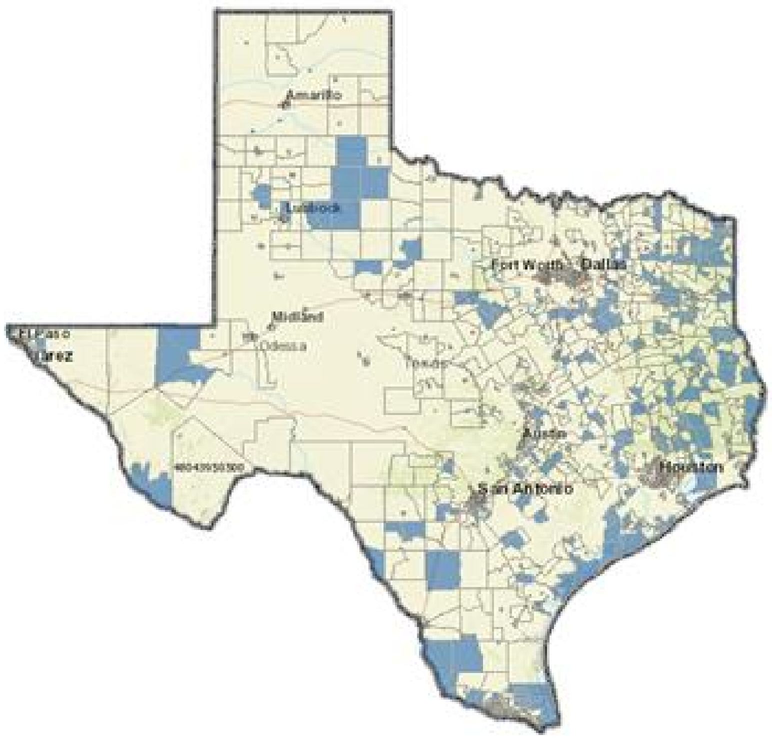


TAX INCENTIVIZED OPPORTUNITY ZONE PROGRAM

Chris Compton
Brandon Jones

WINSTEAD

Opportunity Zones

- Introduction
- Tax Incentives
- Vocabulary (QOF, QOZ Property and QOZ Business Property)
- Planning Considerations
- Timeline
- Selected Open Issues

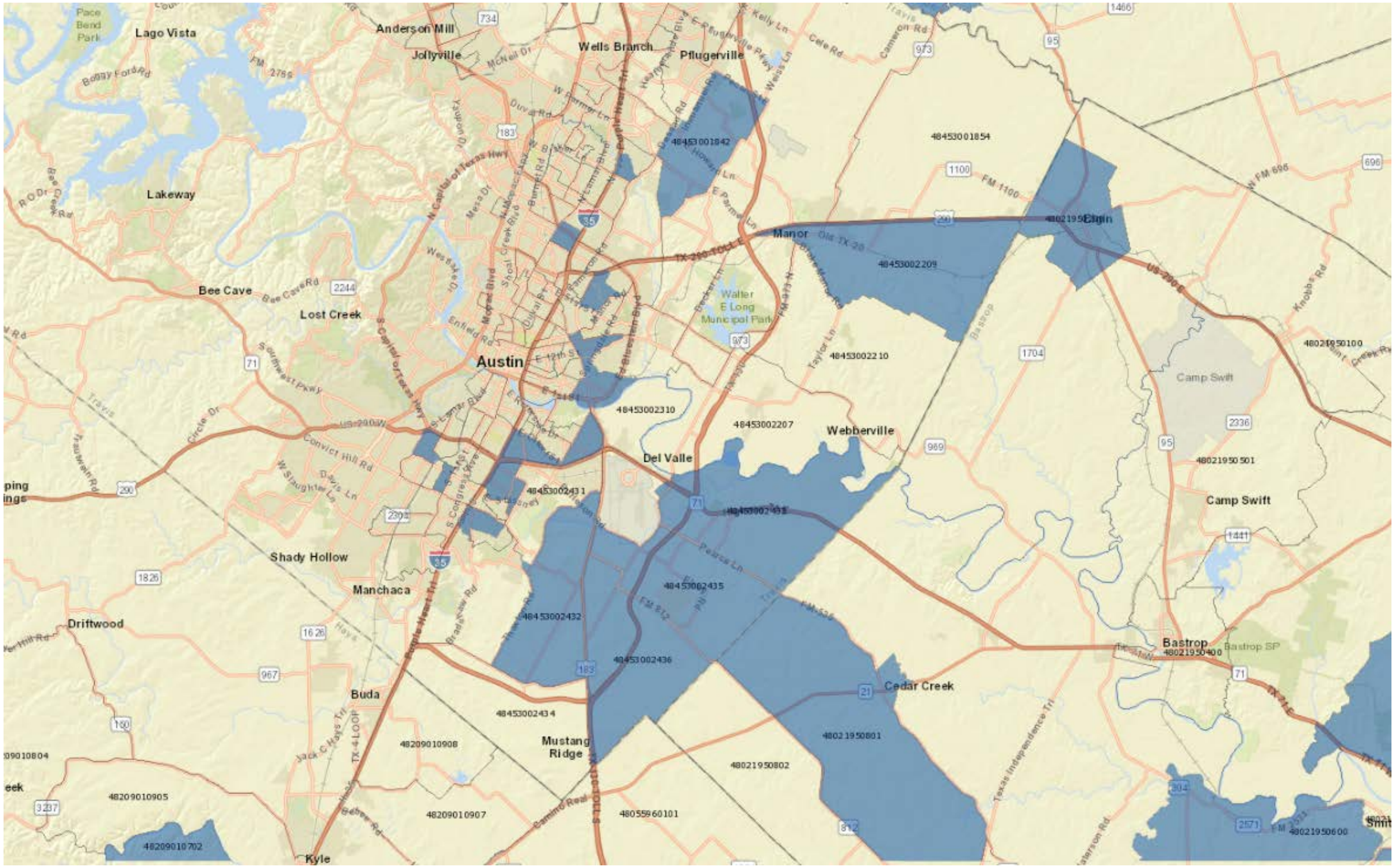
Introduction

The Opportunity Zone program was created by the 2017 Tax Cuts and Jobs Act to encourage investment in low-income communities (“**Opportunity Zones**”). Under this program, a taxpayer can defer an unlimited amount of tax (and obtain additional tax exclusions if certain requirements are satisfied) on gains reinvested in a “Qualified Opportunity Fund” or “QOF”

Qualified Opportunity Zones

- The new tax law allows states, the District of Columbia, U.S. possessions, and Puerto Rico to designate qualified opportunity zones (QOZs)
- Texas designated 628 census tracts in 145 counties
- Treasury certified the Texas QOZs on April 9, 2018
- A map of the designated QOZs is available at https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml

Austin



Lago Vista
Anderson Mill
Jollyville
Wells Branch
Pflugerville
Lakeway
Manor
Elgin
Bee Cave
Lost Creek
Austin
Walter E Long Municipal Park
Camp Swift
Webberville
Del Valle
Shady Hollow
Manchaca
Driftwood
Buda
Mustang Ridge
Cedar Creek
Bastrop
Bastrop SP
Kyle
48453001842
48453001854
48453002209
48453002210
48453002310
48453002207
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48209010907
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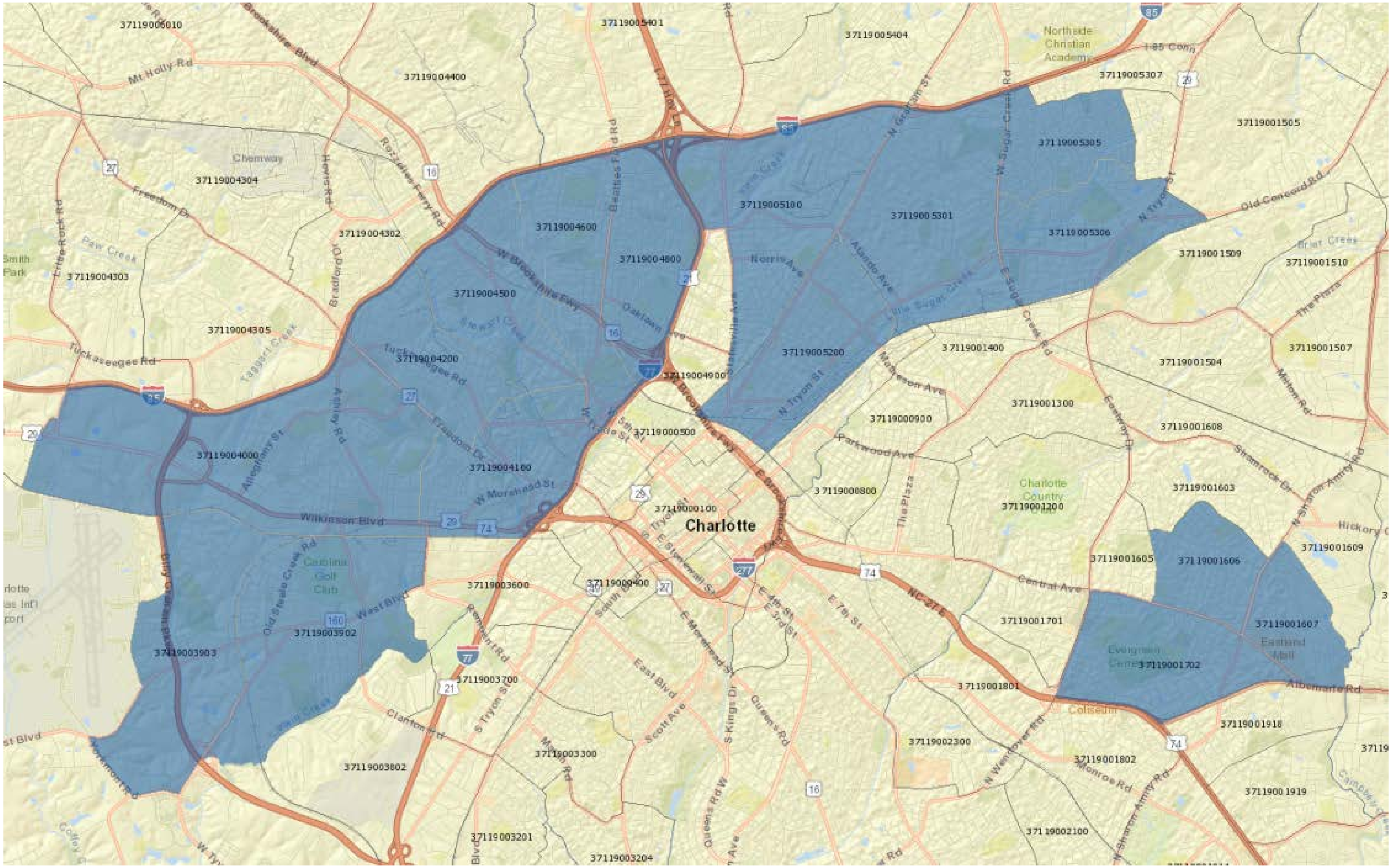
48021950600

Charlotte



Charlotte
Brookshire Blvd
Mt Holly Rd
Freedom Dr
Tuckaseegee Rd
Wilkinson Blvd
W Morehead St
Statesville Ave
N Tryon St
N Graham St
Norris Ave
Parkwood Ave
The Plaza
Central Ave
Albemarle Rd
East Blvd
Scott Ave
Queens Rd
Monroe Rd
Clanton Rd
West Blvd
Carolina Golf Club
Charlotte Country Club
Eastland Mall
Coliseum
Northside Christian Academy
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37119004800
37119004500
37119004200
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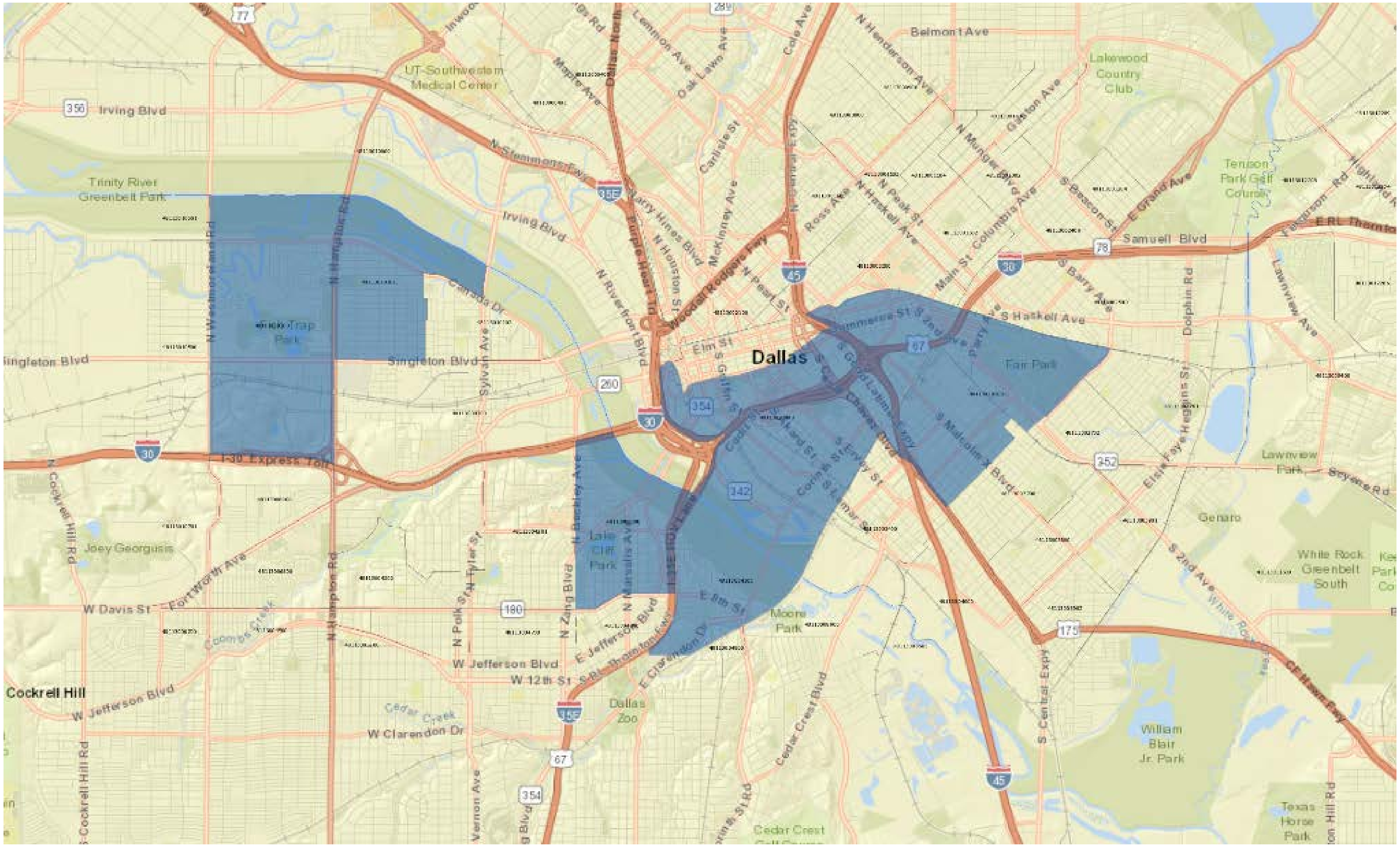
Dallas



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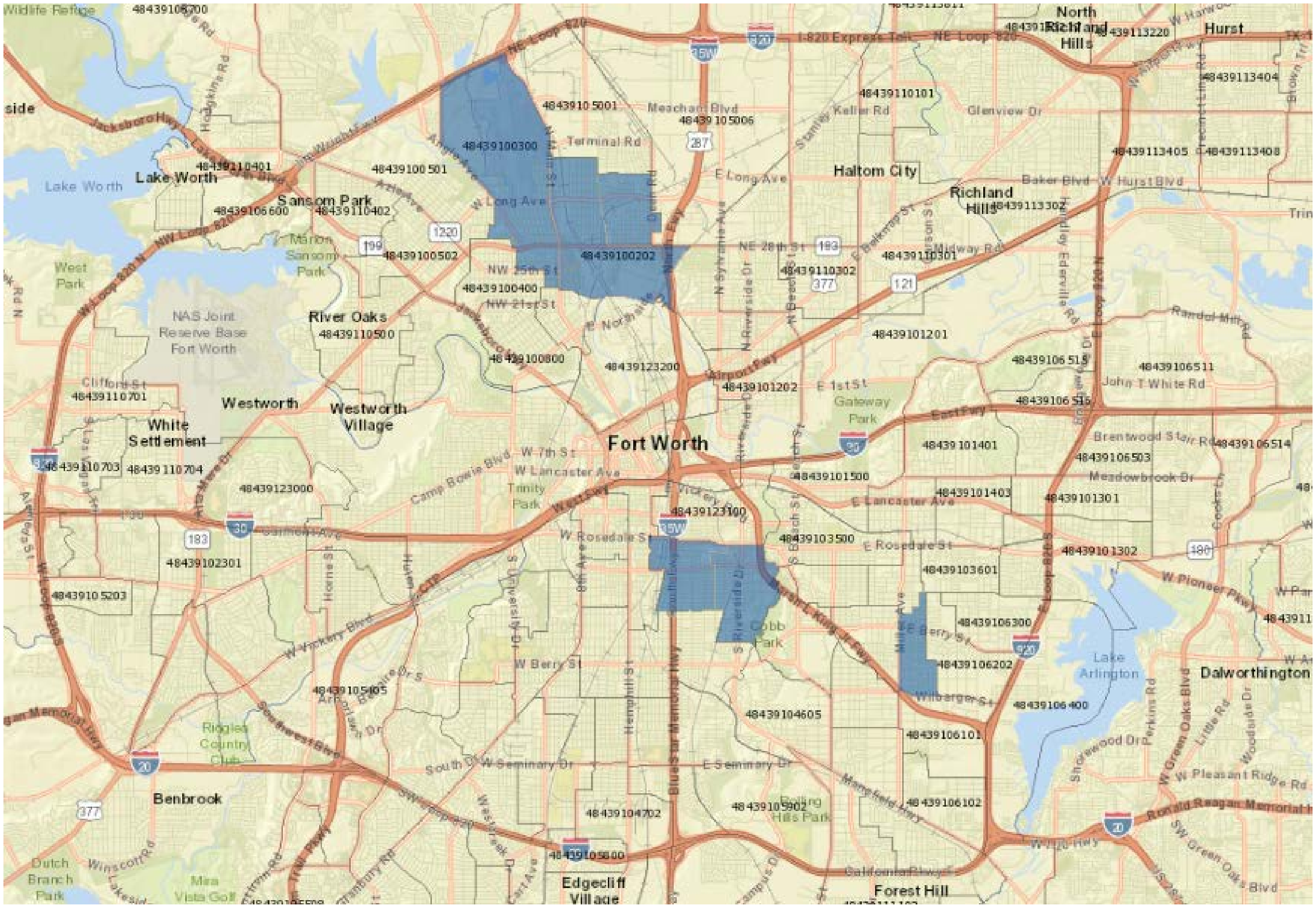
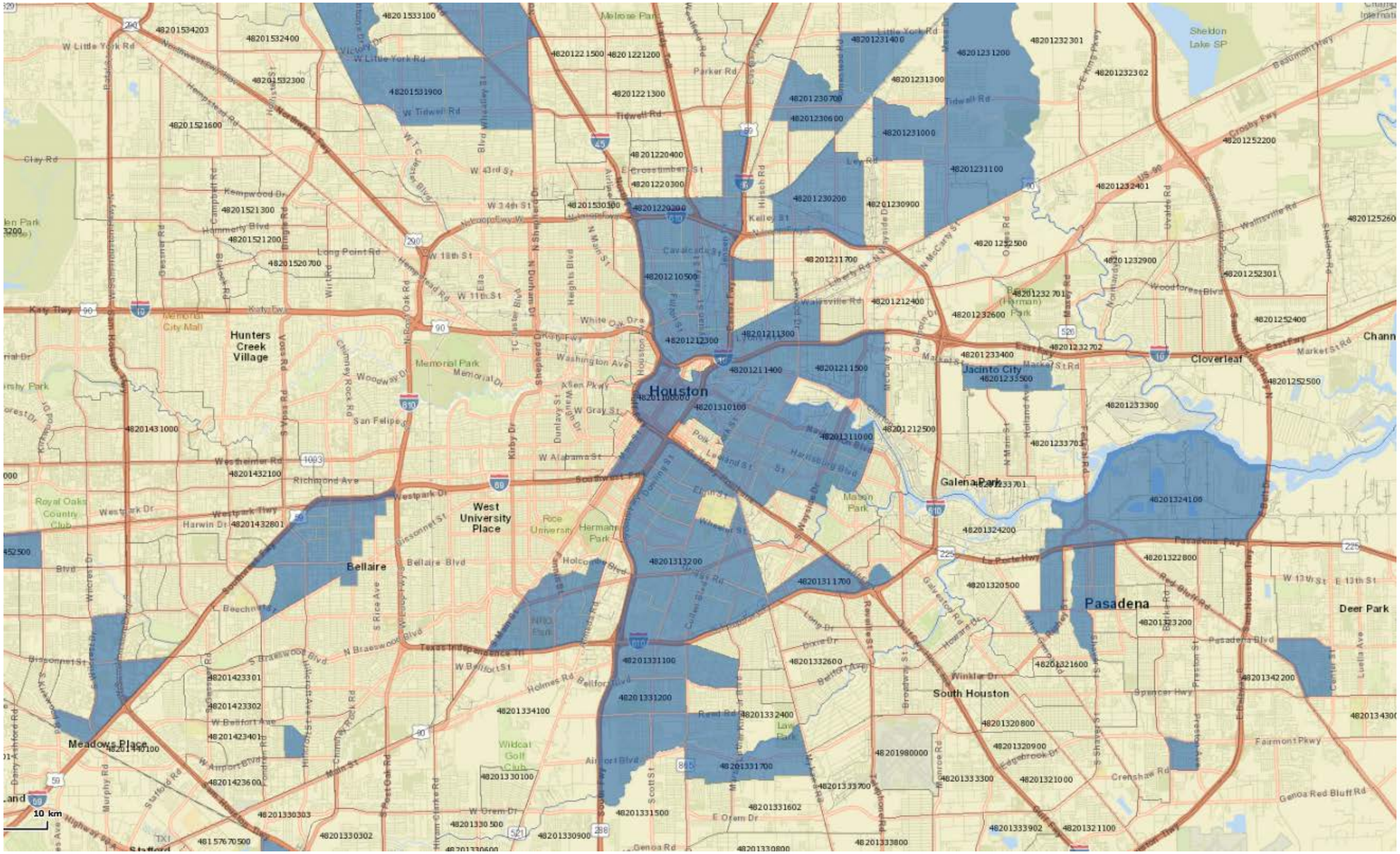
Fort Worth



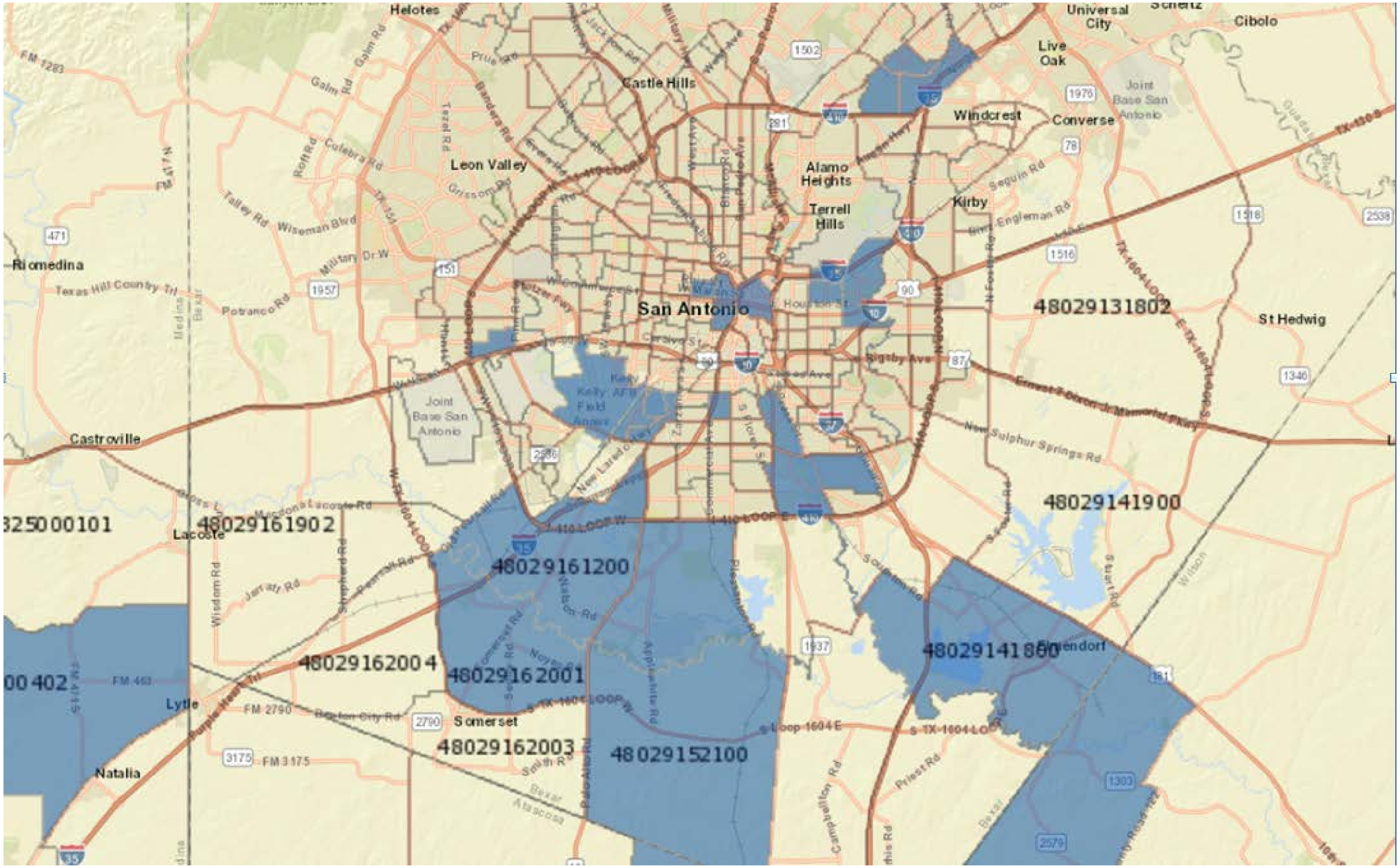
Fort Worth
North Richland Hills
Hurst
Haltom City
Richland Hills
Lake Worth
Sansom Park
River Oaks
Westworth
Westworth Village
White Settlement
Benbrook
Edgecliff Village
Forest Hill
Dalworthington
Lake Arlington
NAS Joint Reserve Base Fort Worth

Houston



Houston
Hunters Creek Village
West University Place
Bellaire
Meadows Place
Galena Park
Jacinto City
Cloverleaf
Pasadena
South Houston
Deer Park

San Antonio



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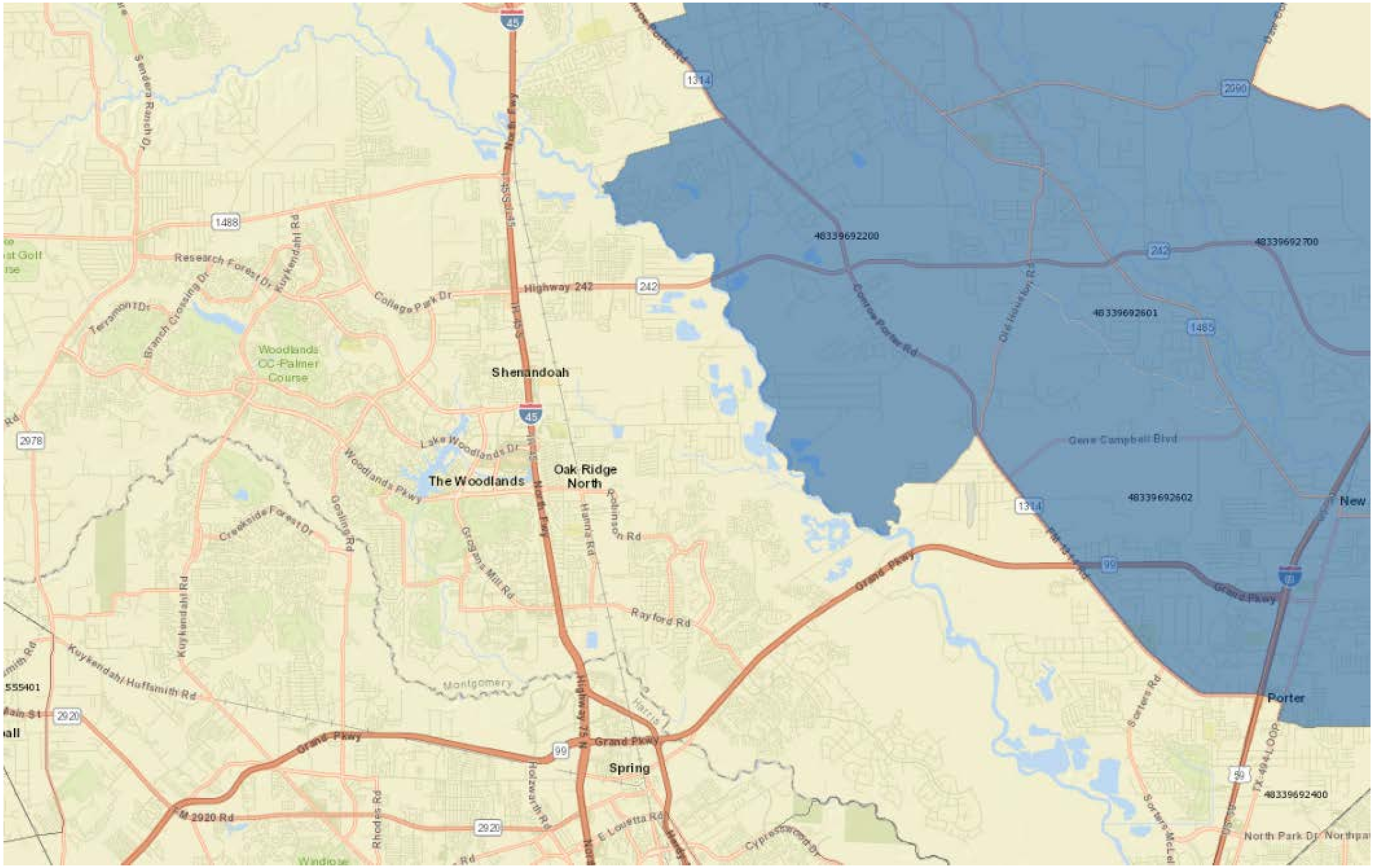
The Woodlands



Guidance

- IRC Sec. 1400Z-1 and 1400Z-2
- Proposed Regulations 115420-18
- Revenue Rule 2018-29
- Form 8996 and Instructions

Tax Incentives

- A tax deferral on rollover gains from the sale of property
- Potential exclusion from taxation of a portion (up to 15%) of the original gains reinvested in an Opportunity Fund
- Potential complete exclusion from taxation of the appreciation on the original investment (but not the original gains reinvested)

Tax Deferral

The amount reinvested is not subject to tax until the earlier of:

- December 1, 2026 or
- when the investment in the Opportunity Fund is sold

Partial Exclusion

- Partial exclusion of the tax on the rollover gain is available by way of a “stepped-up” basis for investments held for at least five years.
- The basis in the investment is increased by
  - 10% if the investment is held for five years or more
  - 15% if it is held for seven years or more
- The stepped up basis applies at the earlier of December 1, 2026 or when the investment is sold

No Tax on Appreciation

- Complete exclusion of the tax for the appreciation of the Opportunity Zone investment (but not the original investment) if the investment is held for 10 years or more
- The exclusion is not impaired solely because of the December 31, 2028 expiration of OZ designation
- Taxpayer must dispose of investment and elect exclusion by December 31, 2047

Example

Suppose a taxpayer realizes a $1 million capital gain from the sale of stock on January 1, 2018, and properly elects to defer that gain by purchasing a $1 million interest in an Opportunity Fund on June 1, 2018. A sale of the taxpayer's Opportunity Fund investment for $2 million on December 31, 2028, should have the following results:

Example

- No tax on the $1 million of gain that is reinvested in the Opportunity Fund until December 31, 2026.

- 15% of the original $1 million of reinvested gain is excluded from taxation so that only $850,000 of gain is recognized and subject to tax on December 31, 2026.

- The additional $1 million of gain from the December 31, 2028 sale of the Opportunity Fund appreciation is excluded from tax.

Example

- The taxpayer's taxable gain is reduced from $2 million to $850,000.
- The taxpayer recognizes $170,000 in tax on December 31, 2026, instead of $200,000 on January 1, 2018.
- On a present-value basis, assuming a 20% capital gains tax and a 5% discount rate, the true economic cost of the taxpayer's tax in 2026 is $104,600 compared to the $200,000 tax that would be levied in 2018.
- Total present value savings of $295,400.

Streamlined Process
Unlimited Benefits

- Taxpayer’s self-certify QOF
- No allocation process like New Markets Tax Credits or Low Income Housing Tax Credits
- No limitation on the amount of capital gain that can be deferred from tax
- No limitation on the amount of Opportunity Fund appreciation that can be excluded from tax

Vocabulary

- Eligible Taxpayers
- Eligible Gains
- Eligible Interests
- Qualified Opportunity Fund
- Qualified Opportunity Zone Property (“QOZ Property”)
  - Qualified Opportunity Zone Business Property (“QOZ Business Property”)
  - Qualified Opportunity Zone Business (Stock or Partnership Interest) (“QOZ Business”)

Eligible Taxpayers

The Proposed Regulations provide that any person that recognizes capital gain for U.S. federal income tax purposes (including individuals; C corporations, including regulated investment companies (RICs) and real estate investment trusts (REITs); partnerships; S corporations; trusts and estates) is eligible to defer all or a portion of such gain by investing in an Opportunity Fund

Eligible Gains

- 1400Z-2(a)(1)(A) provides that gains from the sale or exchange of “any property” may be temporarily deferred and, in some cases, excluded from gross income
- The Proposed Regulations clarify that only capital gain (both long-term and short-term, including any capital gain treated as short-term capital gain under the new “carried interest” tax rules) that would otherwise be recognized before January 1, 2027 is eligible to be deferred
- Taxpayer must reinvest the gain into a QOF within 180 days of a sale or exchange of a non-zone asset
- Taxpayer must make an election for deferral for the tax year in which the asset was sold

Mixed Investments

- Only the “deferred capital gain” invested in a QOF is eligible for the tax benefits
- A taxpayer is free to invest other capital in addition to deferred capital gain in a QOF
- IRS treats such mixed investments as two separate investments, each with separate tax characteristics
- Taxpayers are also able to use QOF as collateral to finance a project in part with loan proceeds
  - For a partnership, this does not create a separate investment at the partner level

Recycling Deferred Gain

- A taxpayer can avoid tax on the disposition of a QOF Investment if the taxpayer re-invests the previously deferred gain through a new investment in a QOF (which could be either the original QOF or another QOF)
- Reinvestment requirements: (1) the investor has to make the new investment in a QOF within 180 days of the date that the investor would otherwise have been required to include in income the previously-deferred deferred gain, and (2) the investor has to have disposed of the entire initial investment

Eligible Interest

- Equity Interest
  - Stock (including Preferred Stock)
  - Partnership Interest (including a Partnership with special allocations)
- Debt will not qualify

Qualified Opportunity Fund

A Qualified Opportunity Fund ("**QOF**") is

- any investment vehicle which is organized as a corporation or a partnership
- Organized for the purpose of investing in qualified opportunity zone property
- holds at least 90 percent of its assets in qualified opportunity zone property (the "**90% Test**")
- Taxpayers self-certify QOF on Form 8996

QOF 90% Test

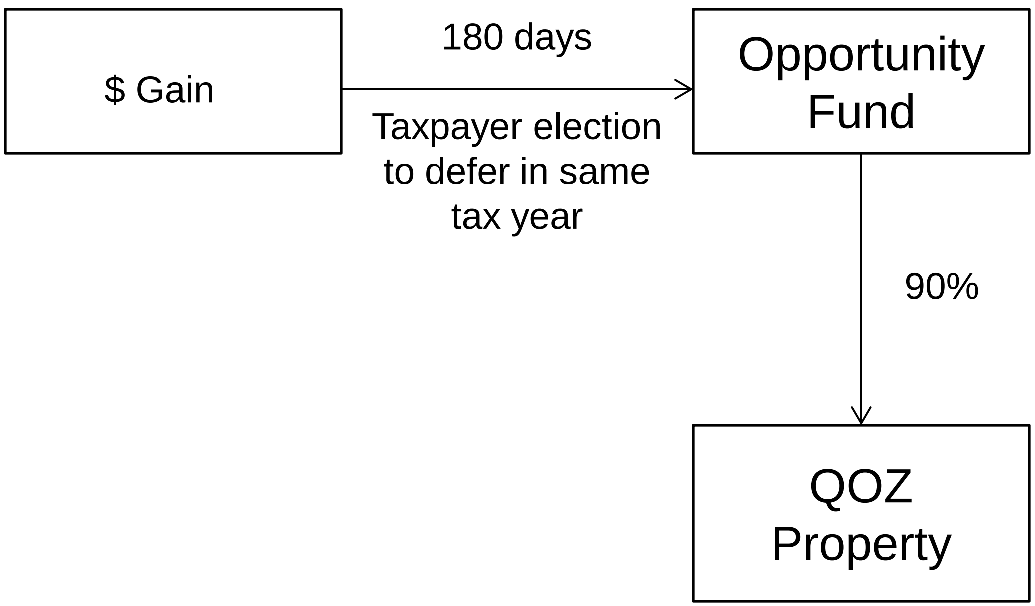
- 90% Test is measured twice a year and averaged for compliance
- Form 8996 is used for annual reporting of compliance with the 90%Test
- Penalty imposed equal to the shortfall multiplied by the IRS underpayment rate

QOZ Property

The term "qualified opportunity zone property" means:

- QOZ Business Property
- QOZ Business
  - Partnership interest
  - Stock

QOF Diagram



$ Gain
180 days
Taxpayer election to defer in same tax year
Opportunity Fund
90%
QOZ Property

QOZ Business Property

Tangible property used in a trade or business if—

- the property is acquired by purchase after December 31, 2017;
- the original use of the property in the QOZ commences with the QOF or the QOF substantially improves the property; and
- substantially all of the use of the property is in a QOZ.

QOZ Business Property

- SUBSTANTIAL IMPROVEMENT — taxpayer incurs rehabilitation or improvement costs with respect to the property in excess of the original acquisition cost of the property within 30 months of the acquisition

- RELATED PARTY— Taxpayers cannot acquire QOZ Business Property from a related person (including, for this purpose, some 20-percent-affiliated entities and controlled groups).

Land as QOZ Business Property

- Land can never have its original use commence with a QOF (or its QOZ Business)
- Land and an existing building can be substantially improved by expenditures in excess of the existing building basis without regard to land basis
- No rules for acquisitions of unimproved land in a QOZ

QOZ Business

A trade or business in which

i. substantially all of the tangible property owned or leased is “qualified opportunity zone business property”;

ii. at least 50% of the gross income is derived from the active conduct of a qualified business within a QOZ;

iii. a substantial portion of the intangible property must be used in the active conduct of a qualified business within a QOZ;

iv. has less than 5% nonqualified financial property; and

v. is not a golf course, country club, massage parlor, hot tub facility, suntan facility, gambling facility, or package store.

QOZ Business Stock or Partnership Interest

Requirements:

- Acquired by QOF from the QOZ Business solely in exchange for cash after December 31, 2017
- As of the time of issuance (and during substantially all of QOF's holding period), the corporation or partnership that issued the interest constitutes as QOZ Business

“Substantially All”

- Substantially all of the tangible property owned or leased by the QOZ Business is QOZ Business Property
- “Substantially all” means seventy percent (70%)
- No guidance on if QOZ Business Property must constitute a minimum percentage of the entity’s total property (including intangible property)

Active Conduct of Business

- The Statute does not define the “active conduct of a trade or business”
- Similar to the New Markets Tax Credit program and the Gulf Opportunity Zone Program
- Expect most activities that constitute a trade or business for federal income tax purposes to be considered the active conduct of a business, with the exception of passive activity rental real property, triple net leases and possibly residential rental property

Nonqualified Financial Property

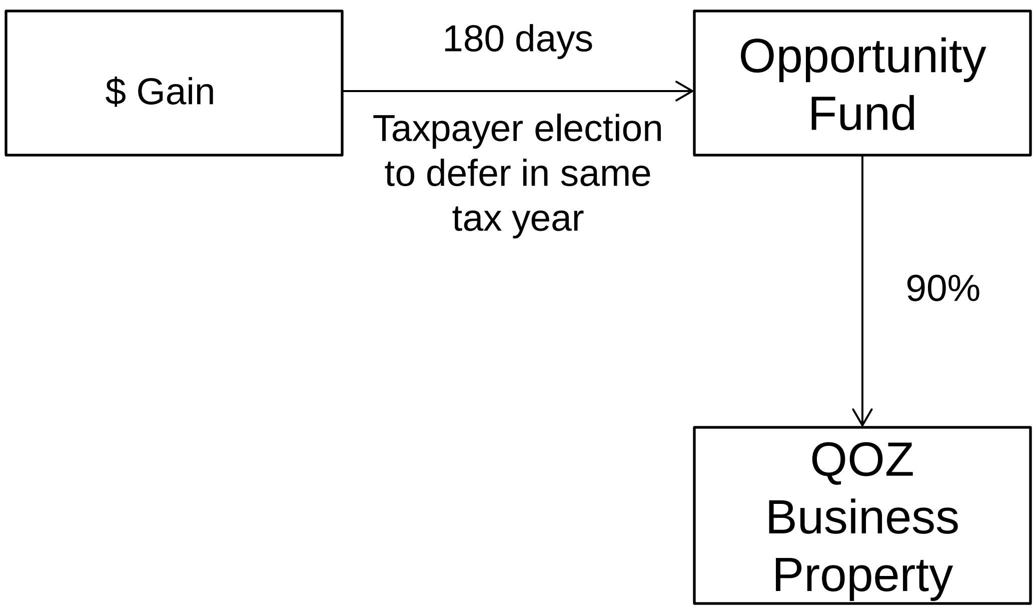
- 5% limit on “nonqualified financial property”

- debt instruments, stock, partnership interests, annuities, and derivative financial instruments (including options, futures, forward contracts, and notional principal contracts) other than (1) reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of no more than 18 months; and (2) accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of inventory property

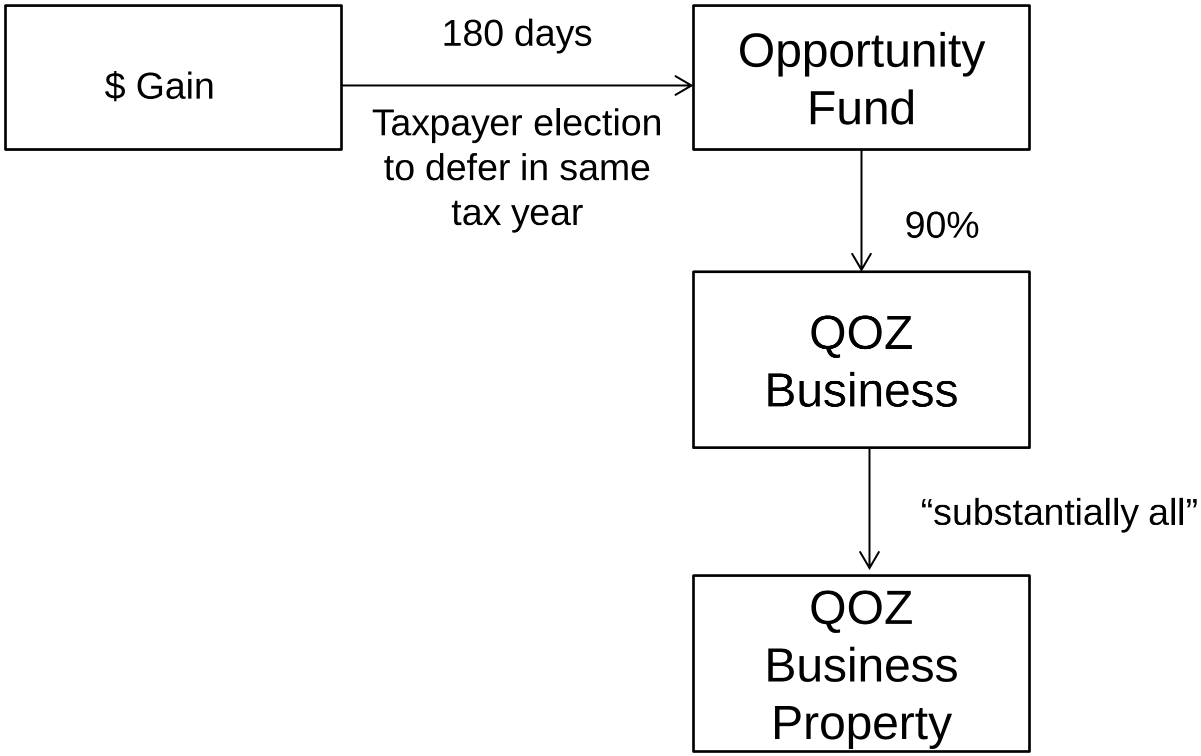
Working Capital Safe Harbor

- Working capital can be held for up to 31 months pursuant to a written plan for the acquisition, construction, or substantial improvement of tangible property in an opportunity zone
  - The plan includes a schedule of expenditures consistent with the ordinary business operations of the business
  - The schedule shows the working capital assets must be spent within 31 months
  - The working capital assets must be used consistent with the written plan

Planning Considerations QOF Direct Investment



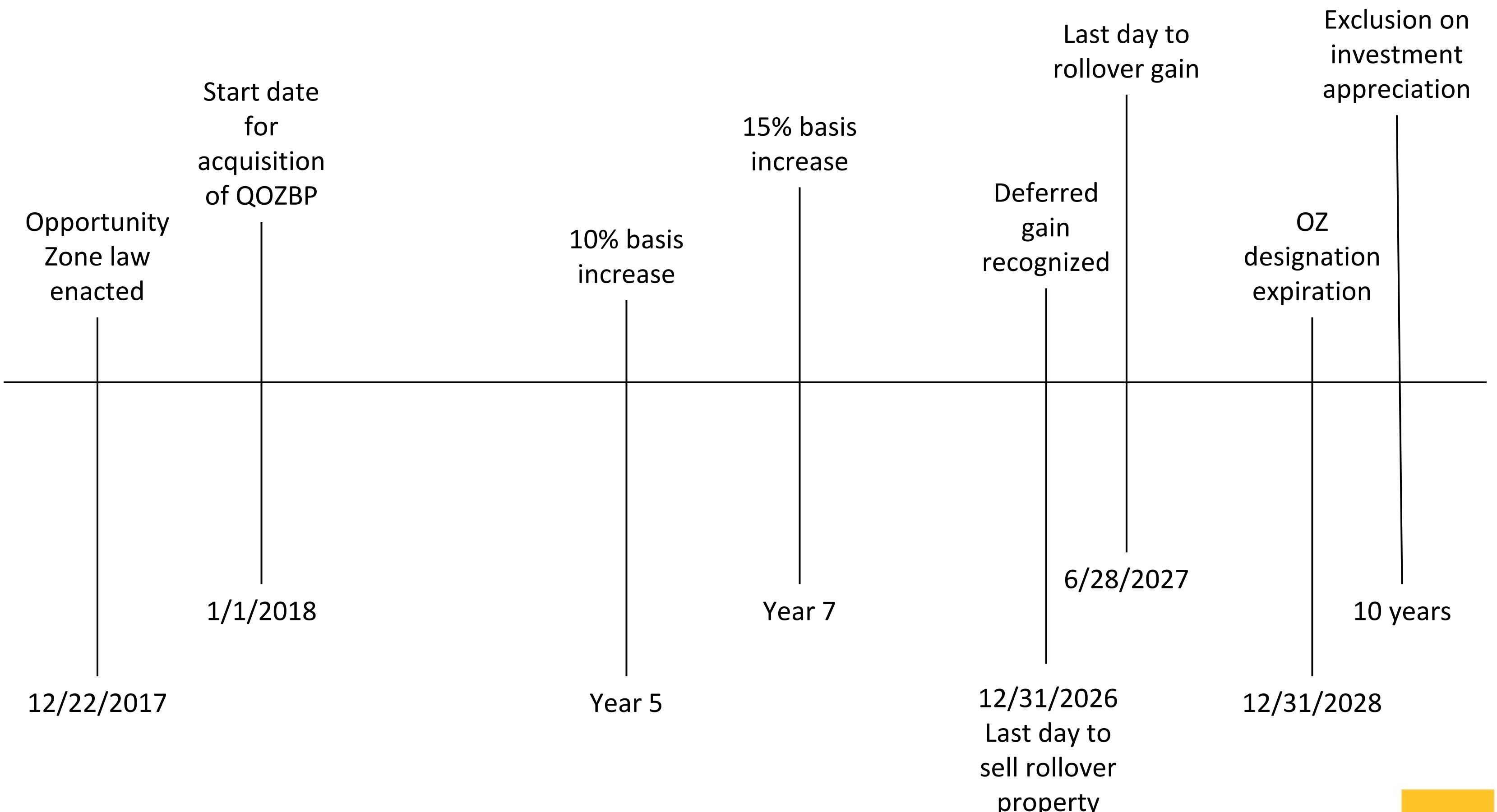
Planning Considerations
QOF Indirect Investment



Comparison of Direct/Indirect Investment

Direct	Indirect
90% of assets must be QOZBP	70% “substantially all” QOZBP
No guidance on working capital safe harbor	Working Capital safe harbor applies to unlimited amount of cash
No active conduct standard	50% of gross income from active conduct of trade or business
All IP counts toward 10% of non-QOZBP assets	Can own unlimited amount of IP (if substantial portion used in QOZB)
No prohibition on sin businesses	Prohibition on sin businesses
No specific reference to lease of property by a QOF	Property leased by a QOZB subject to QOZBP rules
No special 5-year rule for property directly held by QOF as QOZBP	Special 5-year rule for property held by a QOZB as QOZBP

Opportunity Zone Timeline



Timing Considerations

If a partnership does not elect to defer gain, partners are eligible to make deferral election

- Partner can make deferral election within 180 days of end of partnership year (when gain is distributed)
- Partner can elect to make the deferral election when the partnership sold the asset creating the gain

Timing Considerations

Investments made after 2019 but before 2022

- Taxpayer cannot hold an interest in the Opportunity Fund for at least seven years before December 31, 2026
- The rollover gain will be deferred and 10 percent may be excluded.
- The maximum potential exclusion of 15 percent of the rollover gain is not be available.

Timing Considerations

Investments made after 2021 and on or before June 28, 2027 (180 days after December 31, 2026)

- The taxpayer cannot hold the interest in the Opportunity Fund for at least five years before December 31, 2026
- The taxpayer's tax on his rollover gain will be deferred, but no exclusion on the original investment will be available

Selected Open Issues

Treasury has requested comments on all aspects of "original use" and "substantial improvement"

- What metrics for determining original use?
- What if the property is a vehicle that was previously used within the opportunity zone but acquired from a person outside the opportunity zone?
- Should some period of abandonment or under-utilization of tangible property erase the property's history of prior use in the opportunity zone?

Selected Open Issues

The Treasury Department and the IRS request comments on proposed 2047 end date for the section 1400Z-2(c) basis step-up election.

- Election to step-up basis without sale or disposition
- If so, how is the basis adjustment calculated?

Selected Open Issues

Is there any start-up grace period for a QOF 90% Test?

- Many commenters have requested at least an 18 month period, but so far there is no guidance or safe harbor

What facts and circumstances will be sufficient to show ‘‘reasonable cause’’ for failing to meet the 90% test?

- There is currently no guidance on this issue. There is guidance in the REIT context that could be helpful. Under the applicable regulations, reliance on a tax opinion rendered by a tax advisor generally constitutes ‘‘reasonable cause.’’ [Treas. Reg. 1.856-7(c)(2)].

Selected Open Issues

Can a business that leases unimproved building space in a QOZ be a QOZ Business?

- Substantially all of the tangible property owned *or leased* by a QOZ Business must be QOZ Business Property
- If the lease space is not "substantially improved", will this count against the QOZ Business?

Selected Open Issues

Draft IRS Form 8996 appears to permit an entity to self-certify as an Opportunity Fund, even if it fails the 90% Asset Test in its first year (and thus owes a penalty), so long as the entity's organizational documents include a statement of its purpose of investing in Opportunity Zone Property by the end of its first tax year and a description of the Opportunity Zone activity that the entity expects to engage in; however, the Proposed Regulations do not directly address the issue of failure to satisfy the 90% Asset Test in the Opportunity Fund's first year.

Selected Open Issues

Can a QOF be formed as a single-member LLC?

- In the absence of guidance to the contrary, a single-member LLC treated as a disregarded entity for federal income tax purposes likely could not itself be a fund, but, as a disregarded entity, should be permissible in an ownership chain underneath a QOF.

Selected Open Issues

How long does a QOF have to re-invest capital?

- Section 1400Z-2(e)(4)(B) specifically authorizes regulations to make sure that a QOF has a ‘‘reasonable period’’ in which to re-invest the return of capital from investments in qualified subsidiaries and/or the proceeds from a sale or other disposition of QOZ Business Property. Treasury has stated that the second set of regulations (due by the end of the year) will provide guidance on what constitutes a ‘‘reasonable period’’ for re-investment.

Winstead Opportunity Zone Team

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