THE POWER OF BEING UNDERSTOOD

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UNDERSTANDING AND INVESTING IN QUALIFIED OPPORTUNITY ZONES

Iowa Economic Development Authority Presentation

September 2019

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Agenda

- Opportunity zones 101
  - Real estate
  - Operating companies
  - Investors
- State tax issues
- Key takeaways

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OPPORTUNITY ZONES 101

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Background

- Opportunity zone (OZ) program
  - Created by the Tax Cuts and Jobs Act of 2017
  - New Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code
- Spur economic growth in low income/distressed areas by harvesting unrealized gains and injecting capital.
- Proposed Treasury Regulations issued so far
  - Round one in October, 2018
  - Round two in April, 2019
- May be third round dealing with reporting and data gathering

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Overview of OZ program

Taxpayers can get capital gains tax deferral (& more)

for making timely investments in

Qualified Opportunity Funds (QOFs)

which invest in

Qualified Opportunity Zone Businesses (QOZBs)

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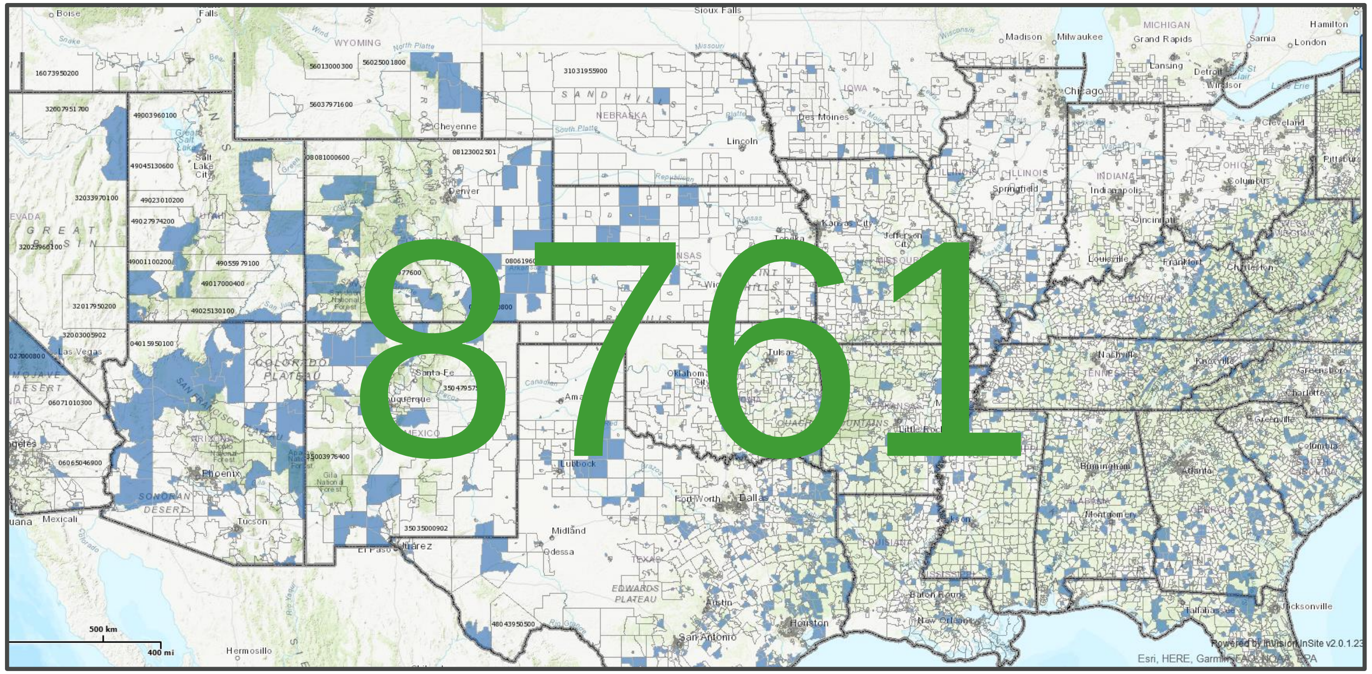
Treasury certified OZs



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Find the zones at the IRS website or at www.eig.org/opportunityzones/

- Low-income or low-income adjacent
- Established in 2018
- Won't change
- Based on the 2010 census

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Tax benefits to investors in QOF

1. Deferral of gain recognition from original transaction (gain #1) until earlier of sale or Dec. 31, 2026

2. Partial forgiveness (exclusion) of gain from original transaction (gain #1) (10 percent after five years to 15 percent after seven years exclusion possible)

3. Forgiveness (exclusion) of additional gains from the OZ fund investment appreciation (gain #2)

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OZ investment timeline

Year 1

Property is sold for a gain. (e.g. stock in a public company is sold resulting in proceeds $150 and a capital gain of $100).

Within 180 days, the $100 gain is reinvested in a QOF.

Year 5

Taxpayer received a $10 step up in basis in connection with the original gain. (e.g. if the taxpayer sold the interest in the QOF after 5 years they would recognize a gain of no more than $90 not $100).

Year 7

Taxpayer receives a $5 step up in basis in connection with the original gain. (e.g. if the taxpayer sold the interest in the QOF after 7 years they would recognize a gain of no more than $85 not $100).

Year 8

12/31/2026

Tax on deferred gain of $85 is due. (Assuming FMV of QOF Interest is higher than the deferred gain.)

Year 10

Taxpayer would not owe any tax related to post acquisition appreciation on interest of the QOF if sold.

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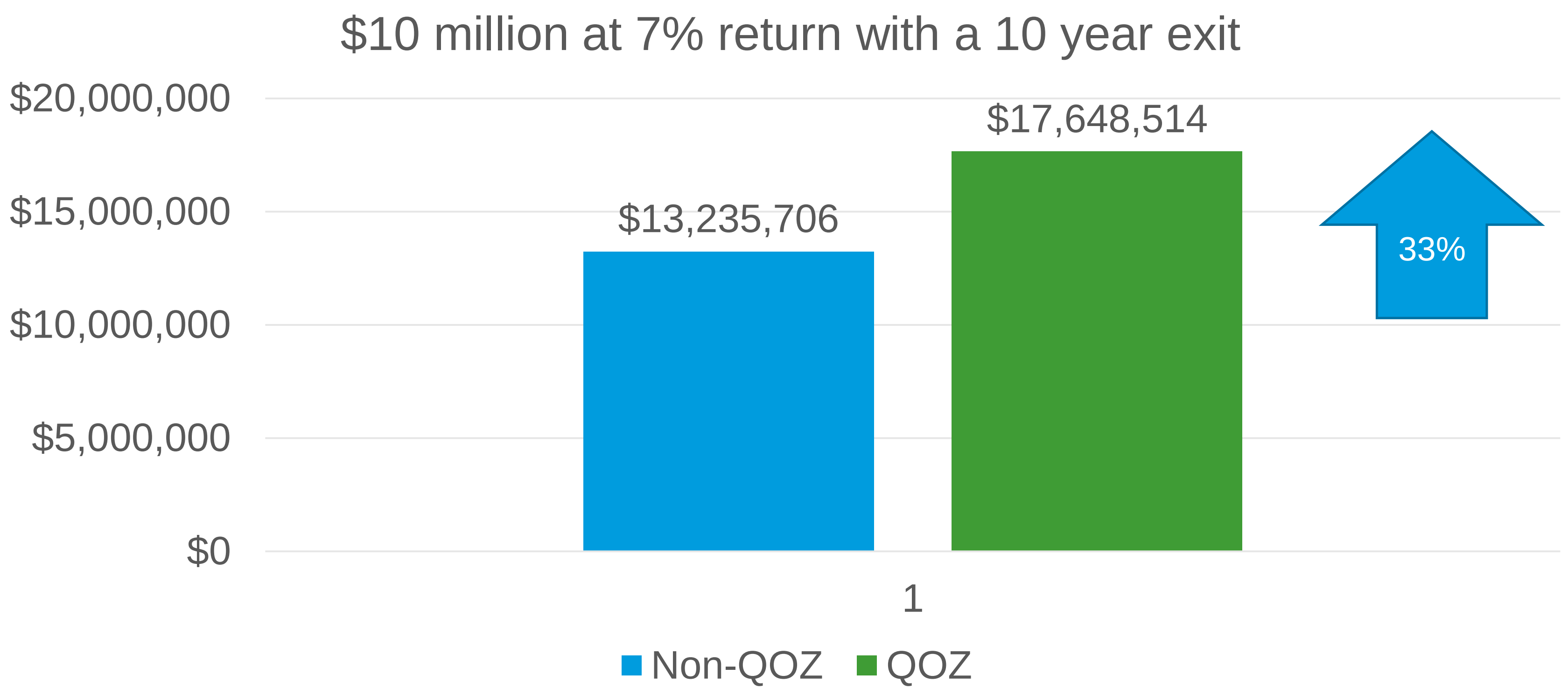
Opportunity zone–return difference



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QOF STRUCTURES AND QUALIFICATIONS

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Qualified opportunity fund–90 percent asset test

- The QOF can meet its **90%** asset test by owning Qualified Opportunity Zone Business (QOZB) directly.
  - Value based on tax basis or financial reporting basis
- Investment must be made within **6 months** of receiving the cash from the investor.

- Failure to meet the 90% test will result in penalties while the fund is in non-compliance
- Failure DOES NOT cause the QOF to immediately lose it's status

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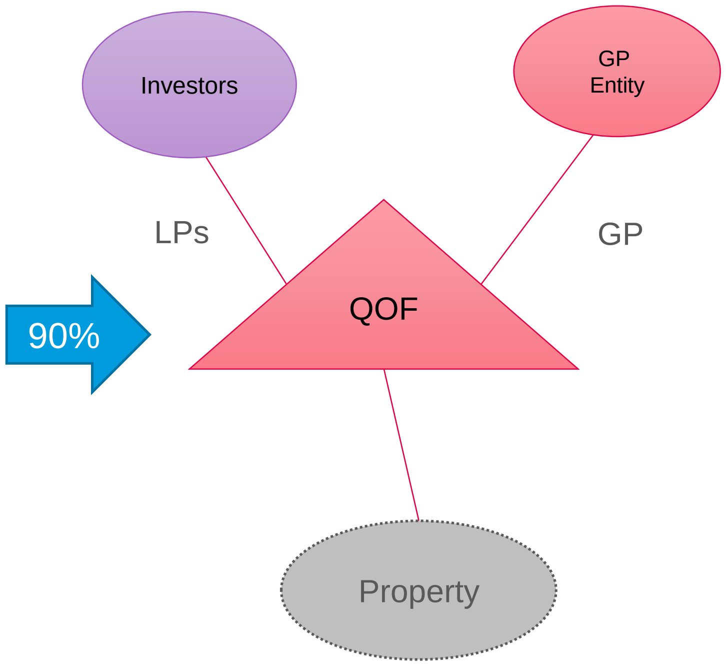
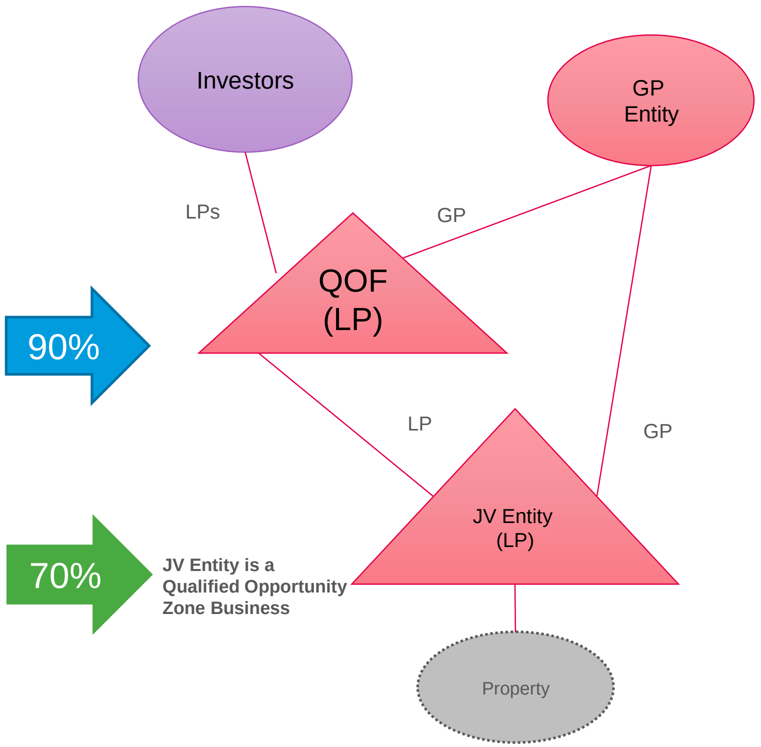
Direct investment vs. indirect investment





- Direct investment
- Indirect investment

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REAL ESTATE

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Real estate overview

- One of the first and most popular OZ investment
  - Easier to meet the 70 percent tangible asset and 50 percent gross income tests
- Requires the property be new or significantly improved (i.e. value-add)
- Specific ruling regarding real estate development are addressed by the IRS:
  - Land improvement and treatment
  - Working capital and development plans
  - Permitting and development challenges
  - Leverage and ability for debt financed distributions

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Invested asset and tangible business assets tests

- Tangible property qualifies as Opportunity Zone Business Property if:
  - Acquired or leased after Dec. 31, 2017;
  - **Original use** of property in OZ commenced with the QOF, or the QOF **substantially improves** the property within 30 months, except for leased property and land
  - During substantially all **(90%)** of the QOF’s holding period for property, substantially all **(70%)** of the use of property was in a Qualified Opportunity Zone
  - **31 Month** Working Capital safe-harbor, provided the business has a written plan to deploy the capital
- If property is owned by a QOF indirectly (through a partnership or a corporation), then 70% of the tangible property owned or leased by such corporation or partnership should meet above criteria (“Substantially all test”).

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Original use test

- QOZ business property must have original use by the QOF or QOZB (or meet the substantial improvement test)
- Original use defined as when property first placed in service and subject to depreciation or amortization
- Building may qualify as original use by the QOF or QOZB if vacant or unused for at least five years before QOF or QOZB places the property in service
- Original use test does not apply to land
  - However, must be used in trade or business or intend to improve the land by more than insubstantial amount within 30 months of acquisition (land banking)

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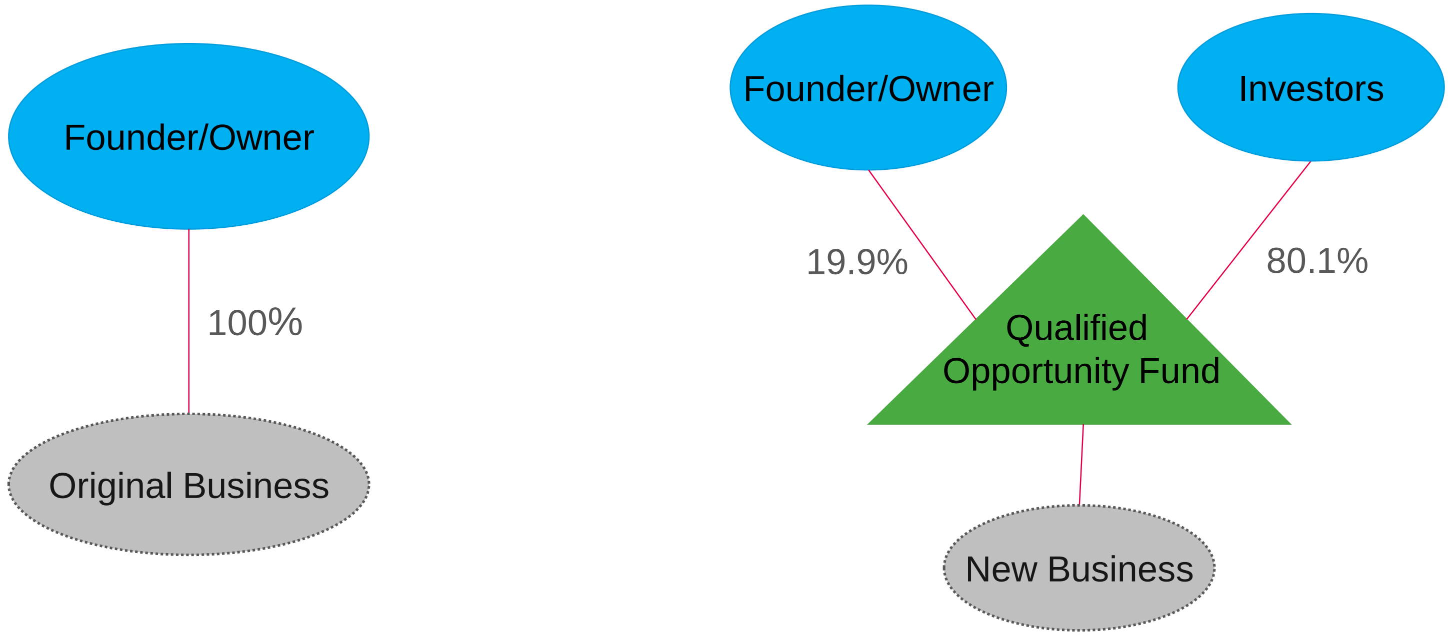
Existing business with new investors

Old Investors must be less than 20% ownership in "New Business" and the gain from the sale can be used for the new investment



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Substantial improvement test

- If not original use, the QOF/QOZB must "substantially improve" the property during any 30-month period.
- The test is met if "additions to basis with respect to the property" in the hands of the QOF/QOZB exceed the adjusted basis of the property at the beginning of the 30-month period (more than doubling the basis).
- If land and building are purchased, the test is measured by additions to basis of the building, not the land.
- Land is QOZBP if used in the trade or business.
  - Land banking (speculation) is not a trade or business
- Cannot aggregate property for substantial improvement test

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Real property straddling a QOZ

Real property will be deemed to be located in a qualified OZ if:

- the amount of real property based on square footage located within the qualified opportunity zone is substantial (more than 50%) as compared to the amount of real property based on square footage outside of the zone, and
- the real property outside of the zone is contiguous to part or all of the real property located inside the zone,
- then all of the property would be deemed to be located within a qualified zone.

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Leased property

- Improvements made by a lessee to leased property qualifies as original use if market rate lease
- Tangible property leased by a QOF or QOZB is a counted as a “good” asset for purposes of the 90% asset test and 70% tangible property test
  - Leased property may be valued based on financial statements or present value of lease payments
- Ownership or leasing of rental real estate is considered “active conduct” of a trade or business
  - Merely entering into triple net lease is not considered active business

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Related party leases

- Opportunity fund can lease property from a related party
- Lease cannot have prepayments that apply to more than a 12 month period
- All leases must be at fair value
- Anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases of real property (other than unimproved land).

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Property contributions

- Property can be contributed to an OZ Fund
- Investor can have a qualified and unqualified investment in the OZ Fund (Mixed Fund)
- *Trap for the unwary*: OZ Fund investment in subsidiary must be in cash

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Distributions, debt and exits

- Investments can be divested and proceeds reinvested without resetting the 10 year clock
  - 12 Months to reinvest and 31 month safe-harbor rule applies
  - Gains related to sales prior to 10 years are taxable
- Funds can invest in multiple businesses
  - Any exit event after 10 years is tax free
  - All investments must be divested by Dec. 31, 2047
- Debt financed distributions
  - Traditional partnership rules apply, whereby a debt financed distribution may be made provided the investor has basis
  - Special rules apply to distributions in the early fund years

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Comparing OZ (1400Z) investment to like-kind exchange (1031)

- Deferral of original transaction gain
  - 1400Z–temporary on 85%, possibly permanent on 15%
  - 1031–temporary, unless basis step up at death of owner
- Deferral of gain on new investment
  - 1400Z–permanent exclusion after 10 years
  - 1031–no exclusion, but deferral available through 1031 exchange
- Timing
  - 1400Z–no identification rule, 180 days to invest
  - 1031–45 day identification rule, 180 days to invest

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Comparing OZ investment to like-kind exchange (cont.)

- Investment amount to obtain deferral
  - 1400Z–Only amount of original gain required to be re-invested
  - 1031–Amount realized on sale required to be re-invested
- Source of investment
  - 1400Z–any source; no tracing of original gain sale proceeds
  - 1031–sale proceeds must be reinvested; constructive receipt rules apply
- Type of investment
  - 1400Z–must be interest in a qualified opportunity zone fund, not limited to real estate
  - 1031–must be ownership of like-kind real estate

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Comparing OZ investment to like-kind exchange (cont.)

- Construction
  - 1400Z–developments must reach minimum target amount within 30 months after investment
  - 1031–like-kind rules require qualifying improvements exist at time of acquisition

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OPERATING BUSINESSES

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Qualified Opportunity Zones and Industry Implications

- Manufacturing
- Consumer Products
- Healthcare
- Business and Professional Services
- Healthcare
- Financial Services
- Technology
- Lifesciences

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Qualified Opportunity Fund

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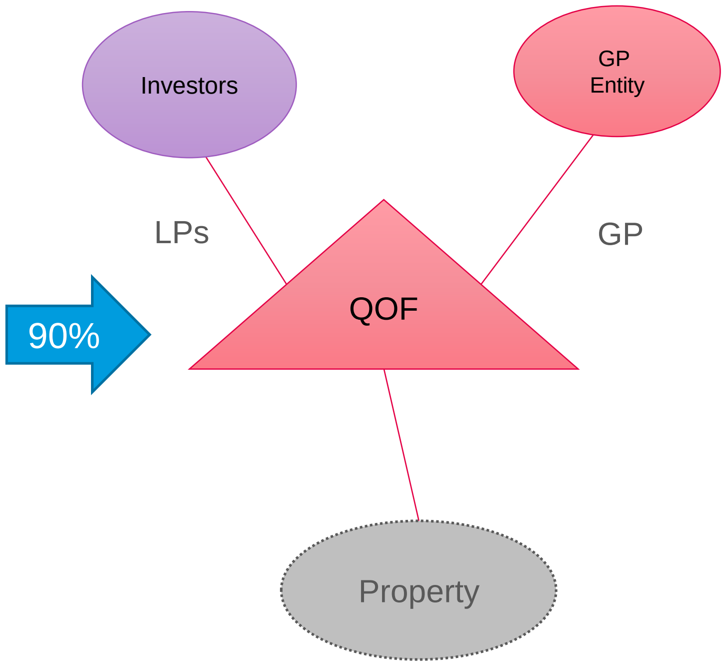
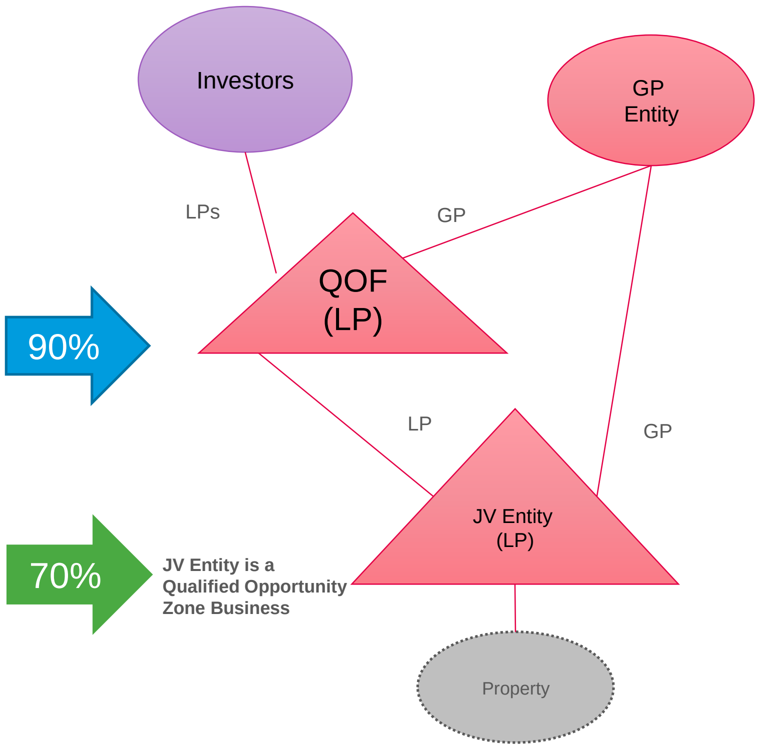
Direct investment vs. indirect investment





- Direct investment
- Indirect investment

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Qualified opportunity zone business property

- QOZBP is tangible property used in a trade or business of the QOF if:
  - the property was acquired by the QOF via purchase from an unrelated party after Dec. 31, 2017;
  - the original use of property in the Qualified Opportunity Zone commences with the QOF, or the QOF substantially improves the property; and
  - during substantially all of the QOF’s holding period (90%) for property, substantially all (70%) of the use of property was in a Qualified Opportunity Zone.

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Qualified opportunity zone business

- A Qualified Opportunity Zone Business (QOZB) is a trade or business:
  - in which substantially all (70%) tangible property owned or leased by the taxpayer is Qualified Opportunity Zone Business Property (defined later);
  - in which at least 50% of the QOZB's gross income is derived from active conduct of a trade or business in the QOZ;
  - in which a substantial portion (40%) of the QOZB's intangible property is used in the active conduct of the trade or business;
  - in which less than 5% of the QOZB's property is financial property such as stock, debt, options, etc. (but QOZB can hold reasonable amounts of working capital); and
  - which is not a specified "sin business" (defined later).

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Invested asset and tangible business assets tests

- Tangible property qualifies as Opportunity Zone Business Property if:
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  - **Original use** of property in OZ commenced with the QOF, or the QOF **substantially improves** the property within 30 months, except for leased property and land
  - During substantially all **(90%)** of the QOF’s holding period for property, substantially all **(70%)** of the use of property was in a Qualified Opportunity Zone.
  - **31 Month** Working Capital safe-harbor, provided the business has a written plan to deploy the capital
- If property is owned by a QOF indirectly (through a partnership or a corporation), then 70% of the tangible property owned or leased by such corporation or partnership should meet above criteria (“Substantially all test”).

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Gross income test

- At least 50% of the QOZB's gross income must be derived from active conduct of a trade or business in the QOZ.
- Three safe harbors added by Proposed Regulations:
  - 50% of services performed by employees and contractors are in the QOZ (measured by hours);
  - 50% of the amounts paid for services (W-2 and contract Labor) performed for the business are for services in the QOZ;
  - 50% of the gross income is generated by tangible property of the business in the QOZ and the management or operational functions are performed in the QOZ
- Can also meet based on facts and circumstances

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Real property straddling a QOZ

Real property will be deemed to be located in a qualified OZ if:

- the amount of real property based on square footage located within the qualified opportunity zone is substantial (more than 50%) as compared to the amount of real property based on square footage outside of the zone, and
- the real property outside of the zone is contiguous to part or all of the real property located inside the zone,
- then all of the property would be deemed to be located within a qualified zone.

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Leased property

- Improvements made by a lessee to leased property qualifies as original use if market rate lease
- Tangible property leased by a QOF or QOZB is a counted as a “good” asset for purposes of the 90% asset test and 70% tangible property test
  - Leased property may be valued based on financial statements or present value of lease payments
- Ownership or leasing of rental real estate is considered “active conduct” of a trade or business
  - Merely entering into triple net lease is not considered active business

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Related party leases

- Opportunity Fund can lease property from a related party
- Lease cannot have prepayments that apply to more than a 12 month period
- All leases must be at fair value
- Anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases of real property (other than unimproved land).

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Leased property and intangibles

- Leased property does not need to be substantially improved.
- The valuation of leased property for the tangible asset test is based on either:
  - The value on the financials
  - Present value of future lease payments
- For Intangible Property to qualify a substantial portion (40%) must be used in the active trade or business.

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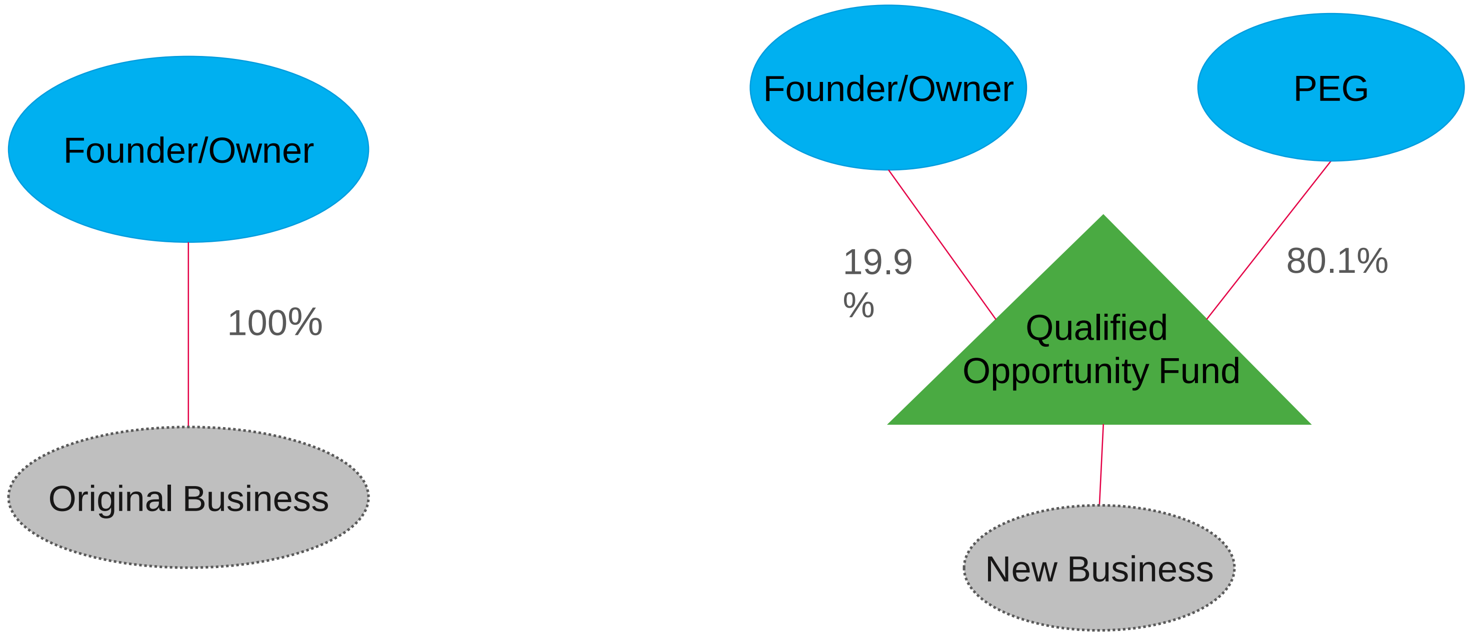
Existing business with new investors

Old Investors must be less than 20% ownership in "New Business" and the gain from the sale can be used for the new investment.



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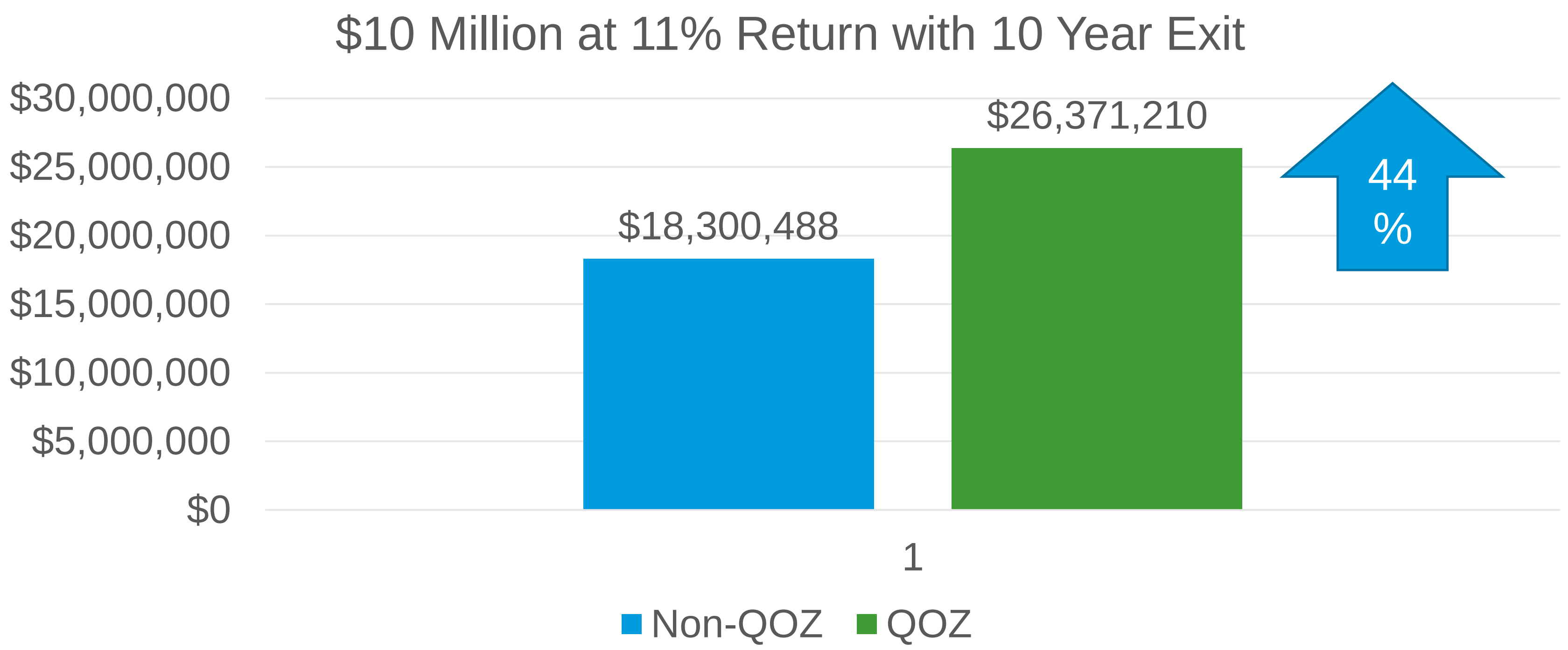
Opportunity zones–return for the private equity



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Other highlights

- Investments can be divested and proceeds reinvested without resetting the 10 year clock
  - 12 Months to reinvest and 31 Month Safe-Harbor rule applies
  - Gains related to sales prior to 10 years are taxable
- Funds can invest in multiple businesses
  - Any exit event after 10 years is tax free
  - All investments must be divested by December 31, 2047

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What makes a good opportunity Zone Investment?

- Growth companies or companies with potential for high growth
- Start-ups or companies looking to raise significant capital
  - OR Existing companies with significant capital investment plans
- Companies in or near Opportunity Zones or with the ability to relocate to one

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TAX BENEFITS TO INVESTORS

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Eligible investors

Individual	Partnership	C Corporation	S Corporation
Trust	Estate	REIT	RIC

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Tax benefits to investors in qualified opportunity fund

1. Deferral of gain recognition from original transaction until as late as 2026

2. Partial forgiveness (exclusion) of gain from original transaction (10% to 15% exclusion possible)

3. Forgiveness (exclusion) of additional gains from the OZ fund investment appreciation

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Eligible Gains

- All capital gains qualify, but what about:
  - Section 1231 gains? Yes. Must net 1231 gains/losses.
  - Ordinary income/gains? No.
  - Depreciation recapture? Ordinary income – No; Unrecaptured 1250 gain – Yes; this is simply a rate differential (25%) but still a capital gain.
  - Section 465 mark-to-market income of dealers? No.
- Gains from sale/exchange with related party does not qualify
  - Defined as 20% or more common ownership/control

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Eligible gains from partnerships

- A partnership can elect to defer gain at the partnership level
- If partnership does not elect to defer gain, and allocates gain to partners, then each partner can elect to defer the gain.
- Proposed regulations allow re-investment within 180 days of partnership year end (typically December 31) – so by June 29th.

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Step 1: Asset sale and gain deferral

- Investor sells appreciated assets and reinvests the **gain** into a QOF
  - Any type of existing asset qualifies (stocks, real estate, etc.). There is no “like-kind” requirement. Cannot be sale to “related party.”
  - The investor makes gain deferral election by completing relevant portions of Form 8949 and Schedule D on its tax return for the year of the deferral.
  - The <u>gain</u> amount must be invested into a QOF within 180 days of the sale or exchange triggering the gain.
- **<u>TAX BENEFIT #1</u>** – Investor defers paying income tax on <u>gain</u> amount reinvested into a QOF until earlier of sale/exchange or December 31, 2026.

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Step 2–QOF invests in qualifying property

- Qualified Opportunity Fund (QOF) is self-certified partnership or corporation
- Must hold at least 90% of its assets in QOZ property:
  - Stock in a corporation (QOZ stock),
  - Partnership interest (QOZ partnership interest, or
  - Tangible property used in a trade or business (QOZ business property)

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Step 3–Timing of payment of the deferred tax

- The investor pays tax on the original deferred gain at the earlier of (i) the sale of their interest in the QOF, or (ii) December 31, 2026.
- **TAX BENEFIT #2**
  - If the investor has held its QOF investment for at least 5 years, 10% of the deferred gain is permanently forgiven via basis step-up; 90% taxed.
  - If the investor holds its QOF investment for at least 7 years, an additional 5% (for a total of 15%) of the deferred gain is permanently forgiven via basis step-up; 85% taxed.
  - Note that to get the 7-year benefit, an investor must invest in a QOF no later than December 31, 2019. If invested after December 31, 2021, no 5-year benefit.

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Step 4 – Possible Elimination of Tax at Exit from QOZ

- TAX BENEFIT #3 – If the investor holds its QOF investment for at least 10 years, a step up to fair market value results in no tax on the gain realized by the investor at exit.
  - December 31, 2047 is latest date to elect step up to avoid gain recognition on the QOF investment
  - Applies only to the portion of interest acquired that is equal to the original deferred gain amount due to the “split investment” rule of IRC 1400Z-2(e)(1).

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Inclusion events

- Proposed Regulations identify several “inclusion events” that will result in recognition of gain by a QOF investor:
  - Transfer of investment reducing equity interest in QOF
  - Distribution of property from QOF
    - For partnership, to the extent FMV exceeds basis
    - For S Corp, to the extent treated as gain from sale/exchange
  - Worthless stock deduction
  - Termination or liquidation of QOF
  - Liquidation of QOF owner–portion of distribution treated as sale for FMV
  - Transfer of investment by gift or charitable donation

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Transactions that are not inclusion events

- Transfer of QOF investment due to investor’s death, except:
  - Sale or exchange of investment by decedent’s estate;
  - Disposition by heir or beneficiary of estate;
  - Disposition by surviving joint owner.
- Contribution of QOF investment to Grantor Trust
  - Creation or termination of grantor trust is inclusion event

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STATE AND LOCAL TAX CREDITS & INCENTIVES

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State conformity to IRC

- Not all states treat investments in QOFs in the same way as the federal government for tax purposes.
- Non-conformity impacts the favorable tax treatment of QOZ investments at the state level.
- Different federal and state tax treatment also requires detailed schedules and record keeping.

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QOZs: Connections with other incentives

- Beyond conformity with the IRC, states are looking to adopt credits and incentives that specifically incentivize projects in OZs.
- Benefits available on day one for additional savings beyond OZ benefits.
- Location in a designated QOZ may make the project more attractive to state and local economic development agencies for purposes of traditional C&I programs.
- No limitation in the QOZ statute for pursuing other C&I opportunities.

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Specific programs with significant overlap

- New Markets Tax Credits (NMTC)
- Tax Increment Finance (TIF)
- Work Opportunity Tax Credit (WOTC)
- State Tax Credits
- State QOZ Programs

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QOZs and NMTC

- The NMTC program is a competitive federal incentive that offers third party interest-only forgivable loans to projects in distressed census tracts.
- Substantial overlap between QOZ and NMTC projects (geography and program goals).
- NMTC projects must result in community benefits.
- Business in the eligible area receives an interest-only forgivable loan to add to a project's capital stack.
- Funds can be used for a variety of different project costs.

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QOZs and WOTC

- The Work Opportunity Tax Credit (WOTC) is a federal job creation credit that incentivizes employers that hire disadvantaged employees.
- Residents of QOZs may be more likely to meet the qualification requirements for WOTC.
- For-profit companies that frequently hire from disadvantaged groups can use WOTC to further improve a project’s ROI.

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State QOZ Programs - Iowa

Iowa is a conforming state

Iowa Code section 422.3(5)(a)

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KEY TAKEAWAYS

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Tax Benefits to investors in QOF

1. Deferral of gain recognition from original transaction (gain #1) until earlier of sale or Dec. 31, 2026

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3. Forgiveness (exclusion) of additional gains from the OZ fund investment appreciation (gain #2)

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What makes a good Opportunity Zone investment?

- Growth companies or companies with potential for high growth
- Start-ups or companies looking to raise significant capital
  - OR Existing companies with significant capital investment plans
- Companies in or near Opportunity Zones or with the ability to relocate to one

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