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Disclaimer

The following presentation is a high level overview of Opportunity Zones as created by the Tax Cuts and Jobs Act. It is not intended to be a comprehensive analysis of the provisions presented nor is it intended to cover the entirety of the Tax Cuts and Jobs Act. This presentation is for informational purposes only and is not to be construed as, or used as, tax advice.

Iowa Commercial Real Estate Association
Opportunity Zones – What are they and how to utilize them

January 3, 2019

Brandon Pratt, Senior Tax Manager

What is an Opportunity Zone?

- Qualified Opportunity Zones are census tracts that qualify as low-income communities.
- The Qualified Opportunity Zones were nominated by a committee of economic development leaders selected by Gov. Reynolds and then certified by the Treasury Department.
- Once an OZ is designated it remains designated for 10 years. All the current qualified OZ's will expire 12/31/2028.
- Approximately 31 million people live in designated OZ tracts
- 56% of OZ residents are ethnic minorities, compared to 38% of US
- Qualified Opportunity Zones have an average poverty rate of nearly 31% and an average unemployment rate of 14.4% (current US unemployment 3.7%)
- Interestingly, of the 945 census tracts in Puerto Rico, 861 are deemed OZ tracts

Why create Opportunity Zones?

- Based on ideas that date back to 1950 and a forum founded by Dwight D. Eisenhower
- Created to unleash capital locked in highly appreciate assets for investment in distressed communities
- Designed to provided higher after tax internal rates of return on new investments in OZ's, which should incentivize more capital investments in OZ's
- Higher rate of return should also slightly reduce the cost of capital

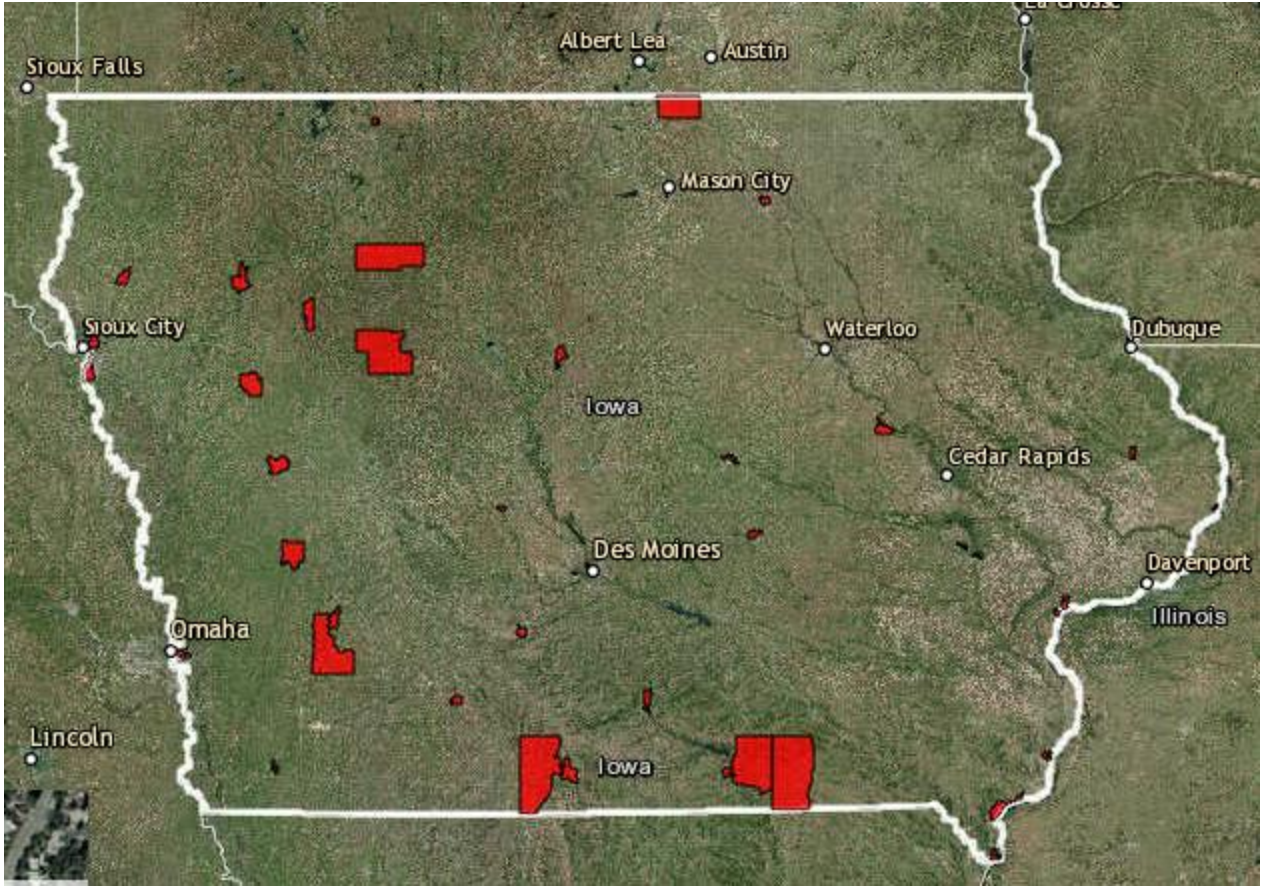
Where are the Opportunity Zones in Iowa (Communities)

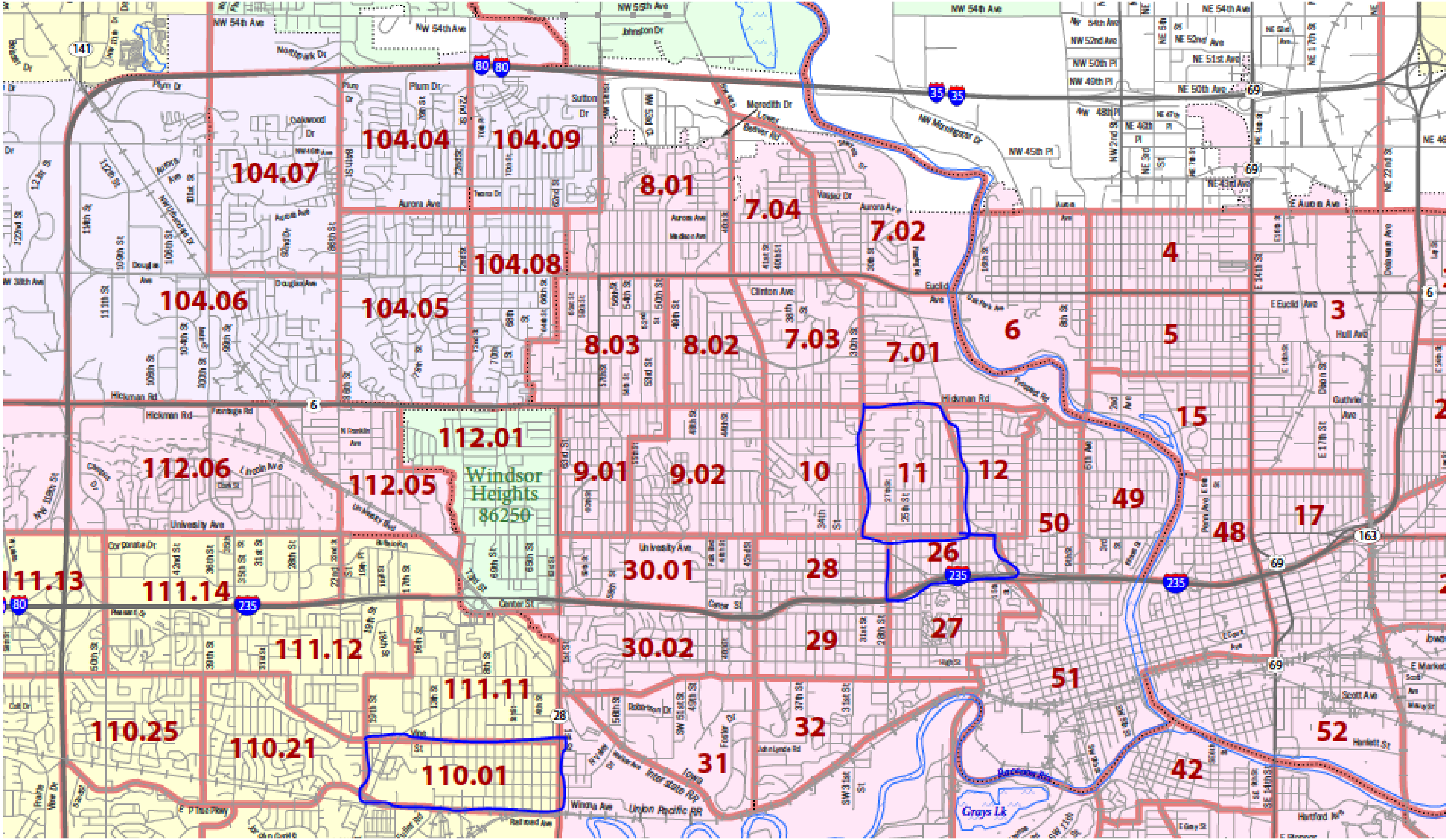
Atlantic
Bloomfield
Burlington
Cedar Rapids
Centerville
Charles City
Chariton
Cherokee
Clinton
Coralville
Council Bluffs
Creston
Davenport
Denison
Des Moines
Dubuque

Estherville
Fort Dodge
Fort Madison
Grinnell
Griswold
Harlan
Ida Grove
Iowa city
Keokuk
La Mars
Lamoni
Laurens, Havelock, Plover
Leon
Maquoketa
Marshalltown
Mason City

Muscatine
Northwood
Perry
Rockwell City
Shenandoah
Sioux City
Storm Lake
Vinton
Waterloo
Webster City
West Des Moines
Winterset

IEDA Opportunity Zone Map

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104.09
104.07
8.01
7.04
7.02
104.08
4
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104.05
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7.01
6
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15
112.01
112.06
112.05
Windsor
Heights
86250
9.01
9.02
10
11
12
49
50
48
17
26
30.01
28
111.13
111.14
27
111.12
30.02
29
111.11
51
110.25
110.21
110.01
32
31
52
42
NW 54th Ave
Aurora Ave
Hickman Rd
University Ave
Euclid Ave
Clinton Ave
Grays Lk

Benefits of Opportunity Zone

- Deferral (temporary) of Capital Gain (but not adjusted basis) - IMPORTANT
  - Gain will be recognized the earlier of sale or exchange of OZ Fund Investment or Dec. 31 2026
- Partial Exclusion of Deferred Gain – POSITIVE but timing is important
  - Upon investing capital gain in OZ Fund the investor's basis is $0 (no gain has been recognized)
  - Once investment has been held for 5 years basis is increased to 10% of deferred gain
  - Once investment has been held for 7 years basis is increased an additional 5%, to 15%, of deferred gain
  - Statute is silent as to what happens if the mandatory recognition date is before the 5yr and 7yr step-ups. Therefore, it is presumed the step-ups would further increase the basis after recognition. This would be beneficial if the investment is not held 10 year, the investment was sold at a loss, or it could release losses that were otherwise suspended due to basis limitations.
- Exclusion of Additional Gains if held at least 10 years (to encourage long term investment)
  - If the investment in the QOF is held for at least 10 years any appreciation on the investment in the QOF is tax free!
  - Taxpayer must elect to adjust their basis; this election does not affect the required income recognition of originally deferred gain.

Additional Benefit of an Opportunity Zone

Opportunity Zone Benefits can be combined with and complement other tax incentives, including Low-Income Housing Tax Credit, Historic Tax Credit, Renewable Energy Investment Tax Credit and New Markets Tax Credit

- - Great way to shield your tax due at 12/31/2026 if material participating real estate professional
- If you create your own fund, it is important to know that a passive investor may not be able to utilize these credits due to the passive activity loss rules.
- The deferred gain will retain the its character from when it was realized. Therefore, if it was gain from securities investments or an active company, it will not be treated as passive gain. If the deferred gain was from a previous passive investment then you can utilize the credits against the tax generated on the gain in 2026.

Benefits of Opportunity Zone

- What gain is eligible pg 29
- Sale to unrelated people

Traps and Pitfalls

- MUST PROPERLY MAKE DEFERRAL ELECTION UNDER §1400Z-2(a) FOR THE INVESTMENT ON FORM 8949
- MUST RECOGNIZE GAIN EARLIER OF SALE OR EXCHANGE OF INVESTMENT OR DECEMBER 31, 2026 (REGARDLESS OF EXIT OR RECEIPT OF CASH TO PAY TAX)
- Understand the Opportunity Zone Fund structure and requirement to be viable for 10 years after investment (a CPA/Attorney should review documents; importance of passive vs. materially participating real estate professional)
- Interim gains will be allocable when qualified OZ property is sold, unless Final Regulations provide guidance to the contrary. Tax will be due regardless if cash is distributed.
- Iowa Tax Code does not recognize the deferral of gains into Opportunity Zone Funds during 2018, but conforms to most parts of the Internal Revenue Code as of 1/1/2019. Opportunity Zones are not specifically excluded.

What is a Qualified Opportunity Fund?

- Either a Corporation (including S-Corp), Partnership or REIT
- Organized for the purpose of investing in qualified Opportunity Zone property
- Must hold 90% of assets in qualified OZ property
  - Cash does not qualify as OZ property and is not excluded from the calculation
  - Qualified OZ property does not include investments in other QOFs
- Property must be acquired after Dec. 31, 2017.
- Treasury Regulations state that an investment must be an equity interest and cannot be debt
- QOF's must self-certify during its first taxable year by attaching a completed form 8996 to its federal income tax return. Additionally, the return must be filed timely, including extension
- Mixed Funds (fund has both qualifying and non-qualifying investments)

What is a Qualified Property?

- Qualified OZ business property
  - Direct Investment in tangible property in an OZ
  - Property must be acquired by QOF after 12/31/2017
  - Original use of such property commences with QOF or the QOF substantially improves property
  - Substantially improve means additions equal to the adjusted basis at the beginning of the 30-month improvement period
- Qualified OZ Partnership Interest or Qualified OZ Stock
  - Acquisition after 12/31/2017
  - Organized for the purpose of being an OZ business (meaning primary operations of business are in OZ)
  - Could own Qualified OZ tangible property for QOF

90% Qualified OZ Property Asset Test (Important)

- Important b/c creating a QOF is not hard, but non-compliance has a big hammer!
- Average of two testing dates
  - On the last day of the first six-month period of the taxable year of the fund, and
  - On the last day of the taxable year of the fund.
- Cash held by a QOF does not meet the definition of qualified OZ property
- Can rely on the Working Capital Safe Harbor, which allows up to 31 months acquire, construct, or rehabilitate tangible business property if a stringent written plan is adopted and followed.
- Failure to meet 90% test results in monthly penalty of the underpayment rate (cur. 5%) times the excess of 90% of the QOF’s total assets over the QOF’s qualified assets. i.e. $1MM Total assets, $500K qualifying assets, monthly penalty = $1,667 ☹

Working Capital Example:

Developer creates partnership A, with written plan to build multi-family on identified land in Qualified Opportunity Zone. Partnership A sells interest in partnership to QOF B for $5MM cash. Partnership A immediately places invested cash into working capital pursuit its written plan. The written plan specifies the $'s allocated to purchasing the land, developing the building, and the remainder for ancillary expenditures. The expenditures were made in approximate accordance with the written plan. Partnership A has no other gross receipts. Prior to completion of the building the only assets in Partnership A are the land and working capital.

Working Capital Example Analysis:

Partnership A met the three requirements of the working capital safe harbor b/c

1) Partnership A had a written plan to spend the money received from the QOF for the acquisition, construction and/or substantial improvement of tangible property in an OZ
2) Partnership A had a written schedule consistent with the ordinary start-up for a business for the expenditure of working capital
3) A's working capital was actually used in the manner that was substantially consistent with its written plan and the ordinary start-up of a business.

The conclusion would apply if A's plan was to buy and substantially improve a pre-existing commercial building. (This is where it is better than a LKE for a closely held business) In a LKE it is hard to exchange into something you want to rehab… it can be done but all of the rehab costs must come as additional capital rather than exchange proceeds or an EAT must be used in conjunction with advanced planning.

Like-Kind Exchange

- Replacement property must be purchased by same taxpayer as relinquished property
- Exchange must be completed within 180 days of closing on relinquished property
- Must meet 45-day identification requirement
- Must Exchange qualified property for qualified property
- Permanent deferral on real property as long as property is owned.

Qualified Opportunity Fund

- Deferral Election can be made at the partnership or partner level
- Election must be made in partnership with 180 days of gain realization. However, partner has until 180 days after the partnership year end to make their election (could do it sooner if the right opportunity comes along)
- Flexible to identify actual land as long as substantially within written plan
- Can defer securities gains in OZ companies or tangible property
- Deferral until the earlier of sale or exchange of QOF investment or 12/31/2026

Like-Kind Exchange

- Both Exchanged and Excess Basis exist after exchange
- Original Basis + Gain Invested, all chips stay in play, any boot is taxable
- Can roll a highly leverage property into a new highly leverage property with no additional cash, while recognizing no gain
- No on going requirements or certifications after exchange
- Challenging to Exchange into a Rehab or Build to Suit
- Can exchange anywhere in the US
- Direct control of property, not diversified

Qualified Opportunity Fund

- $0 basis upon investment in QOF, this will limit loss deductibility if there is no debt.
- Only gain is invested, can take adjusted tax basis chips off table
- Need cash in the amount of Gain to fully defer (work well for equities, but not leverage real estate)
- Requirements that Qualified Fund must meet the asset test twice a year; large penalties for failure
- More flexible on Rehab and Build to Suit due to working capital safe harbor
- Limited to investing on Qualified OZs
- Syndicated deals will have diversity, and liquidity (if needed), but will lack control

Questions:

Brandon R. Pratt
bpratt@lwbj.com
515-224-7845