PIETRANTONI MENDEZ & ALVAREZ LLC

MEMORANDUM TO CLIENTS AND FRIENDS

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Qualified Opportunity Zones: An Opportunity to Spur Investments in Puerto Rico

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The Tax Cuts and Jobs Act of 2017 grants certain United States federal income tax benefits to taxpayers that invest all or a portion of their capital gains in certain economically distressed areas of the United States ("**Qualified Opportunity Zones**"). Specifically, taxpayers that recognize a capital gain for federal income tax purposes are able to defer and reduce the applicable federal income tax liability on the gain by investing an amount equal to the gain in a Qualified Opportunity Zone.

Nearly all of Puerto Rico has been designated as a Qualified Opportunity Zone. Thus, Puerto Rico's depressed real estate market coupled with the tax benefits that Puerto Rico offers to a wide array of businesses and the federal income tax exemption of the Puerto Rico source income of Puerto Rico residents, should make the island an attractive area for investment of capital gains.

Notably, a taxpayer that invests its capital gain in a Qualified Opportunity Zone of a state of the United States will achieve the deferral and reduction of tax, but the income derived from the investment will be subject to federal and state income tax, if applicable, whereas if the investment is made in a Puerto Rico Qualified Opportunity Zone, such tax benefits will be achieved, and, in addition, if the taxpayer becomes a bona fide resident of Puerto Rico, and the investment is made in manufacturing, tourism facilities, renewable energy or other businesses that enjoy Puerto Rico tax exemption, the income derived from the investment will generally enjoy a Puerto Rico income tax rate of 4% and the dividends derived from such income will generally be exempt from federal and Puerto Rico income tax.

These tax benefits are generally inapplicable to individuals resident of Puerto Rico, corporations organized in Puerto Rico and partnerships whose partners are resident individuals and/or Puerto Rico corporations, because ordinarily the capital gains of these taxpayers are not subject to federal income tax. However, on November 7, 2018 a bill was filed at the Puerto Rico Legislature granting similar benefits to capital gains subject to Puerto Rico income tax. Thus, if such the bill is enacted, each of these taxpayers will also be able to defer and reduce the Puerto Rico capital gains tax and enjoy the exemption on the gain from the increase in value of the investment.

Moreover, if the bill is approved, it will constitute an additional incentive for individuals that enjoy the Puerto Rico tax benefits of Act 22 and the federal income tax exemption on Puerto Rico source income. Currently, the portion of the capital gains derived by these individuals attributable to the appreciation in value of their investment assets prior to their move to Puerto Rico is subject to

United States and Puerto Rico income tax. But, if the bill is enacted and the individuals invest such gains in a Puerto Rico qualified opportunity zone, the gain will enjoy the deferral and reduction of the capital gains tax for federal and Puerto Rico income tax purposes.

The Income Tax Benefits

Taxpayers subject to federal income tax may elect to defer the payment of the federal income tax on short and long term capital gains by investing an amount equal to, or a portion, of the gain in a Qualified Opportunity Zone.

The election is made by filing Form 8949 jointly with its federal income tax return for the taxable year for which the gain would have been recognized.

The deferral period ends on the earlier of December 31, 2026 or the date that the investment is sold (the "**Recognition Date**"). Thus, on the Recognition Date the taxpayer must pay the applicable capital gains tax (i.e., up to 23.8% on long term capital gains and up to 37% on short term capital gains), but if as of such date the investment has been held at least five years, 10% of the gain will be exempt from federal income tax, and if it has been held for at least seven years, the exemption will increase to 15%. Significantly, if the investment goes sour and the value of the investment on the Recognition Date is less than the amount invested, the reduction in value of the investment is exempt from the applicable tax. Thus, in any such case the amount subject to tax will be an amount equal to the value of the investment less 10% or 15% of such amount, if the five year or seven year holding period is met. Moreover, if the investment is held for at least ten years, the gain from the sale of the investment is not subject to federal income tax.

Notably, since the Recognition Date is the earlier of the date of sale of the investment or December 31, 2026, even if the investment is held for ten years, at least 85% of the gain (amount of gain less 15% exemption) must be recognized on December 31, 2026, and the applicable income tax must be paid on April 15, 2027. Still, since the increase in value of the investment is exempt from federal income tax, economically the increase in value after ten years will offset such tax liability in whole or in part. The following example illustrates the impact of the gain recognition and the exemption on the gain derived from investment held for at least 10 years:

(i) A United States citizen resident of the United States realizes a $5 million short term capital gain in 2018, subject to a maximum federal income tax of 37% ($1,850,000), payable on April 15, 2019.

(ii) If the individual (i) invests the gain in a qualified opportunity zone and (ii) after ten (10) years sells the investment at a gain, the result is the following: (x) since the deferral period of the capital gain ends on December 31, 2026, the individual must pay $1,572,500 (85% of the deferred short term capital gains tax) on April 15, 2027 and (y) the gain from the sale of his investment in 2028 is exempt from federal income tax.

(iii) The individual saved $277,500 ($1,850,000 less $1,572,500) and if the investment is sold for 8,000,000, an additional tax savings of $714,000 would be achieved because the $3,000,000 gain, otherwise subject to a $714,000 tax (23.8% X $3,000,000), would be exempt from such tax. Thus, the total tax savings would amount to $991,500.

The Qualification Requirements

To qualify for the tax benefits, the following requirements must be met:

(i) the gain must be derived from the sale or exchange of a capital asset to an unrelated person;

(ii) the capital gain may not be part of a straddle or other transaction that substantially reduced the taxpayer's risk of loss; and

(iii) an amount equal to the capital gain must be invested in a "Qualified Opportunity Fund" (the "**Fund**") on or before a 180 day period beginning on the date that the gain is realized.

A Fund is any corporation, partnership or limited liability company that elects treatment as a partnership or corporation for federal tax purposes, and meets the following requirements:

(i) is organized for the purpose of investing in (A) shares of stock or partnership interests of corporations or partnerships engaged in an eligible business in the qualifying zone (the "**Zone Entity**"); and/or (B) tangible assets purchased by the Fund after December 31, 2017 that are used in the Qualified Opportunity Zone in an eligible trade or business;

(ii) at least 90% of the assets of the Fund must consist of shares of stock or partnership interests in a Zone Entity and/or the tangible assets described in (i)(B) (the "**90% Test**"), above;

(iii) the shares of stock or partnership interests of a Zone Entity must be acquired by the Fund solely for cash and at their original issue.[1]

For this purpose, an eligible trade or business is any trade or business, so long as:

(i) substantially all of its tangible assets (owned or leased) are acquired after December 31, 2017;

[1] No IRS approval is required for the corporation, partnership or limited liability company to be treated as a Fund, but the entity must file Form 8996 with the IRS.

(ii) the original use of such assets in the Qualified Opportunity Zone commences with their use by the Fund or by the Zone Entity, as applicable, or are substantially improved by the Fund or Zone Entity;[2] and

(iii) during the holding period of the investment substantially all of the use of the property is in the Qualified Opportunity Zone (collectively, the "**Trade or Business Requirements**").

Significantly, if the business is conducted by a Zone Entity, 70% of the tangible assets (instead of 90%) must meet the Trade or Business Requirements (the "**70% Test**"), but the following requirements must also be met:

(i) at least 50% of the gross income of the Zone Entity must be from the active conduct of a trade or business;

(ii) a substantial portion of the intangible property of the Zone Entity must be used in the active conduct of a trade or business;

(iii) less than 5% of the aggregate unadjusted basis of the Zone Entity's property may be attributable to financial assets, such as debt, stock and other similar property; and,

(iv) the trade or business cannot be a private or commercial golf course, country club, massage parlor, hot but facility, sun tan facility, racetrack or other gambling facility or any store the principal business of which is selling liquor (collectively, the "**Zone Entity Business Requirements**").[3]

Accordingly, to determine whether the Fund should conduct the eligible business directly, or indirectly through a Zone Entity, it must be taken into account that if the Fund conducts the Business only the Trade or Business Requirements and the 90% Test must be met, whereas, if the business is conducted indirectly through a Zone Entity, the 70% Test ant the Trade or Business Requirements and Zone Entity Business Requirements must also be met. Consequently, if the eligible business is conducted directly by the Fund only 10% of the assets may be assets that do not meet the Trade or Business Requirements and if the business is conducted by a Zone Entity, 30% of the assets may be assets that do not meet the Trade or Business Requirement, but the Zone Entity Business Requirements must also be met.

Breach of Trade or Business or Zone Entity Business Requirements

A Fund that fails to meet the 90% Test is subject to a penalty for each month it fails to meet the requirement test. The penalty is an amount equal to the product of the amount of the shortfall and

[2] Assets are "substantially improved" if an amount that exceeds the purchase price of the asset is used to improve the asset during a maximum period of 30 months. In the case of investments in buildings, an amount equal to the purchase price of the land does not have to be invested in improvements to the land or building.

[3] The Zone Entity Business Requirements do not have to be met if the business is conducted directly by the Fund.

the federal short-term rate plus three percentage points, unless there is reasonable cause for the failure to meet the test.

The IRS and the Treasury intend to issue additional proposed regulations addressing the application of the penalty and the circumstances that could lead to the revocation of opportunity fund status.

Additional Proposed Regulations

This summary is based on the provisions of the Tax Cuts and Job Act of 2017 and the proposed regulations issued by the IRS and the Treasury on October 19, 2018. The proposed regulations will be effective on or after the date of approval of the final regulations. But, the proposed regulations expressly provide that the taxpayers and the Funds may rely on the rules set for therein, so long the regulations are applied in their entirety and in a consistent manner.

Additional proposed regulations have been announced by the IRS and the Treasury addressing some of the matters that still require clarity.

If you have any questions or comments, or wish additional information regarding this matter, please contact any of the following attorneys:

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