OZ Capital Accelerator Program Webinar

Defer • Reduce • Eliminate

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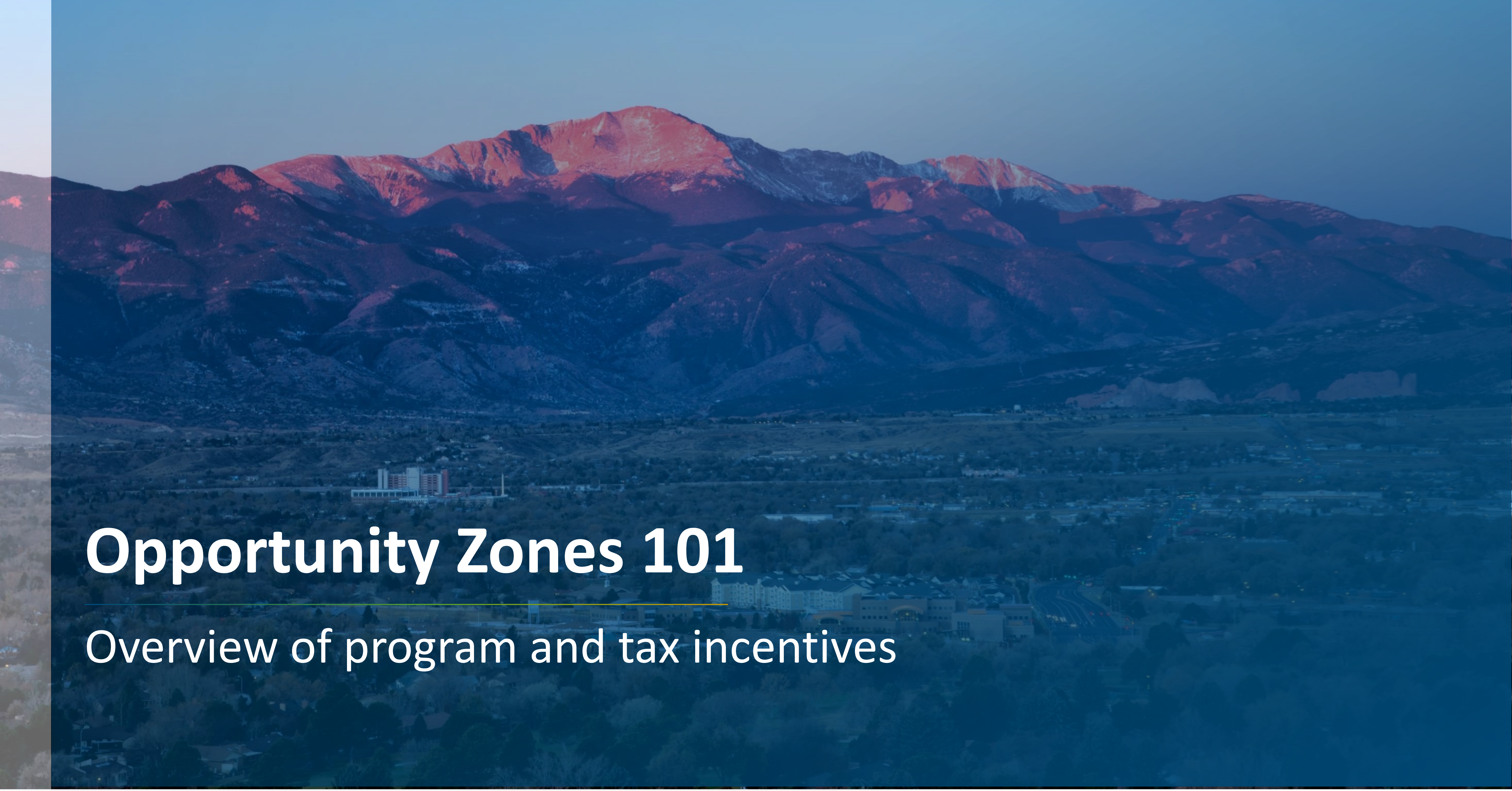
25 YEARS + COUNTING

A TOP ACCOUNTING FIRM, MOUNTAIN REGION

Accounting Today
2017, 2018, 2019, 2020

FIRM FACTS

EMPLOYEES	PARTNERS	FOUNDED
77	10	95’

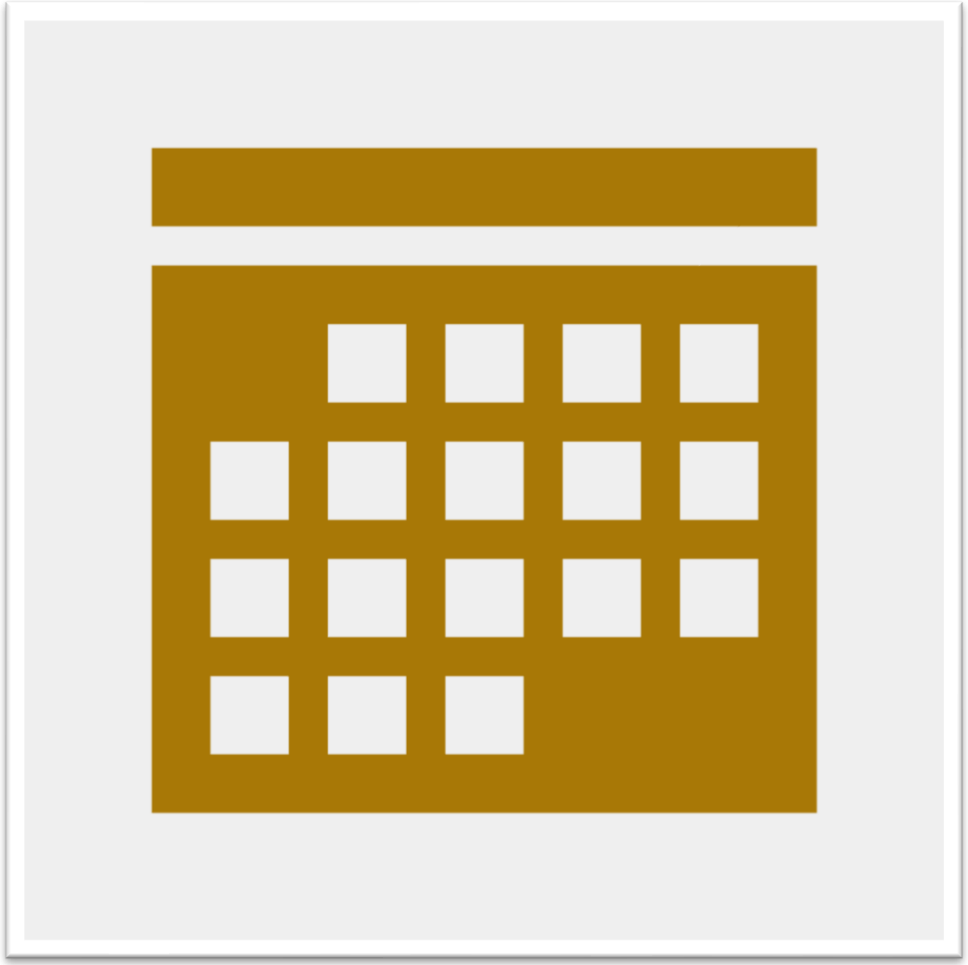


Opportunity Zones 101

Overview of program and tax incentives

Effective Dates of QOZ Final Regulations

- **Final QOZ regulations**
  - Issued December 19, 2019
  - Effective March 13, 2020
- **Until March 13, 2020:**
  - Taxpayers can **choose to apply either:**
    - The proposed regulations
    - Or, the final regulations for taxable years that begin on or before **March 13, 2020**



Opportunity Zones Facts

Opportunity Zones (OZ) are a **new incentive** of the Tax Cuts and Jobs Act of 2017.

OZs are designed to spur **long-term investment** in **low-income areas**, defined by census tract boundaries.

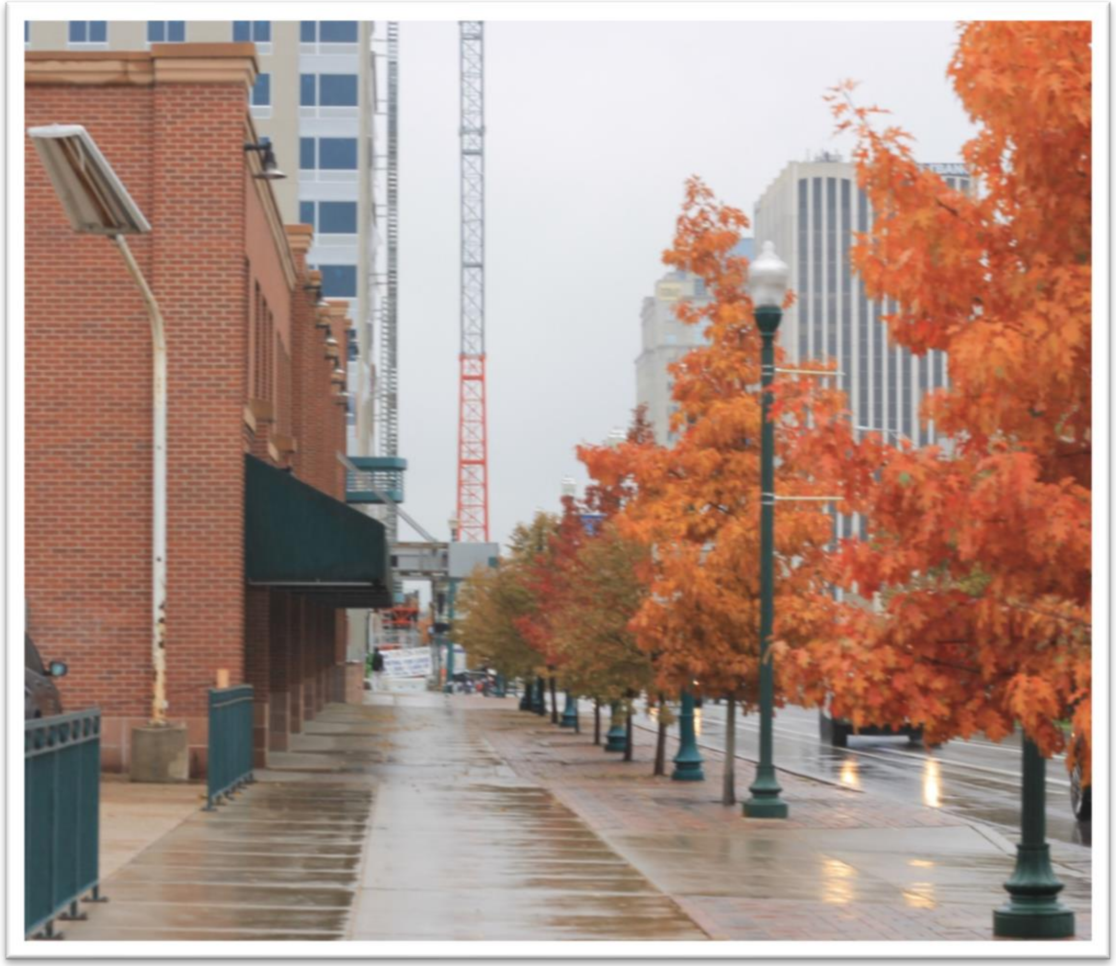
OZs are **federal tax incentives**, different from Enterprise Zones, which are **state income tax credits.**

Where are these zones?

- **126 statewide.**
- **Eight opportunity zones in El Paso County**:
    1. North Nevada Corridor
    2. West Downtown
    3. East Downtown
    4. The Citadel
    5. Powers Corridor
    6. Memorial Gardens
    7. COS Airport
    8. South Academy
- Search by address at **www.skrco.com**

How and why these zones?

- For El Paso County zones, local city, county and economic development groups completed a **"rigorous process to nominate census tracts for Opportunity Zone status."**
- Eligible census tracts had to have at least **a 20% poverty rate** or a median **family income of no more than 80%.**
- Governors **could only designate 25%** of total number of low-income census tracts in the state.
- Department of Treasury approved the final certification of Opportunity Zones.
- Zones are certified and **locked in for 10 years**.



Source: City of Colorado Springs

Up to three wins of "OZ Tax Benefits"

1

Defer paying tax on original capital gain.

2

Reduce tax owed on original gain.

3

Eliminate tax on new capital gain earned from OZ investment.

Original Capital Gain Tax Owed

2

1

Sale of qualified stock or business property.
Capital gain of $1 million is realized; elect to defer.
You incur a $200k in capital gain tax.

Invest $1m gain in Qualified Opportunity Fund (QOF)
Within 180 days of sale.

CAPITAL GAIN TAX DEFERRED

Recognize original capital gain tax;
by Dec. 31, 2026.
Pay $170k for original gain in 2026 tax filing.

2018 2019 2020 2021 2022 2023 2024 2025 2026 2027 2028

HOLD FOR 5 YEARS

HELD FOR 7 YEARS

Waiting period begins
to qualify for the reduced tax owed.

10% reduction
in capital gain tax owed.

+5% reduction
in capital gain tax owed.

3

HOLD FOR 10 YEARS

New QOF investment
Holding period begins.

Complete elimination
of tax on new gain earned from OZ investment.

* Dates and details are tied to fictional example. Not tax advice.

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Gains Eligible for Deferral

Win 1
Defer

- Only investments from capital gain deferrals qualify for OZ benefits. Eligible gains:
  - Long term capital gain (including §1231 gains, 28%)
  - Short term capital gain
  - Net §1256 contracts
  - Capital gain dividends including REIT/RIC
  - Installment sales
- **Not all gains from an event must be invested**
- No tracing requirement for the cash investment
- Deferral election made on Form 8949 and Form 8997

Gains Ineligible for Deferral

Win 1
Defer

- Capital gain cannot be from a sale to a related party (e.g., lineal ancestors, direct descendants, siblings, 20% entity ownership).
- No "Circular" Gains
  - Can not sell property to a QOF/QOZB and reinvest into the QOF for additional deferral and OZ benefits
- Gains taxed at ordinary rates

Disposal of QOF assets

Win 3

Eliminate

HELD FOR 10 YEARS

- After a **minimum of 10 years**, an election can be made to set basis to the fair market value at the time of sale.
- Appreciation beyond 10 years is **eligible for elimination until 2047.**
- Interest in QOF must be **disposed of** by the end of 2047

State Tax Implication

[State Tax Code Conformity – Corporate Income]

[State Tax Code Conformity – Personal Income]

- Colorado conforms to Federal law
- Non-Colorado Opportunity Zone property may be taxed depending on each state's rules
- In general consider:
  - State where gain was realized
  - State(s) where the OZ fund has nexus, or sufficient physical presence
  - State or residency of the taxpayer

Layering Other Credits/Deductions with OZ Incentives*

All regular operating deductions apply to QOF operations, including depreciation acceleration and 20% QBI deduction.

- Low Income Housing Credits – Federal and CO
  (5/17/19 CO credits $10M)
- FHA – 2/3 **reduction in fees** for multi-family projects in OZ where 90% of units qualify for LIHTC and deployment of a team to accelerate applications
- New Market tax credits
- CO Enterprise Zone tax credits
- Tax Increment Financing funds
- State incentives being rapidly developed

*Not a comprehensive list.

OPERATING A QOF

Qualified Operating Fund

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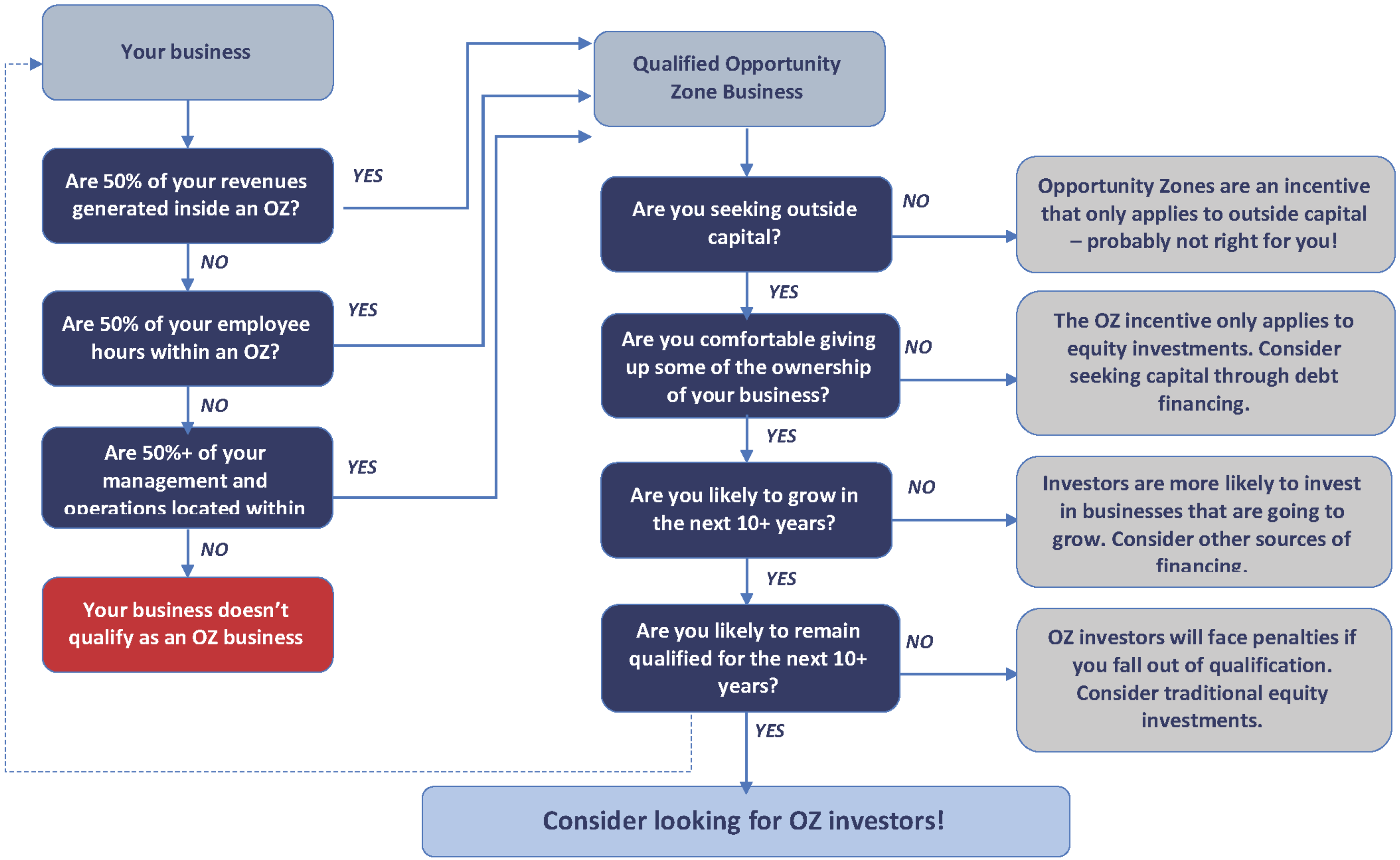
Opportunity Zones: Are they right for your business?



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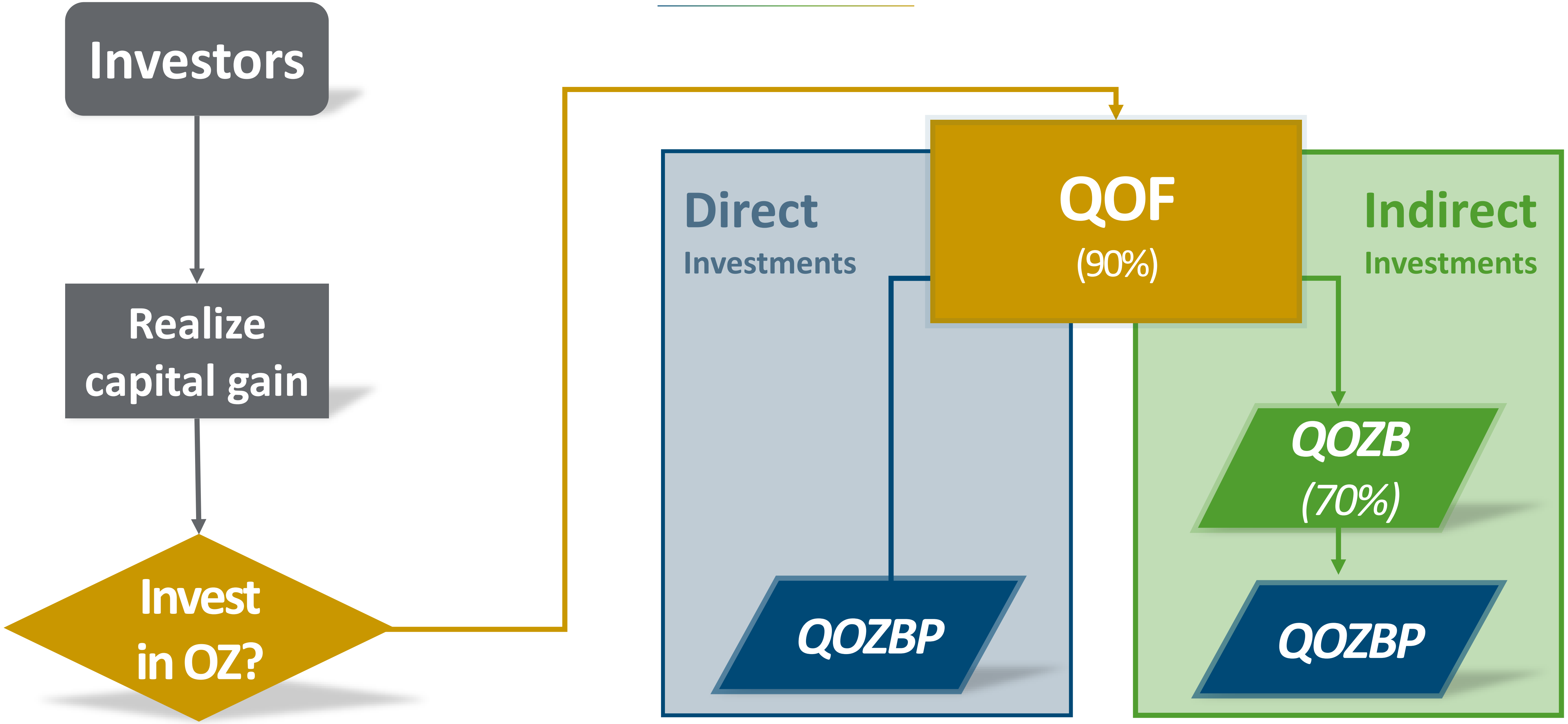
Qualified Opportunity Fund (QOF)



Indirect Investment: QOZB - Stock and Partnership Interests

- The investment must be **acquired after December 31, 2017** in exchange for cash
- Must be a **qualified opportunity zone business**, or is being organized for the purpose of being a qualified opportunity zone business
- Must remain a qualified opportunity zone business for **substantially all** of the qualified opportunity fund's holding period

Asset Test for QOFs

Must hold at least 90% of assets (either QOZB or QZOBP) in Opportunity Zone Property, determined by the average of the percentage of Opportunity Zone Property held on:

The last day of the first six-month period of the fund's taxable year.

The last day of the fund's taxable year.

June 30

Dec 31

JAN FEB MAR APRIL MAY JUNE JULY AUG SEPT OCT NOV DEC

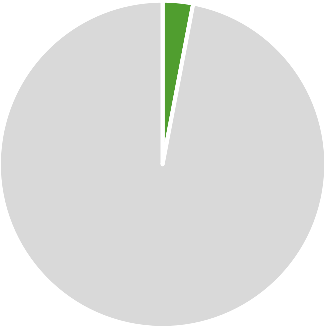
Source: Novogradac & Company LLP; Snell & Wilmer

QOZB

A trade or business in which **substantially all (70% of assets used in QOZ for 70% of the time during 90% of the holding period = 40%)** of the tangible property owned or leased by the taxpayer is located in a **qualified opportunity zone** and:

At least 50% of income derived from active conduct.

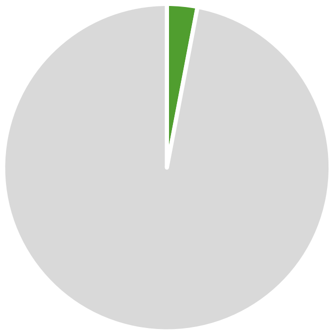
40%
of intangible property used in active conduct of business.



< 5 percent unadjusted basis of property is nonqualified financial property.

Cash - Working Capital Safe Harbor

QOZBP

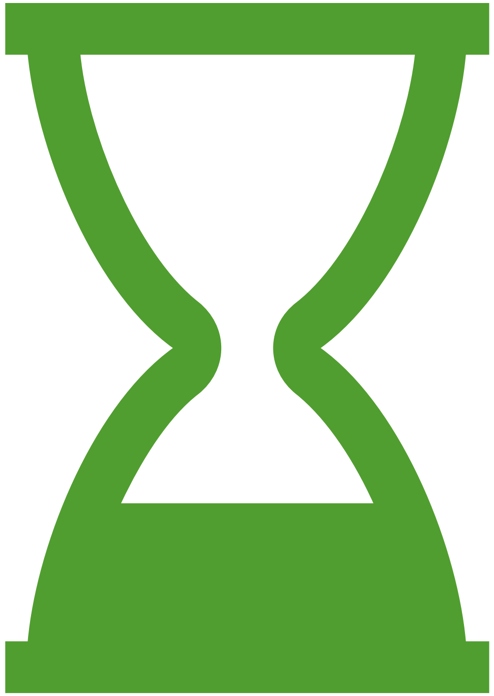


< 5 percent unadjusted basis of property is nonqualified financial property

- Cash, cash equivalents or debt instruments (term 18 months or less) are **considered working capital** if held by a QOZ business for up to **31 months,** IF:

  1. There is a **written plan or schedule** which outlines the deployment of assets in either acquiring/constructing or rehabilitating QOZBP or developing a trade or business (identifying leased space, employee hiring plans, space plans, permits etc.)
  2. The working capital assets are **actually utilized** in a manner **consistent with the schedule**.

Cash - Working Capital Safe Harbor



- QOZBs can use multiple working capital safe harbors for each cash infusion not to exceed **62 months** from the initial working capital safe harbor
  - Each cash infusion will have its own 31-month working capital safe harbor
  - Each safe harbor is required to have its own written plan and the cash must be used in manner consistent with the schedule

90% or 70% Asset Test

QOZBP

QOZ business property (QOZBP) is tangible property meeting the following requirements:

1. Acquired or leased after December 31, 2017
2. The “original use” commences with the QOF or the QOF has “substantially improved” the property
3. Substantially all of the use of the property is within a QOZ

QOZBP: Acquired and Original Use

QOZBP

- Property must be purchased by the QOF/QOZB from a **non-related party**
- **Property contributed to the QOF is eligible for the deferral election but NOT the acquisition provision**
- Tangible property "Original use" – initial use for depreciation or amortization purposes must be in QOZ (e.g. QOF/QOZB purchases a used personal use vehicle – it would qualify because not previously depreciated)
- Buildings vacant for at least three years purchased by a QOF/QOZB qualify. If property was vacant for at least a year at the time the zones were designated, then property must be vacant only for one-year post designation. A building is considered vacant if more than 80% of the square footage of useable space is not currently being used.

QOZBP: Acquired and Original Use

QOZBP

- Buildings acquired directly from the government through bankruptcies or tax sales do not have to be substantially improved.
- Brownfield certified sites satisfy the original use requirement if investments are made within a reasonable period to ensure that the entire site meets basic safety standards for both human health and the environment.
- Vacant land purchased by a QOF/QOZB qualifies as original use. If the land is unimproved or minimally improved, the land must be substantially improved. Unimproved land fails to be QOZ business property if it was purchased with an expectation that it would not be improved by more than an insubstantial amount.

QOZPB: Substantial Improvement

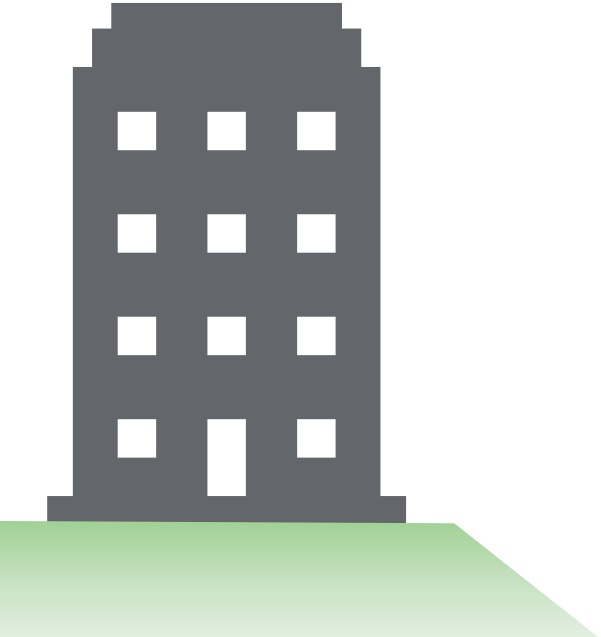
QOZBP

- Substantial improvement to an existing building within the OZ occurs if within 30 months after acquisition, additions to basis in the BUILDING (not Land) exceed the building's basis.
- Non-qualified property (purchased from a Related Party or property contributed to a QOF) cannot be improved. If a building is constructed on contributed land, the building will be QOZB, the land remains non-qualified.

QOZPB: Substantial Improvement

QOZBP

Non-qualified property (purchased from a Related Party or property contributed to a QOF) cannot be improved.



30-Month Renovation Project

- Initial Purchase
  - Hotel $4M
  - Land $1M
- Structural Renovations
  - Structural Updates $1.5M
- Non-structural Tangible Assets
  - Purchase Furniture* + Linens* $1M
  - Restaurant + Equipment $1M
  - Purchase Exercise Equipment $500k
- New Basis After Renovation
  - Hotel $8M
  - Land $1M

$4M in substantial improvements

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Substantial Improvement, cont.

- If land is unimproved or minimally improved, the land must be substantially improved. Unimproved land fails to be QOZ business property if it was purchased with an expectation that it would not be improved by more than an insubstantial amount.
- Tangible personal property is treated as substantially improved if the equivalent of its basis is expended within 30 months on an aggregated basis and the new property improves the functionality of original non-qualified assets.

QOZBP: Leased Property

QOZBP

- Lease must be initiated after December 31, 2017 at market value rate
- Lease does NOT need to satisfy original use
- QOF or QOZB is NOT required to substantially improve leased property
- Related party leases are allowed with additional requirements:
  - No prepayments of more than 12 months of lease payments
  - Leased tangible PERSONAL property (e.g. equipment, furniture and fixture)
    - Must either satisfy the original use requirement OR
    - QOF/ QOZB must acquire OTHER tangible property of equal value within 30 months of the lease inception
  - Leased RP Real Estate property qualifies if there is no plan or expectation that the property would be purchased from less than FMV or the lease will not qualify as QOZBP

QOF: Noncompliance Penalty for 90% Requirement

- There is a **monthly penalty** for noncompliance

Monthly penalty = **% Shortfall** X **Underpayment Rate**

Underpayment rate = Federal short-term rate plus 3%, **Currently 5%**

- No penalty if failure is due to **reasonable cause**
- Penalty QOF Partnerships: Penalty **imposed upon the Partners**

Note: QOF can elect to ignore un-deployed capital contributed within prior 6 months for purposes of the 90% test

Meet JT Manufacturing, a QOZB

- **YEAR ONE**: they were formed with $3M of capital gain investment
- Growing company with worldwide customer base
- **YEAR FOUR:** Infused additional $2M of capital gain investment

QOZB Operating Business – JT Manufacturing

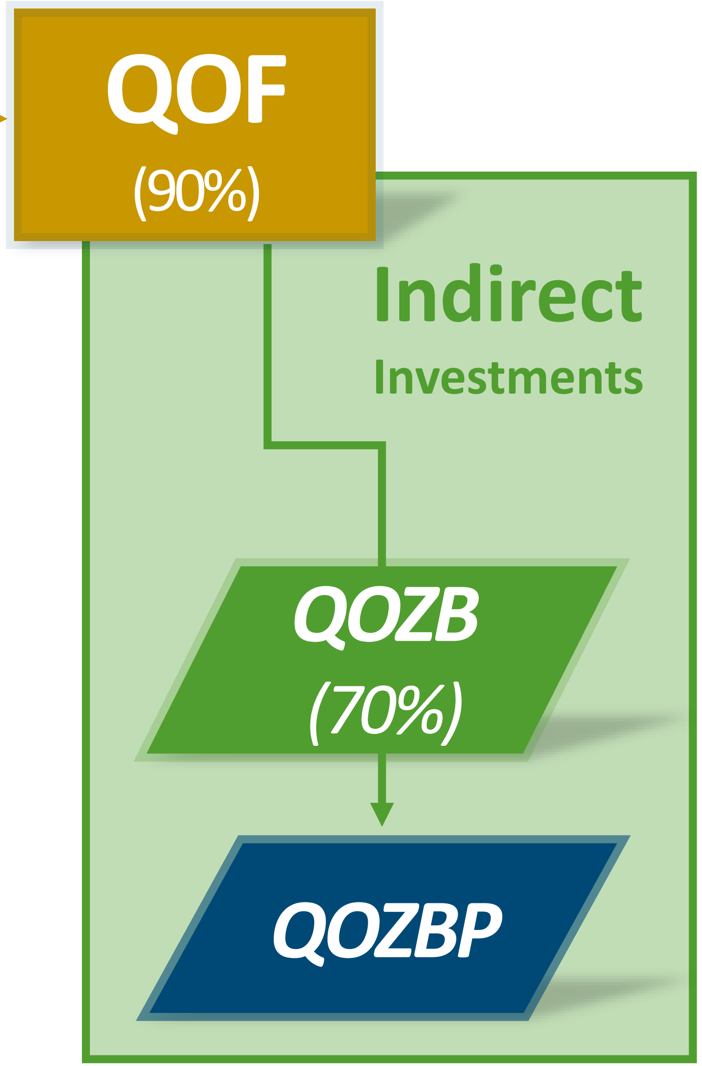
Year One

- $3M working capital
  - Sourced from deferred gains
- Written business plan
  - 31-month implementation schedule
  - $1M in equipment
  - $800k in salaries
  - $1.2M in operating costs including lease payments
  - Present value (PV) of 5-year lease $350k

Year Four

- $2M capital infusion
  - Must be deferred capital gain, extends 10-year timeline
  - $1.5M equipment
  - $500k intangible purchase
- Worldwide customer base
- 10 employees
  - Eight in QOZ; two work remotely
  - Manufacturing occurs 100% in QOZ

QOF Indirect Investment Example



Tests for QOZBs	YEAR 1	YEAR 4	YEAR 14
Asset Test (70% assets in QOZ)	$3M working capital + $350k PV lease	$2.5M equip + $500k intangibles + 350K PV lease	
Income Test (50% employee hours OR wages OR tangible property)	N/A – presumed met	• 80% of employee hours in zone • Test met • Customer base irrelevant	Sell the business
Active trade or business (y/n) (50% active trade or business)	Y – written plan to develop T/B	Y	

COVID-19 and Notice 2020-39

Notice 2020-39 provided the following relief to QOFs and their investors in response to the COVID-19 pandemic:

- **180-day Investment Requirement –** If a taxpayer's 180th-day investment requirement falls between 4/1/2020 and 12/31/2020, the taxpayer now has until 12/31/2020, to invest that gain into a QOF.
- **Reasonable Cause Exception –** A QOF's failure to pass the 90% test on any semiannual testing dates from 4/1/2020 through 12/31/2020, will automatically be considered due to reasonable cause. The penalty will not be imposed or the QOF disqualified.
- **Substantial Improvement –** the 30-month period beginning after the date of acquisition is suspended for the period 4/1/2020 to 12/31/2020. In effect, adding an extra 9 months to the improvement period.

COVID-19 and Notice 2020-39

- **Working Capital Safe Harbor –** Since all 50 states are declared Federal Disaster zones because of COVID-19, all QOZB's holding cash intended to be covered under the safe harbor (written plan detailing deployment of assets within 31 months) before 12/31/2020 will receive an additional 24 months to deploy the cash as long as the QOZB meets the safe harbor.

- **12 Month Reinvestment Period –** If a QOF sells a property or has a return of capital, it has 12 months to reinvest the proceeds in a QOZ qualifying investment without impacting the 90% investment standard. The Federal Disaster Zone declarations trigger provisions allowing an additional 12 months for reinvestment if any of the QOF's 12-month reinvestment period includes 1/20/2020 (the date of the disaster identified in the Major Disaster Declarations related to COVID-19).

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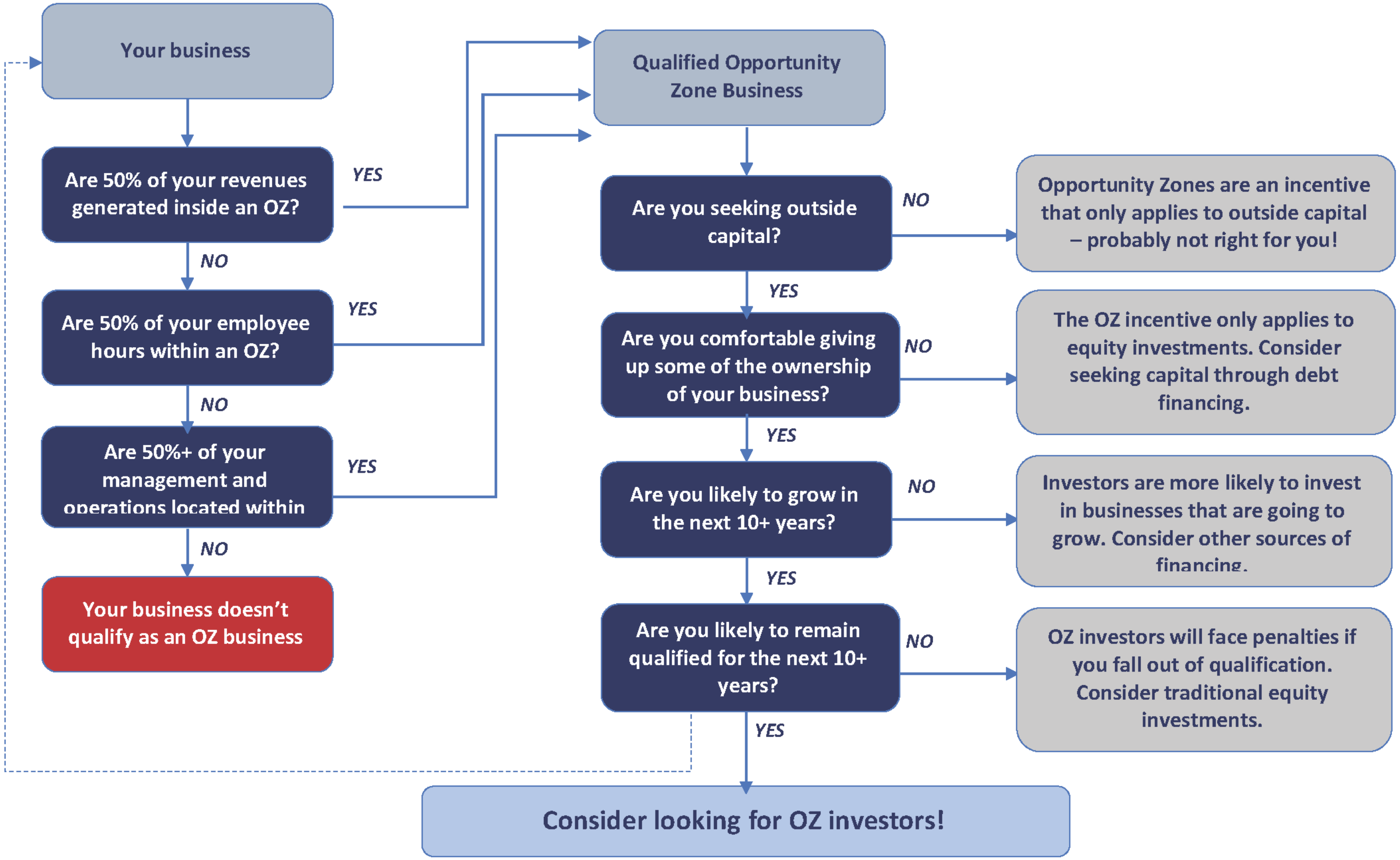
Opportunity Zones: Are they right for your business?



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Thank you!

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