissioners on Uniform State Laws - Series of Unincorporated Business Entities Drafting Committee.

One of approximately 650 Fellows of the American College of Tax Counsel, Leigh is also a sought-after seminar leader for continuing professional education programs. Leigh contributes a bimonthly column, "The Pass Through Partner," in Taxes Magazine, published by CCH Tax and Accounting. Leigh has been recognized for his vast tax law experience in *The Best Lawyers in America* since 1995. A partner in the Nashville office of Waller Lansden Dortch & Davis, LLP, Leigh earned his J.D. from Vanderbilt University Law School. He holds an LL.M. in Taxation from New York University and earned his B.A., *magna cum laude,* from the University of Virginia.

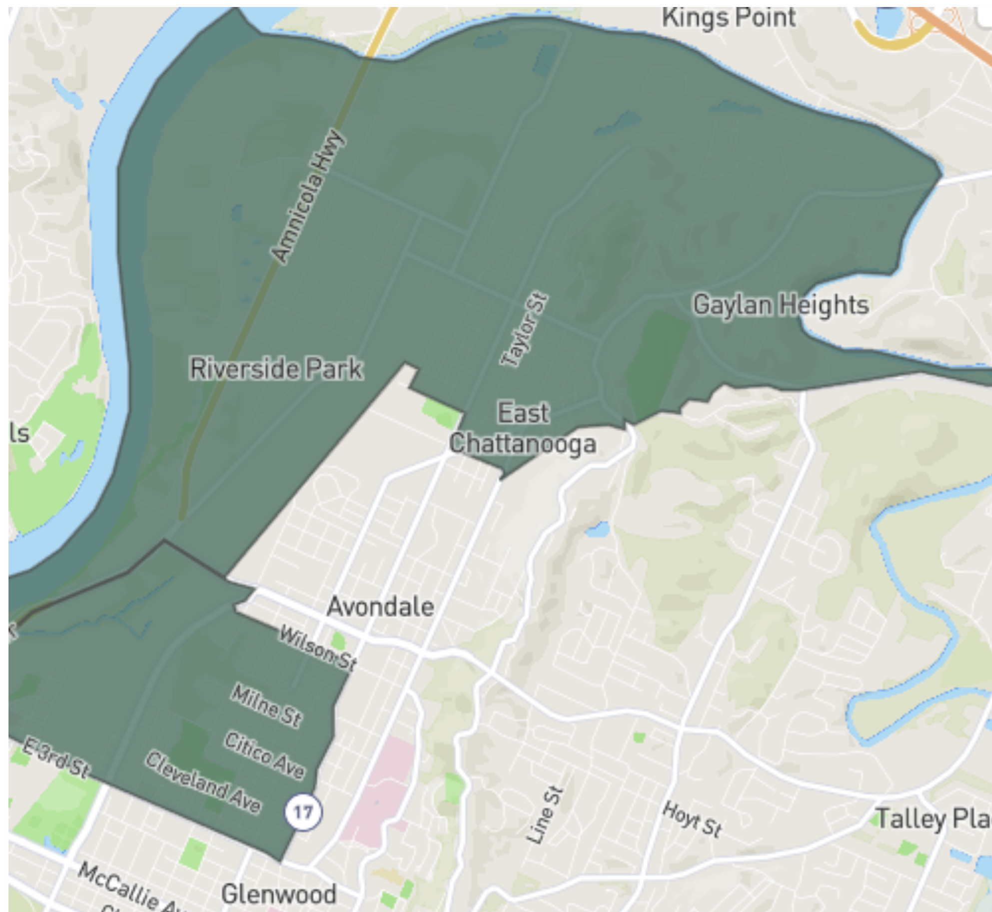
What is an Opportunity Zone

- An opportunity zone is a geographic zip code that has been designated by the Governor pursuant to Section 1400Z-1 for which an investor may invest capital gains recognized by the investor and:
  - Defer the capital gain
  - Eliminate up to 15% of the capital gain
  - Receive a step up in basis of the certain investments that meet certain criteria , including the holding of the Qualified Opportunity Zone Fund (QOF) for more than 10 years

Chattanooga Opportunity Zones



Chattanooga Opportunity Zones



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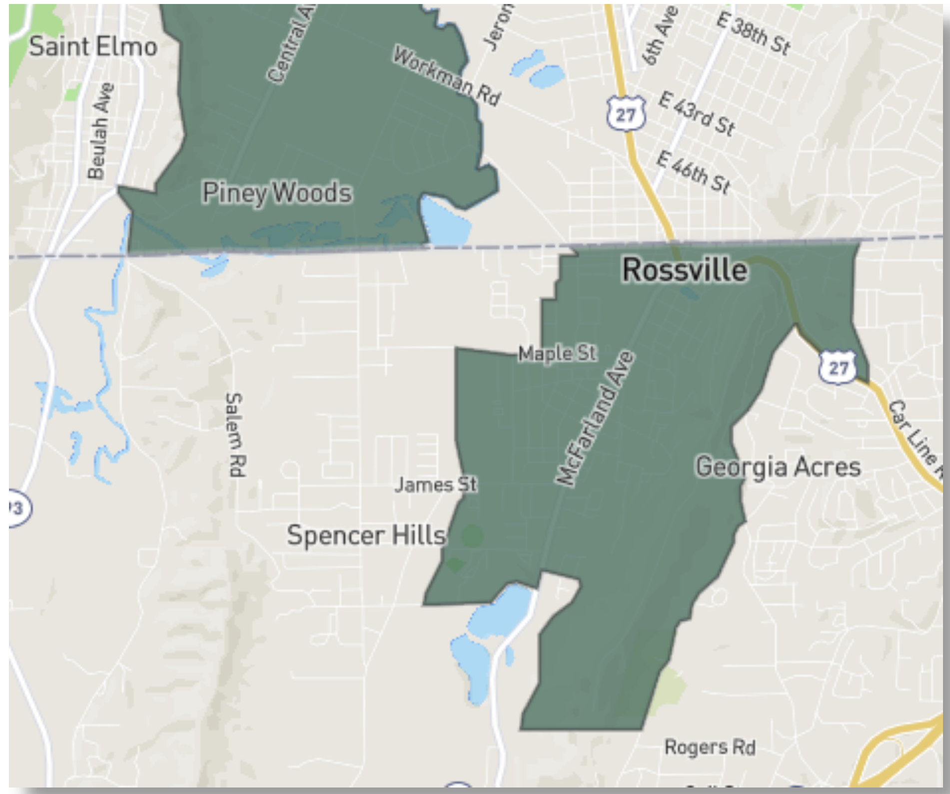

Concept vs. Implementation

- Concept is simple
  - Taxpayers with gains taxable as capital gains can reinvest the gain in a business in a qualified opportunity zone (QOZ)
    - Defer gain recognition to earlier December 31, 2026 or disposition
    - Cash from sale is not traced. Can utilize phantom gain to support QOF investment
  - Taxpayer elects to defer gain (if not elect to defer, do not receive QOZ Benefits)
  - Starts with a zero basis (if QOF is a partnership ignore share of 752(a) debt for this purpose)
    - If before December 31, 2026 hold for
      - Five years, receive basis step up of 10%
      - Seven years, receive basis step up of 15%
      - At December 31, 2016 or disposition, pay tax on initial gain (basis increased as provided above if satisfy holding period) recognize gain and pay tax
      - Gain on the QOF investment itself can be eliminated if hold for over 10 years

Who Can Invest?

- Any person that may recognize capital gain for purposes of federal income tax accounting.
- Includes:
  - Individuals
  - Partnerships
  - C corporations
  - S corporations
  - REITS
  - Trusts
  - Estates
  - Foreign and Non-Foreign

Concept vs Implementation *(continued)*

- Implementation
  - QOF formed for purpose of engaging in business as a QOF
  - QOF self declares on first return
  - 90% of QOF assets are Qualified Opportunity Zone Property (QOFP)
    - Qualified Opportunity Zone Stock (QOZS)
    - Qualified Opportunity Zone Partnership Interest (QOZPI)
    - Qualified Opportunity Zone Business Property (QOZBP)
      - Cannot have more than five percent “financial assets” unless qualify for working capital exclusion

Very Detailed Rules With Continuing Requirement For Period QOF Exists - Intro

- In the offering materials for a QOF, generally see a caveat that there can be no assurance that the investor will receive some or all of the anticipated QOF benefits (Hint)
- 90% asset requirement must be met for substantially the life of the QOF.
  - Substantially for the life of the QOF means 90%
  - Monetary penalty for each month fail the 90% requirement
- What that means to me is for a specific investor is the QOF must exist until after December 31, 2026 if the deferral element is to be achieved (at least for partnerships) and until the investor disposes of the QOF investment (after 10 years for elimination of gain)
  - Timing of adjustment of basis is different for QOF partnerships and QOF corps, including S corporations

90% Asset Requirement

- Percentage is computed as the average of the end of the 6th month of the tax year and the last day of the tax year must result in at least 90% of the assets constituting QOZP
- The QOF must annually file a Form 8896 in which the QOF presents the calculation. If less than 90% a penalty equal to the Federal Tax Underpayment Rate x shortfall is charged (use rate for each month miss the mark and divide each month's result by 12). Add up the months.
- May avoid the penalty if the QOF can show "reasonable cause"
- Not clear that "reasonably cause" waiver solves the 90% time clock. Author expectation is it does not.

Form 8896 (2018 Version) – Standard Calculation

Part II	Investment Standard Calculation		
5	Total qualified opportunity zone property held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes"	5	
6	Total assets held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes"	6	
7	Divide line 5 by line 6	7	.
8	Total qualified opportunity zone property held by the taxpayer on the last day of the taxpayer's tax year	8	
9	Total assets held by the taxpayer on the last day of the taxpayer's tax year	9	
10	Divide line 8 by line 9	10	.

Form 8896 (2018 Version) – Penalty Calculation

Form 8996 (12-2018) Page 2

Part IV **Line 13 Penalty**

If you checked "No" in Part III, line 13, complete Part IV to figure the penalty. Enter the number from line 8 below on Part III, line 13. See instructions if Part I, line 3 is "Yes."

		(a) Month 1	(b) Month 2	(c) Month 3	(d) Month 4	(e) Month 5
1	Total assets on the last day of the month					
2	Multiply line 1 by 0.90					
3	Total qualified opportunity zone property on the last day of the month					
4	Subtract line 3 from line 2. If zero or less, enter -0-					
5	Underpayment rate					
6	Multiply line 4 by line 5					
7	Divide line 6 by 12.0. Round up to two decimal places. See instructions if Part I, line 3 is "Yes"					

	(f) Month 6	(g) Month 7	(h) Month 8	(i) Month 9	(j) Month 10	(k) Month 11	(l) Month 12
1							
2							
3							
4							
5							
6							
7							

8 **Penalty.** Add columns (a) through (l) of line 7. Enter the total here and on Part III, line 13 . . . $

Form **8996** (12-2018)

90% Requirement of QOF

- Obviously only 10% of the assets can be something other than QOZP
- Qualified assets for 90% requirement must be “original use” in the/a (?) QOZ or “substantially improved by the QOF”
  - Ground itself is not required to be substantially improved and is taken out of the mathematical calculation.
    - Anti-abuse rule to prevent “warehousing” of real estate. Cannot buy land with minor or no improvements with intent not to do significant development.
  - Improvements not “original use” must be improved by expending over 30 months more in new improvements (on per asset basis) than purchase price.
  - Any non-cash property contributed to a QOF is in the “bad category”
- Working capital may be classified in the “good assets” if the QOF is directly engaged in operating business (including real estate development)

90% Requirement *(continued)*

- As discussed under 70% test (later) for QOZ business (QOZB), all tangible property must be acquired for cash after Dec. 31, 2917 from an unrelated party.
  - Code Sec. 267 and 707(b)(1) rules apply. 20% vs 50% relatedness.
  - Through statutory construction, Code Sec. 267(c) attribution rules are picked up
- Rental property can be leased from related or unrelated party.
  - Valuation of lease is discussed under 70% (2 methods)
  - Lease must be FMV and customary terms if related party lease
  - Cannot have right to purchase for less than FMV at the future date (good faith estimate on the front end will not automatically work – tested at transaction)
  - If original use not in a/the(?) QOZ and leased from related party, must acquire qualified property of equal or greater value within shorter of (i) term of lease or (ii) 31 months (improvements to leased property will count as well)

90% Requirement *(continued)*

- Because a first tier subsidiary (corp or pass-through) will be able to use a 70% tangible property test, most likely most QOFs will have QOZS and/ or QOZPI for primary assets and be an indirect owner/operator.
- In order to qualify for QOZS or ZOAPI, the subsidiary must be a Qualified Opportunity Zone Business.
  - Requirements:
    - Substantially all ("70%) of the tangible property must be Qualified Opportunity Zone Business Property ("QOZBP").
    - Requirements of Code Section 1397C(2),(4) and (8).
    - Substantial portion (40%) of the intangible property must be used in QOZ
    - Financial Assets (other than working capital) must not exceed 5% of assets.

QPZB 70% QOZBP Requirement

- A QOZB has a 70% of its assets Qualified Opportunity Zone Business Property
- Test using the same testing date rules as the QOF.
  - Tangible property must be used in T or B in a QOZ (applies to leased and purchased)
    - Special rule for inventory. In transit to the QOZ from supplier is deemed in the QOZ as are inventory in transit to customers
    - Special rule for working capital (essentially same rule as for 90%)
      - Applicable to tangible property used in the T or B
      - Applicable to developing an operating business
  - Intangible property is not included in the 70% testing (separate rule for intangible held by QOZB)

Determination of Value for Either 90% or 70% Test

- Annual option to use one of two methods to value purchased property:
  - Applicable financial statement value (if taxpayer has qualifying financial statements)
    - Applicable financial statement is one that requires the assignment of value to the leased tangible property.
  - Alternative valuation method
    - Unadjusted cost basis of the property under Code Sec. 1012 in the hands of the QOF or QOZB.
- Valuation of leased tangible property
  - Present value (using AFR rate at time lease entered into) for term of lease, including extensions if rent is pre-defined).

Other Requirements for QOZBP

- Purchase of tangible property- purchase after 12/31/2017
- Lease may be from related party – entered into after 12/31/2017
  - Lease must be FMV and terms must be arms' length if related party lease
  - If related party, no prepayment of rent for more than 12 months.
  - Cannot have right to purchase for less than FMV at the future date (good faith estimate on the front end will not automatically work – tested at transaction)
    - Fixed or formula price options will be difficult
  - If original use not in the QOZ and leased from related party, must acquire qualified property of equal or greater value within shorter of (i) term of lease or (ii) 30 months after lessee receives possession (improvements to leased property will count as well). Governmental delays can extend time. (Keep good records and time lines).

Other Requirements for QOZBP *(continued)*

- Either original use of the tangible property must be in the/a (?) QOZ or the property must be substantially improved

- During substantially all (i.e., 90%) of the QOZB's holding period of the tangible property, substantially all (70%) of the use of the tanbigble property of the QOZB must be in a QOZ.

Other Requirements for QOZBP

- What is original use (applies to QOF 90% test for the category of QOZBP and to the QOZB 70% test)
- Proposed Regulations issued in May answered this question
  - For purchased property, first use occurs when the property is first placed in service in a manner that allows depreciation or amortization (or would allow depreciation or amortization if the lessee were the property's owner)
  - For leased property, first use occurs on the date any person first places the property in service in the QOZ in a manner that allows depreciation or amortization (or would allow depreciation or amortization if the lessee were the property's owner).
- Property unused or vacant for an uninterrupted period of five years or more, original use in the QOZ begins on the date after that period when any person first uses or places the property in service.

Requirements for QOZB

- The business must not be a Code Sec. 144(c)(6)(B) sin business
  - Sin businesses include a private or commercial golf course; a country club; massage parlor; hot tub facility; a suntan facility; a 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.
    - Marijuana dispensaries are OK
    - Bars are OK

Requirements for QOZB *(continued)*

- Per cross reference to IRC Sec. 1397C(b)(2), (4) and (8) impose three additional requirements:
  - At least 50% of the total gross income of the QOZB must be derived from active conduct of a trade or business within the QOZ
  - Substantial portion of the intangible property of such entity is used in the active conduct of the T or B
  - Less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property

50% Gross Income Requirement

- Proposed Regs. provide 50% Gross Income Requirement will be met if any of the following four criteria are met:
  - **Services based on hours.** At least 50% of the services performed for Tor B are performed in the/a(?) QOZ
    - Numerator = total number of hours performed by employees, independent contractors and employees of independent contractors of services performed in a QOZ during the tax year with denominator total hours such worked.
  - **Survives based on Payroll.** Services performed in the QOZ based on amounts paid for services. At least 50% of the amount paid for services in the QOZ
    - Numerator is total amount paid by entity for services performed in a QOF during the taxable year whether by employees, independent contractors or employees of independent contractors divided by total amount paid for such services.

50% Gross Income Requirement *(continued)*

- **Necessary tangible property and business functions.** TPP of T or B located in a QOF and the management or operational functions performed in THE QOF are each necessary for the generation of at least 50% of the gross income of the T or B
  - Example given is a landscaping business with all equipment and supplies stored in QOZ and management of daily operations in HQ in the QOZ but presumably equipment and personnel go out of QOZ to provide the service.
  - "The activities occurring and the storage of equipment and supplies in the QOZ are, taken together, a material factor in the generation of the income of the business."
- **Facts and Circumstances.** "Based on all the facts and circumstances, at least 50% of the gross income of a QOZB is derived from the active conduct in the QOF".
  - Mere location of formation and PO Box not a material factor.

50% Gross Income Requirement *(continued)*

- A QOZB with written plans to acquire land in a QOZ and construct a building on such land for leasing to third parties and actually doing so is considered in a T or B and deemed to meet the income test even though no income during the construction phase.
- This should also be true if a start-up business.
  - Authority in regular income tax that activity before the business starts selling goods or services is not yet a trade or business.

Substantial Portion of Intangible Property Used in T or B in the QOF

- Proposed Regulations define substantial portion of intangible propert as 40%
- Active trade or business is merely defined as T or B under Code Sec. 162
  - Look at Commr v. Groetzinger (US S CT) "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purposes of engaging in the activity must be for income or profit."
- Solely for purposes of QOZB the ownership and operation (including leasing) of real property is the active conduct of a T or B
  - Merely entering into a triple net lease with respect to real property owned by a taxpayer is not the active trade or business of such taxpayer

Nonqualified Financial Property Limitation for a QOFB

- Definition of “nonqualified financial property” is found in Code Sec. 1397C(e) which is debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property.
- Such term does not include reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less or accounts or notes receivable acquired in ordinary course of T or B for services rendered or from sale of property of such T or B.
  - **Must hold working capital in the qualified assets or not working capital.**

Nonqualified Financial Property Limitation for a QOFB *(continued)*

- Safe harbor for working capital exception to QOZB if three requirements are met:
  - **Designated in writing.** Amounts are designated in writing for the acquisition, construction and/or substantial improvement ot tangible property in a QOF;
  - **Reasonable written schedule.** Written schedule consistent with ordinary start-up of a T or B for the expenditure of the working capita assets. Under the schedule the working capital assets must be spent within 31 months of the receipt by the business of the assets.
  - **Property consumption consistent** with written designation and schedule.

What Happens if QOZB Fails to Meet the 70% Test

- If meets 70% test on the testing dates but not in between, apparently OK
- If flunk on testing date, it is not a QOZB
- Then required to test for each month as the first tier subsidiary QOZB will count against the 10% “bad assets” the QOF can have.
  - Likely causes the QOF to fail its 90% test (unless the QOF can show reasonable cause)

What Happens if QOF Fails 90% Test

- Again, the test is the average of the two testing dates (exception special first year rules)
- If average at those two points in time is not 90% to effects:
  - First monetary penalty previously described
  - Second counts against the 10% the QOF is permitted not to qualify.

Calculation Rules for 90%

- Special first year rules.
  - The QOF can specify when its election is effective and that starts the first testing date clock of six months (end of year does not move).
  - The first six months will in effect merge into the end of year if the effective date is six months or less from the tax year end.
- Ability to ignore capital contributed within 180 days (not six months) of the testing date if held in manner of working capital.
- Working capital that meets the previously described requirements is considered a good asset.

Calculation Rules for 70% Requirement of QOZB

- Can ignore capital contributed within 180 days (not six months) of testing date.
- Working capital that meets the previously described requirements is considered a good asset.

Mixed Fund Investments

- If taxpayer makes an otherwise qualified investment in a QOF but fails to timely make the deferral election, then taxpayer has a non-qualified investment that receives no QOZ benefits.
- If taxpayer investor contributes more cash or FMV or property to a QOF than such taxpayer has capital gain for the year, the taxpayer will have a mixed fund investment
  - Percentage of single investment will qualify for QOZ benefits and percentage will not.
- If multiple investments are made into a QOF partnership, for purposes of 1400Z, need to maintain separate capital accounts for each investment (for regular tax purposes all are combined into one capital account).
  - For example, distributions eliminating the capital account of an investment can cause the interest to be disposed of for purposes of the QOF rules.

Inclusion Events

- As noted at the outset, gain is deferred until the earlier of December 31, 2026 or the disposition of the QOF interest.
- If an interest in a QOF has not been disposed of prior to December 31, 2026, at that date the deferred gain will become taxable.
  - The taxable deferred gain will be reduced by the 10%/15%/ or no percent basis step up permitted for holding the interest more than 5 years or 7 years.
  - The gain recognized is the lesser of (i) FMV of interest on December 31, 2017 or the remaining deferred gain (each adjusted for the basis adjustment described above)
  - The tax rate will be the applicable tax rate for the tax year which includes December 31, 2026.

Inclusion Events *(continued)*

- There are many pages of regulations on inclusion events and deemed inclusion events. A few items are:
  - Transfer of the interest into a grantor trust is not an inclusion event. A trust changing to or from grantor trust status is a triggering event.
  - The by death and by an estate to a beneficiary is not an inclusion event, including the termination of a grantor trust by reason of death.
  - A transfer of the QOF interest to a partnership is not an inclusion event, although a 351 transaction is an inclusion event.
  - A distribution of property by a partnership with a FMV greater than basis.
  - A gift is an inclusion event.
  - A special rule for S corporation investors. If more than 25% of the percentage of stock owned by shareholders at the investment changes, everyone has an inclusion event.

Inclusion Event *(continued)*

- Conversion of an S corporation to a partnership or a disregarded entity is an inclusion event.

- A distribution in excess of basis (excluding basis attributable to Code Sec. 751(a)) within two years of a contribution to an QOF will be deemed to terminate that part of the original investment with the result that the holder will cease having a qualified QOF interest with respect to that portion.

10 Year Rules

- The Code provides that a sale or exchange of an interest in a QOF held for more than 10 years will receive a step-up in basis equal to fair market value.
- The Proposed Regulations provide that a sale of an asset by the QOF will be deemed to have its basis stepped up as well.
- However, the sale by a QOZB (first tier subsidiary) will be subject to tax. This means the first tier subsidiary cannot sell its property.
- When the holder of a QOF sells its interest in a QOF or the QOF sells property, there must be an election to adjust the basis in order to avoid gain.
- The sale or exchange can occur after the ten year holding period until December 31, 2047 for the gain to be excluded by the basis step-up.

Reinvestment by a QOF

- The Code gives the QOF a reasonable time to reinvest the proceeds from the sale or exchange of property without flunking the 90% test. However, this does not control the recognition of gain from the sale or exchange, just does not harm the QOF status.
  - The real estate community was hoping that the QOF could defer the gain and reinvest.

Conclusion

- The ability to invest in real estate or a business on which, after a ten-year holding period, no gain will be recognized is very powerful.
- The investor must have capital gains in the year(s) of the investment and the QOF must meet various requirements for 90% or more of the time it is held by the investor.
- This is a complex but powerful incentive that requires careful structuring and monitoring. Documentation to prove compliance should be contemporaneously developed and retained for years and years to be able to support any IRS audit challenge.

Questions?

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