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Understanding Opportunity Zone Tax Incentives in Light of New Congressional Oversight and the TIGTA Report

WEDNESDAY, JULY 13, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Robert Horwitz, Principal, **Hochman Salkin Toscher Perez**, Beverly Hills, CA

Michel R. Stein, Principal, **Hochman Salkin Toscher Perez**, Beverly Hills, CA

Cory Stigile, Principal, **Hochman Salkin Toscher Perez**, Beverly Hills, CA

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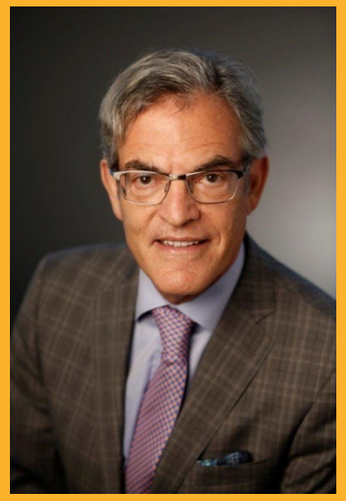
Michel Stein



Robert Horwitz

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Understanding Opportunity Zone Tax Incentives in Light of New Congressional Oversight and the TIGTA Report

July 13, 2022 | 10:00 a.m. – 11:30 a.m. (PST)

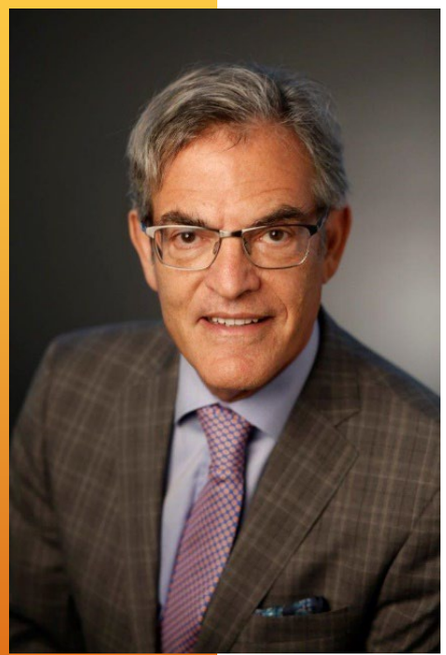
MICHEL STEIN

MICHEL R. STEIN is a principal at Hochman Salkin Toscher Perez, specializing in controversies, as well as tax planning for individuals, businesses and corporations. For more than 20 years, he has represented individuals with sensitive issue civil tax examinations where substantial penalty issues may arise, and extensively advised individuals on foreign and domestic voluntary disclosures regarding foreign account and asset compliance matters.

Throughout his career, Mr. Stein has represented thousands of individual, business and corporate taxpayers involved in civil examinations and administrative appeals, tax collection matters as well as with possible assertions of fraudulent conduct and in defending criminal tax investigations and prosecutions at every administrative level within the IRS. He has litigated tax cases in the U.S. Tax Court, the U.S. District Court, and various U.S. Circuit Courts of Appeal. He continues to provide tax advice to taxpayer's and their advisors around the world.

Mr. Stein is a frequent lecturer at national and regional conferences on topics including cryptocurrency, sensitive tax compliance issues, IRS examinations, International tax issues, State and Federal worker classification issues, etc.

ROBERT HORWITZ



Robert Horwitz has over 35 years of experience as a tax attorney specializing in the representation of clients in civil and criminal tax cases, including civil audits and appeals, tax collection matters, criminal investigations, administrative hearings and in civil and criminal trials and appeals in federal and state courts. He has served as a member of the Executive Committee of the Taxation Section of the State Bar of California and was Chair of the Taxation Section for the 2015-2016 year. He was previously Chair of the Tax Procedure and Litigation Committee of the State Bar Taxation Section.

Prior to joining Hochman Salkin Toscher Perez P.C., Mr. Horwitz was with a boutique tax controversy firm in Orange County, where he represented clients in civil and criminal tax cases in the U.S. Courts of Appeal, U.S. district courts, California superior courts, and before the Internal Revenue Service, the California Franchise Tax Board, the Board of Equalization, the Employment Development Department and the Unemployment Insurance Appeals Board.

Mr. Horwitz has also represented clients in complex civil and white-collar criminal cases, including civil and criminal bank fraud, wind and thermal energy tax shelters, tax fraud and tax collection matters, trademark, trade secrets, securities, and insurance coverage cases. He was also appointed by the United States District Court in Los Angeles to represent a death row inmate in habeas corpus proceedings.

CORY STIGILE

CORY STIGILE specializes in tax controversies as well as tax, business, and international tax. His representation includes Federal and state tax controversy matters and tax litigation, including sensitive tax-related examinations and investigations for individuals, business enterprises, partnerships, limited liability companies, and corporations. His practice also includes complex civil tax examinations, administrative appeals and tax collection proceedings (where he is widely respected for achieving meaningful resolutions of difficult tax collection issues). Mr. Stigile frequently writes and lectures on topics involving taxation. His more recent speaking engagements include "Back to Basics on The Ethics of Federal Tax Practice: Best Practices 101" for the American Bar Association Tax Section, "The Administrative Tax Controversy Case from Examination to Appeals" for the ABA Tax Section, "Tax Settlements – IRS Appeals, FTB Settlement Bureau and CDTFA Settlement Section" for the Channel Counties Santa Barbara Discussion Group of CalCPA, "Income Tax Update" for California State University, Los Angeles, "Tax Identity Theft" for the Taxation Technical Committee of the Los Angeles Chapter of CalCPA, "Best Practices in 'Settling' Cases with the IRS and FTB for the Glendale Estate Planning Counsel, the "IRS Audit Programs and Other Hot Tax Controversy Issues" for the Santa Clarita Valley Discussion Group of the Los Angeles Chapter of CalCPA, "Updates on Civil and Criminal Tax (Federal) for the Best of CLE program in Santa Monica, California, and the "Tips and Tricks for IRS, FTB & SBE Settlements" panel at the Los Angeles County Bar Association Practitioner's Conference. He was also interviewed by Bloomberg Law regarding IRS Wealth Squad audits focusing on the super-rich. Mr. Stigile was awarded the distinction of Super Lawyer Rising Star in 2012 through 2016, as recognized and published in Los Angeles Magazine. He was also on the Planning Committee of the Annual UCLA Extension Tax Controversy Institute and a member of the Western States Bar Association.

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Agenda

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02 Qualified Opportunity Zones: Business

03 Tax Deferral by Investing in a Qualified Opportunity Fund

04 Inclusion of Deferred Gain in Income

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Qualified Opportunity Zones: Background

The Reason for Qualified Opportunity Zones

- Qualified opportunity zones ("QOZ") were designed to spur economic growth in low-income communities by attracting capital
- First introduced in Congress in 2016 as the "Investing in Opportunity Act," by Senators Tim Scott (R-SC) and Cory Booker (D-NJ) and Representatives Pat Tiberi (R-OH) and Ron Kind (D-WI)
- Enacted in 2017 as part of the Tax Cut and Jobs Act as IRC §§ 1400Z-1 and 1400Z-2

Benefits of Opportunity Zones

- For Investors:
  - Defer Inclusion in Gross Income of Capital Gains Invested in a Qualified Opportunity Fund ("QOF")
  - Exclusion from Gross Income on Investments in QOFs held for at least 10 years
- For the QOZ: Investment of outside capital in businesses and business property in low-income communities

What Is a Qualified Opportunity Zone

- A QOZ is a census tract that is a low-income community designated as a "qualified opportunity zone"
- Low-income community is based upon either poverty rate (20% or more) or median family income (80% or less of median family income)
- A census tract that is not a low-income community can be a QOZ if it is contiguous with a QOZ and the median family income does not exceed 125% of that of the QOZ
- QOZ designation lasts for 10 years from the date of designation
- Approximately 8,700 QOZs with over 10% of the US population

Qualified Opportunity Funds

- To defer gain the taxpayer must invest capital gains in a “Qualified Opportunity Fund” (“QOF”) which is an entity
  - Organized as a corporation or partnership for the purpose of investing in QOZ property, and
  - Holds at least 90% of its assets in QOZ property
- An LLC classified as a corporation or partnership for federal income tax purposes can be a QOF
- Qualified Opportunity Zone property is a QOF ownership interest in a corporation or partnership that operates as a QOZ business in a QOZ or tangible property of the QOF that is used in a business in the QOZ.

Qualified Opportunity Zone Property Interests in Corporation or Partnership

- If a QOF's QOZ property is an ownership interest in a corporation or partnership
  - the interest must be acquired after December 31, 2017, solely in exchange for cash
  - the corporation or partnership must be a QOZ business; and
  - for 90% of the holding period of that interest, the corporation or partnership was a QOZ business.

Qualified Opportunity Fund No-No's

- A QOF can be structured to invest in multiple assets or in a single asset, but a QOF cannot be structured to invest in other funds, thereby prohibiting a 'fund-of-funds' model.
- A QOF that fails to meet the 90% investment standard is subject to a monthly penalty equal to the federal underpayment rate multiplied by the excess of 90% of fund assets over fund QOZ property
- A penalty is not imposed if the QOF establishes that failure due to reasonable cause
- If failure not due to reasonable cause the QOF will be subjected to penalty or possibly decertification.

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Qualified Opportunity Zones: Business

What Is an Eligible Qualified Opportunity Zone Business

- A QOF provides the equity capital for a QOZ business
- A QOZ business is one in which “substantially all” of the tangible property owned or leased by the business is QOZ property
- By regulation, “substantially all” means at least 70% of the QOZ business’ tangible property must be QOZ property
- A QOZ business can be
  - A new business formed in a QOZ, i.e., newly constructed rental real estate, a new operating business
  - An existing business in a QOZ that is expanding, i.e., renovating rental real estate in a QOZ, adding new equipment, etc. to an existing business in a QOZ
  - An existing operating business that moves to a QOZ

90% standard versus 70% test

- All QOFs must meet the 90% test, i.e., at least 90% of its funds must be invested in QOZ property, QOZ stock, QOZ partnership interests, or a combination of these
- The 90% test applies to both a “one tier” structure, where the QOF owns the QOZ business directly, and a “two tier” structure, where the QOF owns QOZ stock and/or QOZ partnership interests
- The 70% test requires 70% of the assets of the corporation or partnership to be QOZ property

QOF Reporting Requirements

- Form 8996, Qualified Opportunity Fund, is used by corporations and partnerships that are QOFs to:
  - Self-certify that it is a QOF
  - To provide an accounting of its investments
  - To certify that it meets the investment standard
  - To calculate the penalty if it does not meet the investment standard
- Form 8996 is required to be filed each year with the QOFs federal income tax return

QOZ Business Income

- Each taxable year, a QOZ business must earn at least 50% of its gross income from business activities within a QOZ.
- Regulations provide three safe harbors that a business may use to meet this test, taking into account any of the following:
  - Whether at least half of the aggregate hours of services received by the business were performed in a QOZ;
  - Whether at least half of the aggregate amounts that the business paid for services were for services performed in a QOZ; or
  - Whether necessary tangible property and necessary business functions to earn the income were located in a QOZ.

Businesses that Are Note Eligible QOZ Businesses

- The following businesses are not QOZ businesses
  - Golf course
  - Country club
  - Massage parlor
  - Hot tub facility
  - Suntan facility
  - Racetrack or other facility used for gambling
  - A store whose principal business is the sale of alcoholic beverages for consumption off site
- An entity that derives less than 5% of its gross income from an ineligible business or leases less than 5% of the net square feet of rentable property or less than 5% of the value of other tangible property to an ineligible business will not fail to be a QOF

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Tax Deferral by Investing in a Qualified Opportunity Fund

Gains Eligible for Deferral by Investing in a QOF

- Certain gains, called “eligible gains,” may be deferred by investing in QOFs
- Eligible gains include capital gains and qualified 1231 gains that would be recognized for federal income tax purposes and subject to income tax before January 1, 2027, if gain deferral did not apply
- Section 1231 gains are eligible gains only to the extent it exceeds any amount treated as ordinary income under secs. 1245 or 1250.
- Gain from disposition of an interest in a QOF can be eligible gain
- Gain accounted for under the installment method is eligible gain if it otherwise meets the requirements for eligible gains
- Gains from a transaction with a related person are not eligible gains for purposes of investing in a QOF.
- Gains from straddle transactions are generally not eligible gains

Time Period for Investing in a QOF

- Generally, you have 180 days to invest eligible gain in a QOF.
- The first day of the 180-day period is the date the gain would be recognized for federal income tax purposes if you did not elect to defer the recognition of the gain.
- A partnership, S corporation, estate and a non-grantor trust can elect to defer gain invested in a QOF
- Note: As part of its COVID relief, the IRS extended the period if the deadline fell after April 1 and before December 31, 2020 to December 31, 2021.

Deferral of Gain by a Person with an Interest in a Pass-Through Entity

- Partners in a partnership, shareholders of an S corporation, and beneficiaries of estates and non-grantor trusts that have eligible gains can invest their share of the gain in a QOF and have the option to start the 180-day investment period on:
  - the last day of the entity's taxable year
  - the same date that the entity's 180-day period begins, or
  - the due date for the entity's tax return, without extensions, for the taxable year in which the entity realized the eligible gain
- A taxpayer who receives a RIC or REIT capital gain dividends can choose with respect to eligible gain for the 180-day period to begin either on the last day of the taxable year in which the capital gain would be recognized or on the date of the dividend distribution

Making the Election to Defer Gain

- The election to defer the gain, in whole or in part, is made on the federal income tax return on which the tax on that gain would be reported if not deferred.
- The election is made
  - "in accordance with guidance published in the Internal Revenue Bulletin or in forms and instructions." Treas. Reg. 1.1400Z2(a)(1)(d)(1)
  - the election is made on Form 8949
- A taxpayer can make an election on an amended return if not made on an original return
- If a taxpayer fails to make an election in accordance with IRS guidance, there is a rebuttable presumption that the gain is included in income; the presumption may be rebutted b making the required report or by establishing to the satisfaction of the IRS that "an inclusion event … did not occur."

Deferral of Gain by Nonresident Aliens and Foreign Corporations

- Nonresident alien individuals and foreign corporations may generally elect to defer eligible gains that are otherwise subject to federal income tax in their hands.
- If the gain would be exempt from federal income tax under an applicable income tax treaty, the foreign person must waive any treaty benefits in order to elect to defer the gain.

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Inclusion of Deferred Gain in Income

Inclusion Events

- Gain deferred due to investment in a QOF is not included in income until the earlier of
  - December 31, 2026
  - The date of an inclusion event
- An event is an "inclusion event" to the extent that
  - It "reduces an eligible taxpayer's direct equity interest for Federal income tax purposes in the qualifying investment" – thus a sale of all or part of a taxpayer's interest in a QOF is an inclusion event
  - the taxpayer receives property from the QOF that is treated as a distribution for tax purposes
  - An eligible taxpayer claims a worthless stock loss or worthlessness deduction with respect to its qualifying investment
  - A QOF loses its status as a QOF

Specified Inclusion Events

- By regulation certain events are deemed inclusion events, including:
  - Termination of the QOF, including conversion of a QOF partnership to a C corporation, from a QOF C corporation to a partnership, or from a QOF partnership or corporation to a disregarded entity
  - Liquidation of the QOF and distribution to investors if sec. 336(a) treats the distribution as if the investment were sold to the distributee at fair market value
  - A transfer of a QOF investment by gift, including a charitable contribution
  - A transfer between spouses incident to a divorce
  - A change in the income tax status of an existing trust, such as from a grantor trust to a non-grantor trust

Events that Are Not Inclusion Events

- Certain transfers are not considered inclusion events:
  - A transfer by reason of the owner's death, including transfer to the deceased owner's estate, to the deceased owner's joint tenant, etc.
  - Contribution by the owner of a QOF interest to a grantor trust if the contributing person is deemed the owner of the trust under the grantor trust rules
  - Merger of one QOF partnership with another QOF partnership, if the taxpayer only received an equity interest in the surviving QOF partnership
  - Election, revocation, or termination of a corporation's status as an S corporation

Computing the Gain from an Inclusion Event

- The amount includible as gain from an inclusion event is
  - (a) the **lesser** of (i) the amount of gain excluded under Code Sec. 1400Z-2(b)(2)(A) or (ii) the fair market value of the investment as determined as of the end of the deferral period, over
  - (b) the taxpayer's basis in the qualifying investment that is disposed of in the inclusion event
- If the taxpayer disposes of less than all the investment, the amount of gain excluded is (i) an amount that bears the same proportion to the remaining deferred gain as the fair market value of the portion disposed of bears to the fair market value of the total qualifying investment immediately prior to the inclusion event or (ii) the fair market value of the qualifying investment disposed of in the inclusion event.

Basis in Qualified Opportunity Fund

- Because the investment in a QOF is of gain that has not been recognized, a taxpayer's basis in the QOF is zero
- Basis is increased by the amount of gain recognized above
- If the taxpayer holds the investment at least 5 years, basis is increased by 10% of the deferred gain
- If the taxpayer holds the investment for at least 7 years, basis is increased by an additional 5% of the deferred gain
- If the investment is held for at least 10 years, the taxpayer's basis is equal to the fair market value of the investment on the date it is sold or exchanged.

Example of Gain Deferral – Qualifying Investment Held More than 10 Years

Example of the sale of a QOF interest held more than 10 years:

(i) Facts. In 2020, taxpayer A invests $100 in QOF S, a QOF S corporation, in exchange for a qualifying investment and defers $100 of gain. At the end of 2028, the qualified opportunity zone designation expires for the population census tract in which QOF S primarily conducts its trade or business. In 2031, A sells all of its QOF S shares, realizes gain, and makes an election to increase the qualifying basis in its QOF S shares to fair market value. But for the expiration of the designated zones in section 1400Z-1(f), QOF S and A's conduct is consistent with continued eligibility to make the election under section 1400Z-2(c).

(ii) Analysis. Under paragraph (c) of this section, although the designation expired on December 31, 2028, the expiration of the zone's designation does not, without more, invalidate A's ability to make an election under section 1400Z-2(c). Accordingly, pursuant to that election, A's basis in the QOF stock is increased to its fair market value and A recognizes no gain or loss on the sale.

Anti-Abuse Rules for Qualified Opportunity Zones

- "The purposes of section 1400Z-2 and the 1400Z-2 regulations are to provide specified Federal income tax benefits to owners of QOFs to encourage the making of longer-term investments … of new capital in one or more qualified opportunity zones and to increase the economic growth of such qualified opportunity zones."
- If a "significant purpose" of a transaction is to achieve a federal income tax benefit inconsistent with the purposes of 1400Z-2 and the regulations, the IRS can recast the transaction for federal tax purposes, including treating the transaction as other than a qualifying investment.
- If a partnership is formed or availed of with a significant purpose of avoiding the rules concerning "eligible gain" the IRS can disregard the partnership to prevent the creation of a qualifying investment with respect to any partner or partners that would not otherwise satisfy the rules

TIGTA Report on Qualified Opportunity Funds

- On February 7, 2022, TIGTA released a study on QOF Fund and Investor Noncompliance
- Based on an analysis of IRS tax records, TIGTA found that as of the December 31, 2020:
  - 6,198 taxpayers filed Form 8996 for tax year 2019 reporting QOF assets of approximately $24 billion and total assets of approximately $26.9 billion
  - 16,509 taxpayers filed Form 8997 for tax year 2019 reporting deferral of $22.7 billion of capital gain

TIGTA Critiques IRS Implementation of Opportunity Zone Legislation

- TIGTA found that the IRS took several steps to implement OZ legislation, including
  - Contracting with Treasury's CDFI Fund to help review QOF applications
  - Developing Forms 8996 and 8997 for reporting by QOFs and investors
  - Developing codes for Form 8949 to track QOZ deferred gains
  - Working on a compliance plan to ensure adherence to QOZ requirements
- TIGTA found that the IRS had not developed processes and procedures to
  - Identify all inaccuracies and inconsistencies in the information reported by QOFs and investors
  - Identify QOFs and investors who are not in compliance with annual reporting requirements
  - To address QOFs who fail to meet key program requirements and report potentially false information

Opportunity Zone Pending Legislation

- April 7, 2022, The Opportunity Zones Transparency, Extension, and Improvement Act introduced by bipartisan group of Senators and Representatives
- If enacted, it will be the first substantive change in Opportunity Zone legislation
- Highlights of the bill:
  - extends the deferral period for qualified capital gains through 12/31/2028
  - requires the sunset of certain Opportunity Zone tract designations
  - imposes new reporting requirements to promote transparency
  - creates the "State and Community Dynamism Fund" to provide assistance to state and local governments.

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