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Puerto Rico designated as an Opportunity Zone

Francisco Luis, CPA, JD

Tax Partner

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Federal tax law and regulations

What is an Opportunity Zone?

- an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment
- a locality qualify as Opportunity Zones if they have been certified as such by the Secretary of the US Treasury via his delegation authority to the Internal Revenue Service
- Qualified Opportunity Zone designation remains in effect for 10 years

Opportunity Zones Map

Puerto Rico – Opportunity Zone Map

What is an Opportunity Zone?

- main purpose is to encourage growth and investment in the designated distressed communities by providing federal income tax **incentives** to an **eligible taxpayer** that makes a "timely investment" in a **Qualified Opportunity Fund.**

What are the incentives?

Temporary Deferral

A temporary deferral of inclusion in taxable income for capital gains reinvested into an Opportunity Fund. The deferred gain must be recognized in the earlier of the date on which the opportunity investment is disposed of or December 31, 2026.

Step-up In Basis

A step-up in basis for capital gains reinvested in an Opportunity Fund. The basis is increased by 10% if the investment is held for at least 5 years and by an additional 15% if held for at least 7 years, thereby excluding up to 15% of the original gain from taxation.

Permanent Exclusion

A permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in an Opportunity Zone if held for at least 10 years. This exclusion applies only to the gains accrued after the investment in an Opportunity Zone.

Opportunity Zones incentives

Example

- an eligible taxpayer realizes $1M of capital gain, timely invests the gain in a QOF and sells the QOF interest within 5 years, then the $1M of the gain must be recognized in the year of sale of the QOF interest.
- if the interest is held for at least 5 years, then 10% of the gain may be excluded, representing $100,000 tax free
- if the interest is held for two additional years, another $50,000 (5%) may be excluded, for a total tax free gain of $150,000.
  – The remaining $850,000 must be recognized upon earlier of year of sale or December 31, 2026
- if the interest is held for at least 10 years, and sells for $1.5M, the $500,000 in appreciation would be tax free ($850,000 would be included in income)

What is an Eligible Taxpayer?

- an Eligible Taxpayer is a person that may recognize **eligible gains** for purposes for federal tax purposes.
  - **Individuals;**
  - **C Corporations (including RICs and REITS);**
  - **Partnerships;**
  - **S corporations;**
  - **Trusts; and**
  - **Estates**

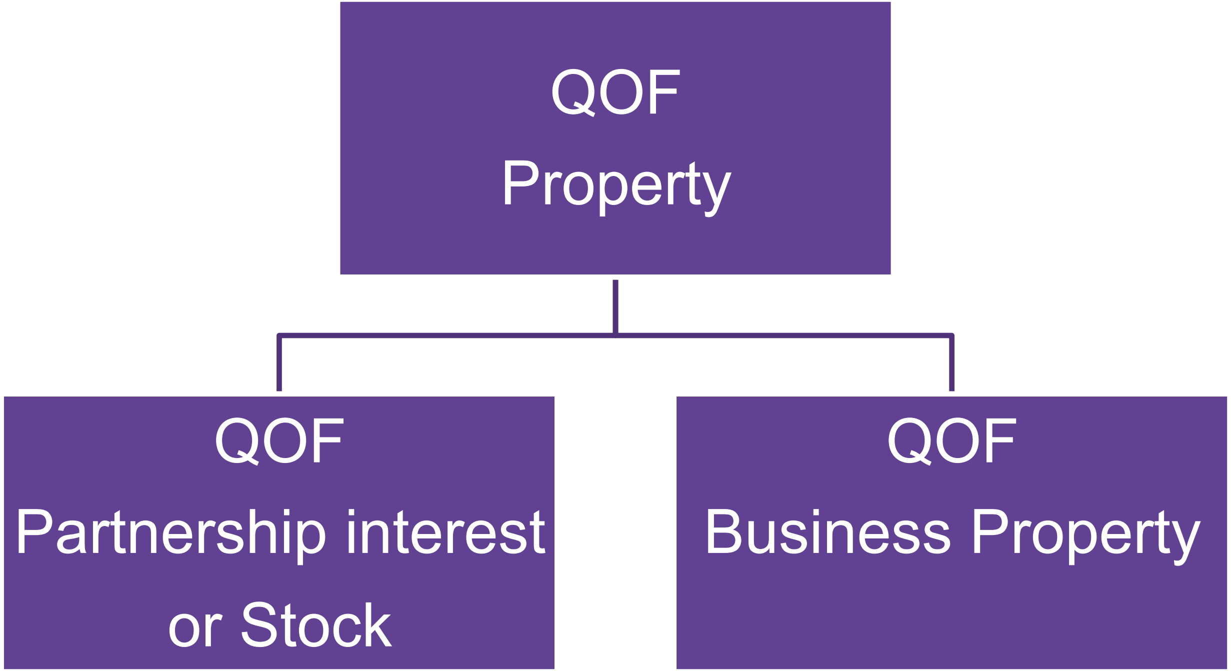
What is an Eligible Gain?

- an amount of gain is an “eligible gain” if such gain is:
  - Treated as a capital gain for federal tax purposes;
  - Would be recognized for federal tax purposes before January 1, 2027;
  - Does not arise from a sale or exchange with a person that is “related” to the taxpayer (20% criteria instead of 50%)
- to achieve the “temporary deferral” the “eligible gain” must be invested in the Qualified Opportunity Fund within 180 days of the date when the transaction was effected.

What is a Qualified Opportunity Fund?

- investment vehicle that is setup as either a partnership of corporation for investing in eligible property that is located in an Opportunity Zone and that utilizes the investor's gains from a prior investment for funding the Opportunity Fund.
  - fund must hold at least **90%** of its assets in a Qualified Opportunity Zone property (QOZ property)
  - regulations adopt a self-certification procedure that will allow the QOF to certify that it qualifies for QOF treatment.

Qualified Opportunity Fund property



QOZ Partnership Interest and QOZ Stock

- the equity investment must be acquired after December 31, 2027 in exchange for cash;
- must be a qualified opportunity zone business, or is being organized as such;
- must remain a qualified opportunity zone business for **substantially all** of the qualified opportunity fund's holding period

QOZ Business Property

- means tangible property used in a trade or business of the QOF if the following requirements are met:
  - QOF acquires by purchase from an unrelated person after December 31, 2017;
  - either:
    - The original use of such property in the QOZ commences with the QOF, or
    - The QOF "substantially improves" the property; and
  - during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a QOZ
  - substantially means that the cost of improvement during the 30 month period from the date of purchase exceeds the QOF's purchase price of the property

QOZ Business

- is a trade or business in which:
  - “substantially all” of the tangible property owned or leased by the taxpayer is “QOZ business property”;
  - at least 50% of the total gross income of such entity is derived from the active conduct of such business;
  - a substantial portion of the intangible property of such entity is used in the active conduct of any such business;
  - less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to non-qualified financial property; and
  - the business is not a “sin business”

Prohibited business

- "Sin Businesses":
  - any private or commercial golf course,
  - country club,
  - massage parlor,
  - hot tub facility
  - suntan facility
  - racetrack or other facility used for gambling, or
  - any store the principal business of which is the sale of alcoholic beverages or consumption off premises

Original Use and Substantial Improvement

- QOF rules require that either (i) the original use of the QOZ property begin with the QOF or (ii) QOF substantially improves property within a 30 months by making capital improvements that exceed the cost of the property
  - regulations reserve definition of original use – it is unclear whether QOF can purchase newly constructed building that is not yet in service; what if property was abandoned?
  - substantial improvement rules are taxpayer friendly
  - substantial improvement is measured by cost of building, not including land

Original Use and Substantial Improvement
Example

- QOF purchases property for $800, allocating $420 to land and $380 to building
- QOF spends $400 in next 30 months to improve building
- property is treated as substantially improved
  - there is no guidance in the regulations for the case of vacant land or with building scheduled for demolition

90% Test

Directly Held Property v. Qualified Partnership interest or Stock

- if the QOF holds QOZ property directly, the directly held property is subject to the 90% test
- but if the QOF owns stock or a partnership interest in a qualifying entity, then:
  - “substantially all” of the tangible property owned or leased by the entity must be QOZ property (the regulations define “substantially all”| for these purposes as **70%**)
  - if QOF owns more that one entity, each entity must satisfy the 70% test

90% Test

Directly Held Property v. Qualified Partnership interest or Stock

- as a practical matter, if the QOF raises $10M which is used to purchase QOZ property
  - directly held property - $9M must be QOZ property
  - property held by underlying entity:
    - QOF must invest $9M in entity, of which 70% (or $6.3M) must be QOZ property

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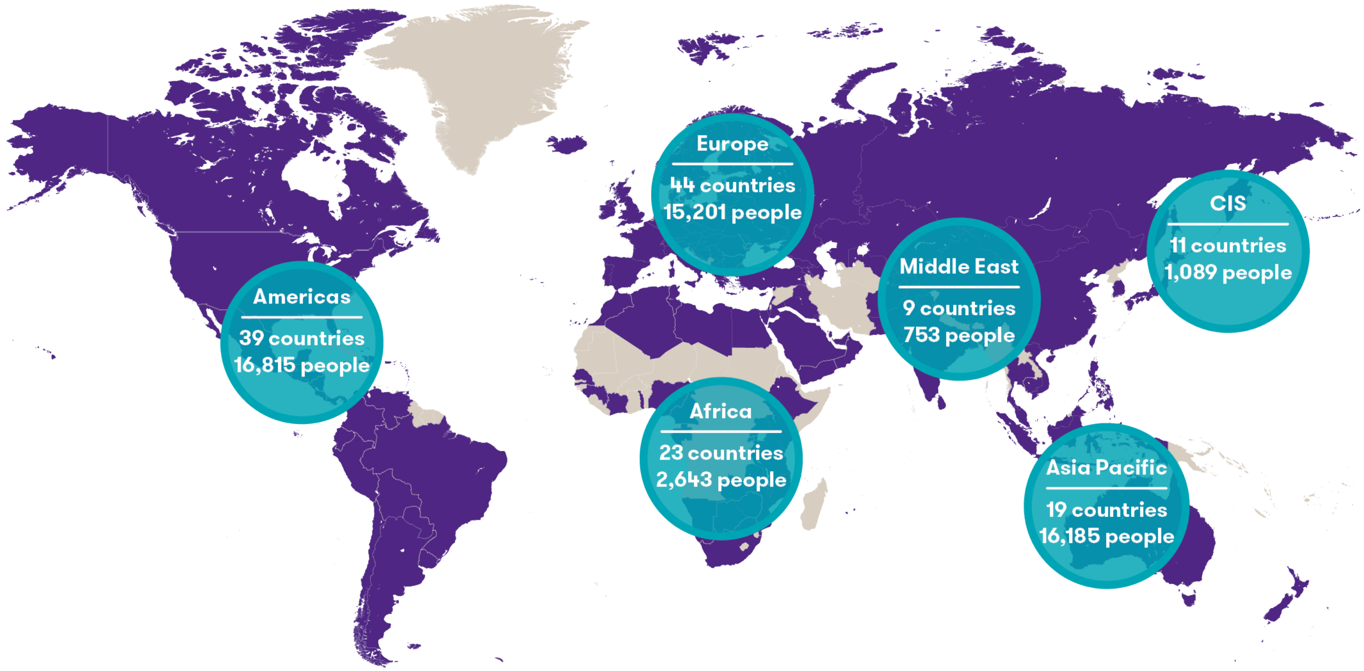
Thank you

Questions



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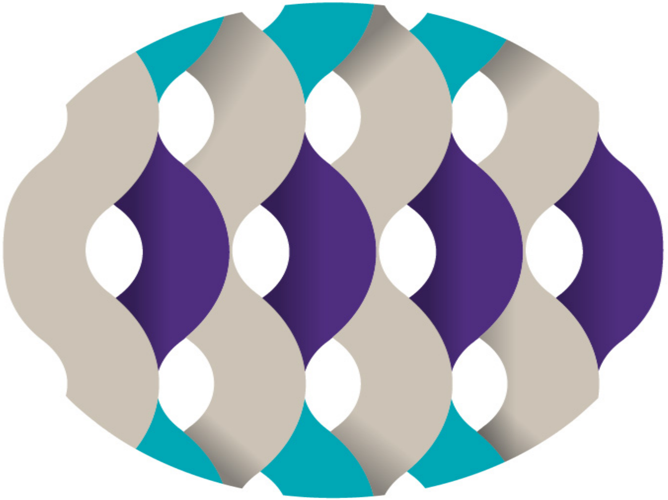

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