



Tax Incentives for Investments in Qualified Opportunity Zones

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Agenda

- Overview
- Qualified Opportunity Zones
- The Tax Incentives – Deferral, Reduction, Exclusion
- Qualified Opportunity Funds
- Inclusion of Deferred Gains
- Miscellaneous

Opportunity Zones – Overview



- **Purpose:** help economically distressed communities through substantial, swift, and sustained business investment
 - Successor to other tax incentives with similar purposes
 - Targeting estimated \$6 trillion in unrealized capital gains
- **Tax Incentives:** three additive federal income tax incentives:
 1. **Deferral** of invested gains to as late as 12/31/2026
 2. **Reduction** of deferred gains after 5 years (10%) and 7 years (15%)
 - 12/31/2019 deadline to obtain full 15% reduction
 - 12/31/2021 deadline to obtain 10% reduction
 3. **Exclusion** of post-investment gain after 10 years (12/31/2028 deadline)
- **Procedure:** invest in a corporation or partnership that self-certifies as a “qualified opportunity fund” (“**QOF**”)
 - 90% of assets in a designated Qualified Opportunity Zone (“**O Zone**”)

Opportunity Zones – Overview

- **Who will invest?**

- Investors with recognized gains willing to invest in O Zone projects
- Investors willing to recognize gains and invest those gains in O Zone projects (e.g., diversify concentrated positions or exit positions with perceived low growth potential)
- Social impact funds and investors
- Investors can be
 - Individuals, corporations (C or S), partnerships, trusts
 - U.S. or non-U.S. persons
- No tax incentives for tax-exempt organizations, including pension funds and retirement accounts
- No tax incentives for investors without eligible gains

Opportunity Zones – Overview

- **How will the funds be organized?**
 - Alternatives
 - Partnership/LLC
 - C Corporation
 - Public or Private REIT
 - Other?
 - Single asset versus multi-asset funds
 - Considerations
 - Forecasted operating income or loss relative to capital appreciation
 - Nature of the assets (real estate versus other)
 - Liquidity for investors
 - Managing the asset exit (or exits)
 - Variation in alternatives and effects contributes to investor confusion

Opportunity Zones – Overview

- **Who will provide the projects?**
 - Fund managers seeking to deploy capital earmarked for O Zones
 - Developers seeking capital for projects already in O Zones, or willing to pursue projects in O Zones
 - Will QOFs and their investors offer a lower cost source of capital?
 - Will the cost of O Zone property rise to offset any lower cost of capital and mute the pre-tax returns?
 - States and O Zone communities seeking to attract investment
 - Property owners in O Zones
 - Growing businesses willing to locate in O Zones

Opportunity Zones – Overview

- **How's it going so far?**
 - Huge interest
 - More than 100 QOFs have been formed with \$26+ billion of capacity
 - Actual closed capital is estimated to be well short of capacity so far
 - Some limiting factors:
 - Deal economics
 - Limitations on the tax incentives (e.g., long holding periods and temporary deferral)
 - Regulatory / compliance uncertainty and complexity
 - Will the program turn out to be all sizzle and no steak?

Opportunity Zones – Overview

- **Guidance**

- IRC Sections 1400Z-1 and 1400Z-2
- IRS proposed regulations: REG-115420-18 (10/19/18) and REG-120186-18 (4/17/19)
- IRS Revenue Ruling 2018-29 (10/19/18)
- IRS Form 8996 and instructions (QOF self-certification), and instructions to IRS Form 8949 (regarding deferral election)
- Executive Order 13853 (12/12/18), establishing the White House Opportunity and Revitalization Council
- Community Development Financial Institutions (CDFI) Fund website
 - <https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx>
 - Better interactive map: <https://eig.org/opportunityzones>
- Information websites: Opportunitydb.com; Novoco.com

Opportunity Zones – Overview

- If you remember only one thing:

BUYER BEWARE!



Qualified Opportunity Zones

Qualified Opportunity Zones

- **Designation of Qualified Opportunity Zones (“O Zones”)**

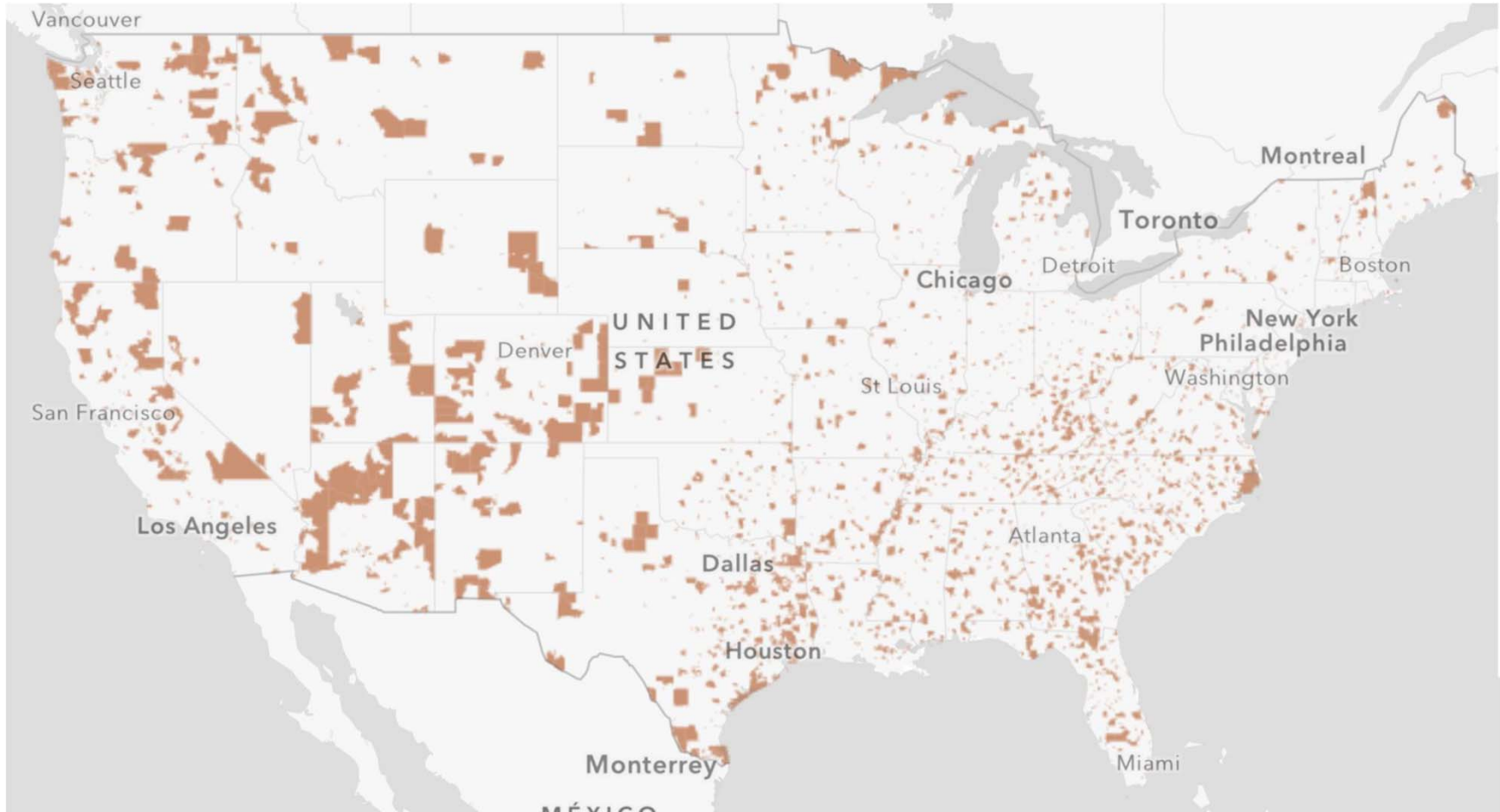
- Eligible zones:

- A population census tract that is a low-income community (“LIC”)
 - Poverty rate $\geq 20\%$
 - Non-metropolitan area: median family income (“MFI”) $\leq 80\%$ of statewide MFI
 - Metropolitan area: MFI $\leq 80\%$ of the greater of statewide MFI or metro area MFI
- Certain contiguous tracts where MFI $\leq 125\%$ of MFI of the adjoining LIC

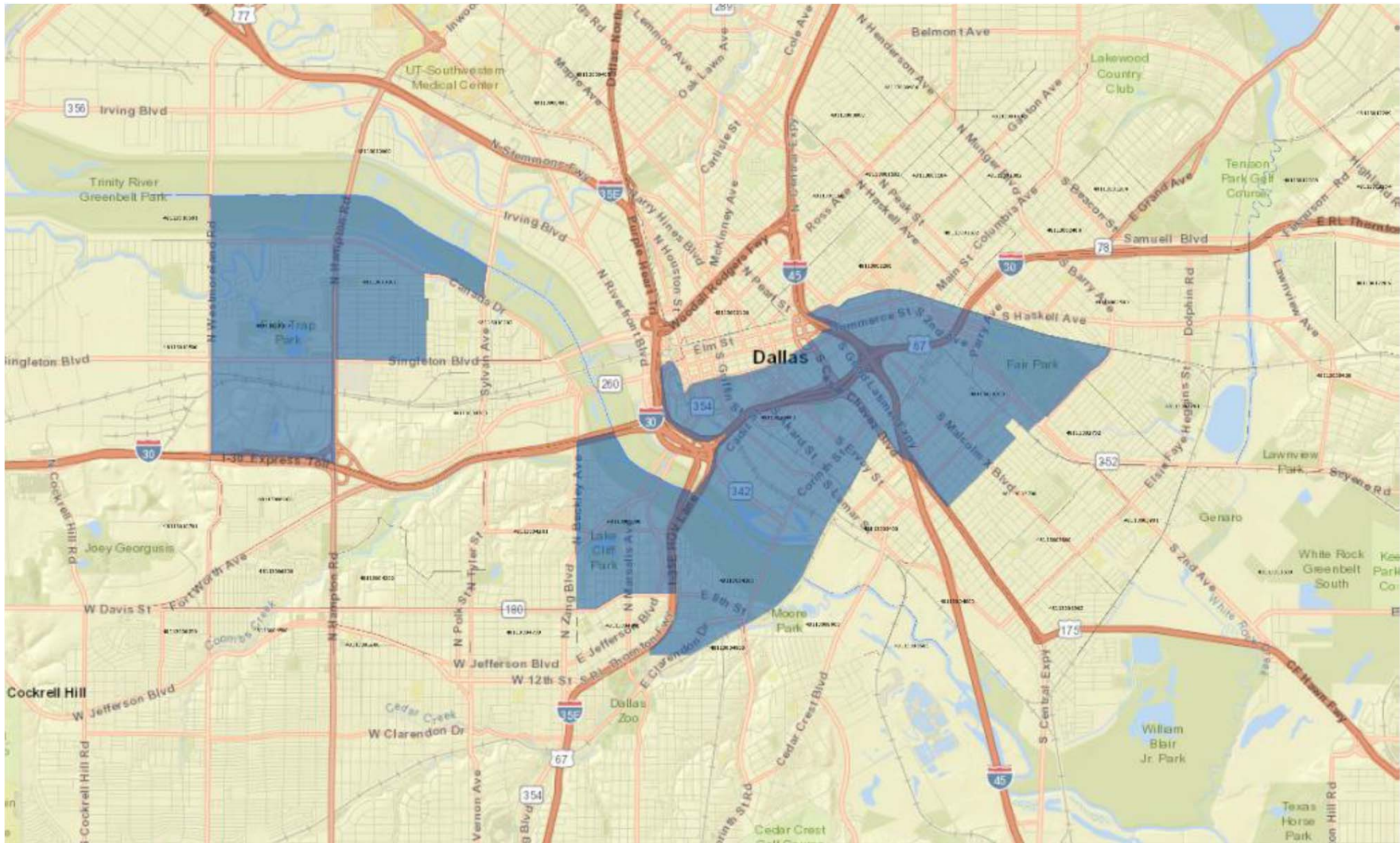
- Designated zones:

- Each state was allowed to designate a number of tracts in the state up to 25% of the number eligible tracts, or a minimum of 25 tracts, as O Zones
- All of Puerto Rico
- Designations expire 12/31/2028
- Map: <https://eig.org/opportunityzones>

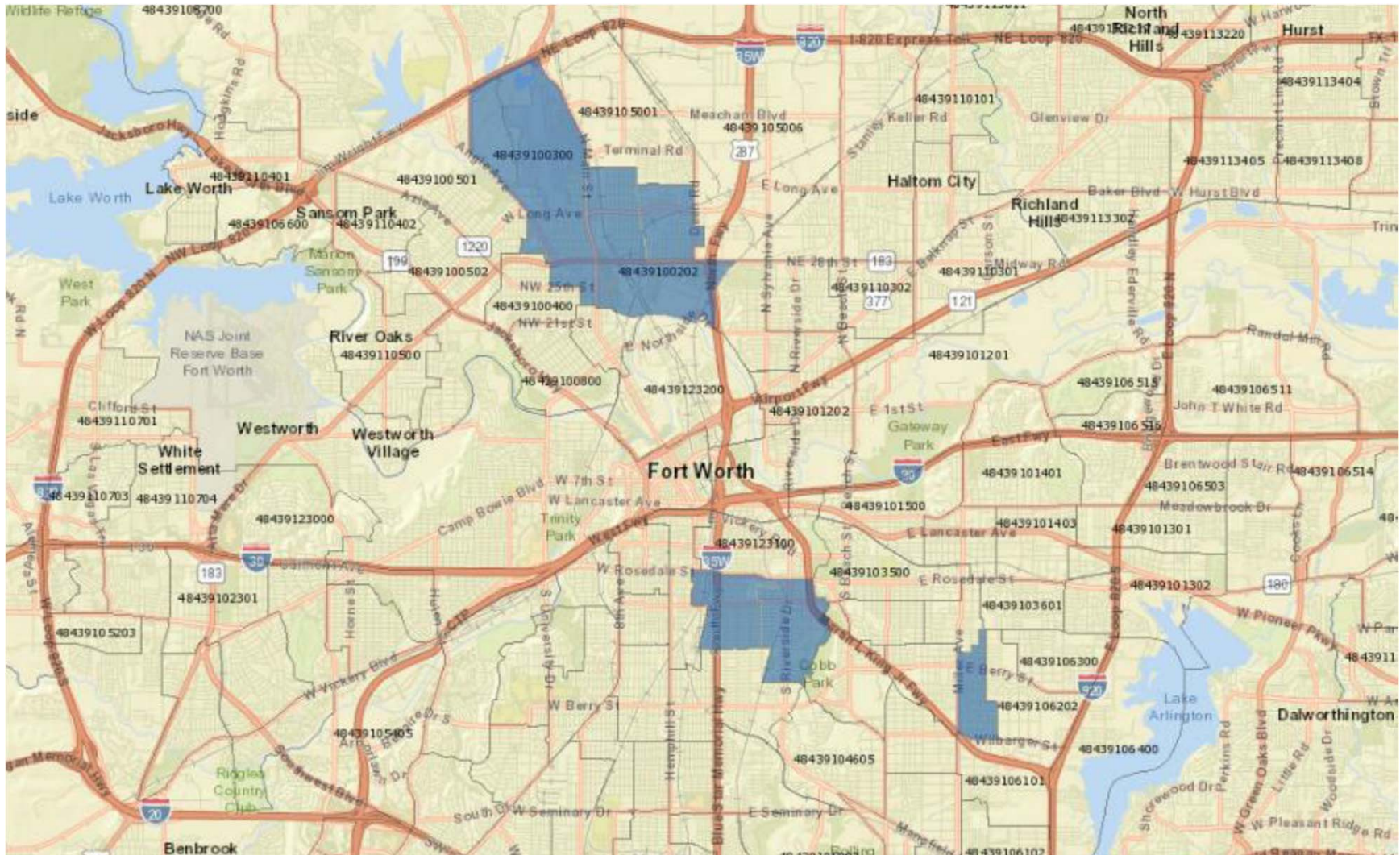
Qualified Opportunity Zones – U.S.



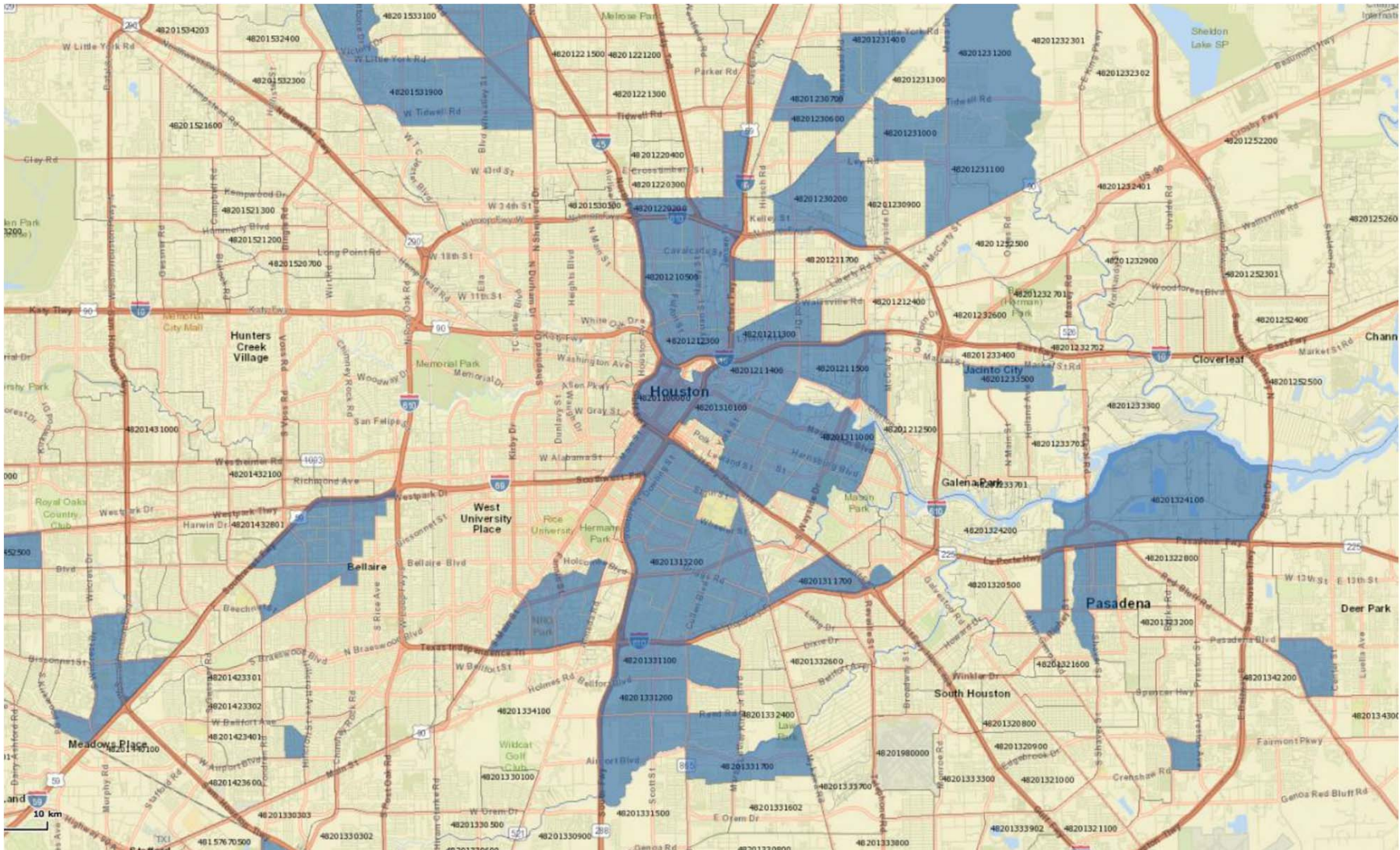
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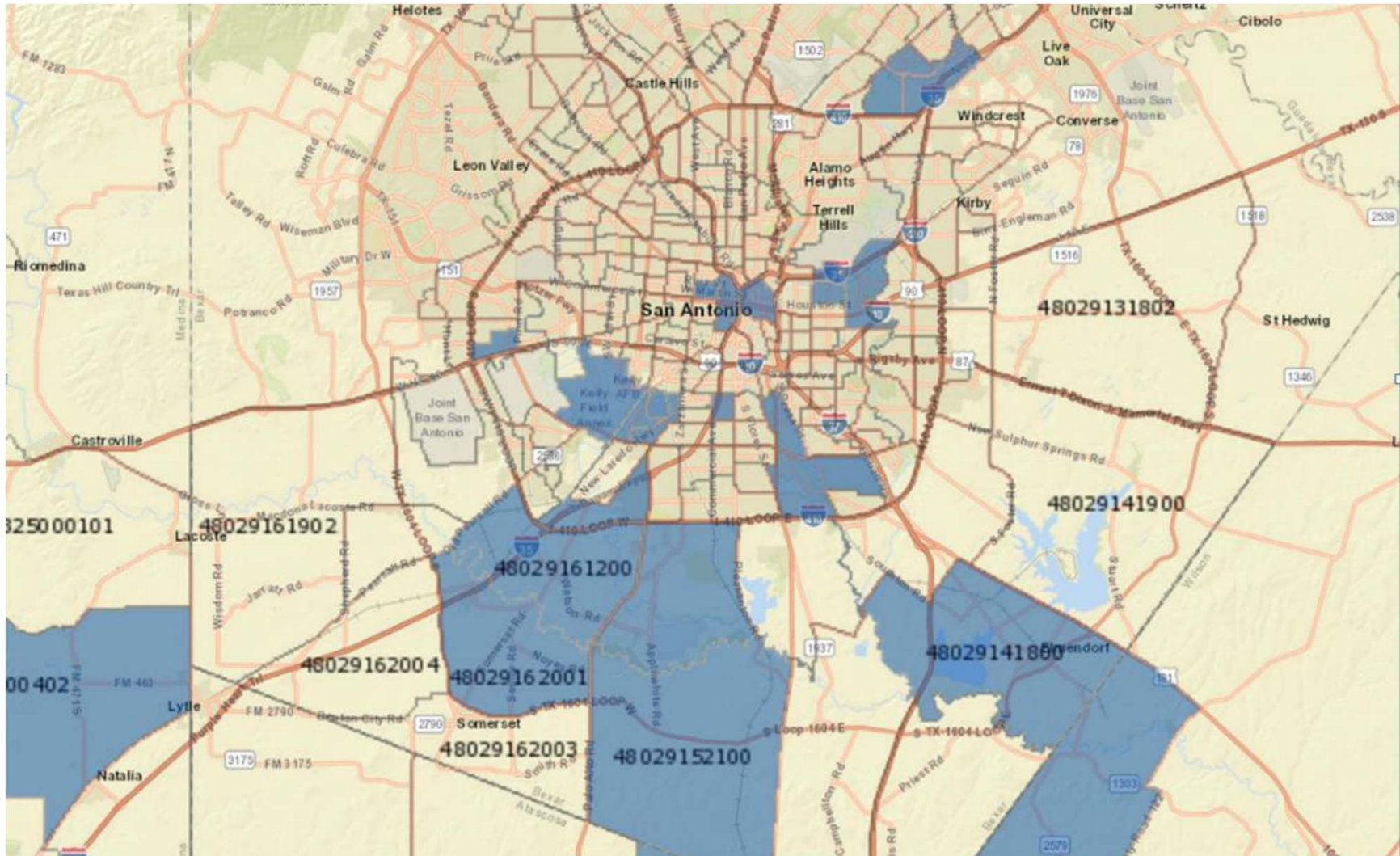
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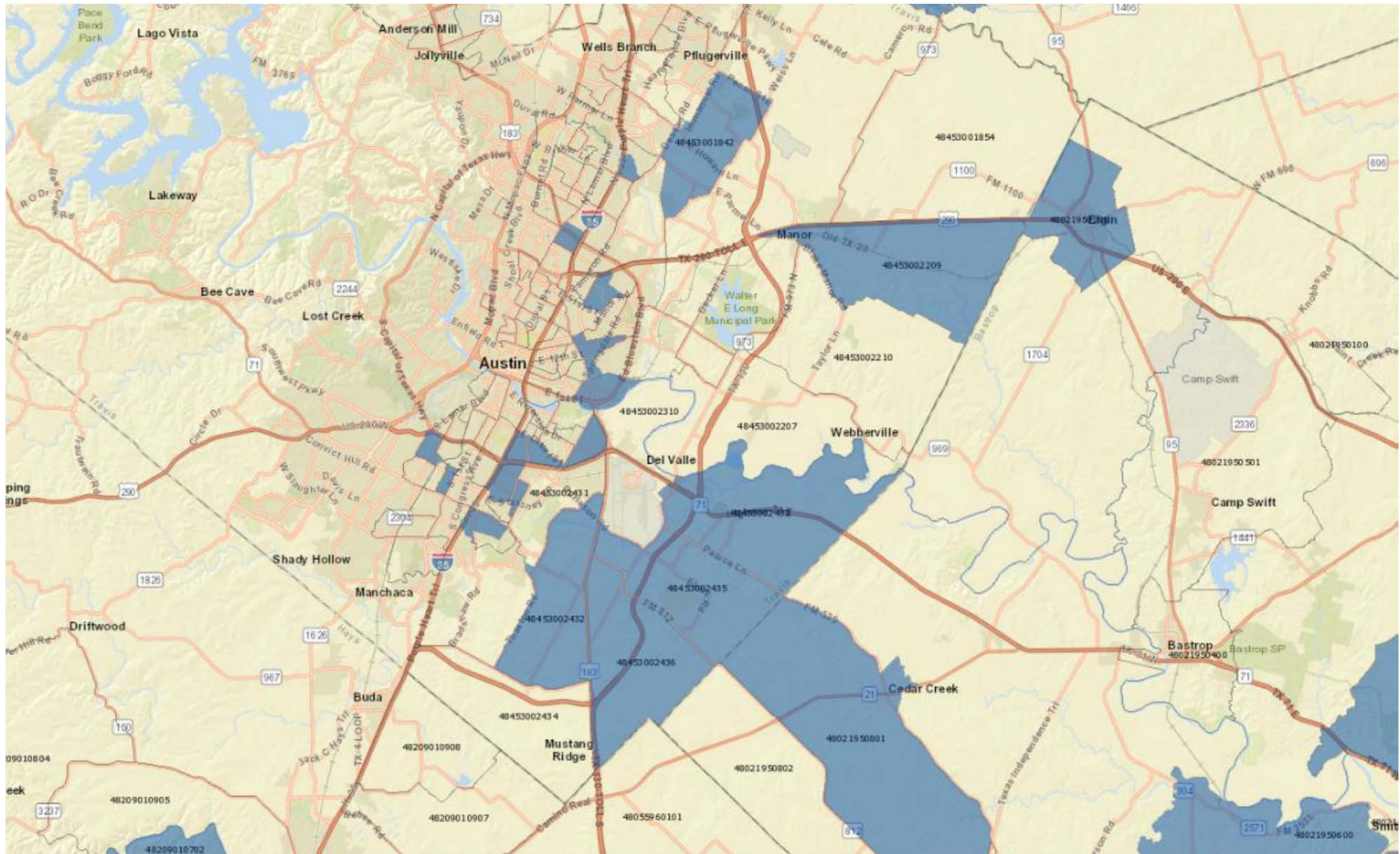
Qualified Opportunity Zones - Houston



Qualified Opportunity Zones – San Antonio



Qualified Opportunity Zones – Austin



The Tax Incentives – Deferral, Reduction, Exclusion

1. Deferral of Invested Gains



- **Deferral Mechanics**

- An eligible taxpayer can elect to exclude from gross income so much of an eligible gain as does not exceed the aggregate amount invested by the taxpayer in a QOF eligible interest during the 180-day period beginning on the date of such eligible gain would otherwise be recognized
- Election is made on **IRS Form 8949** (sale of capital assets) filed with tax return for the year in which the eligible gain would otherwise be taxable
 - Can elect for short-term gain, long-term gain, or both
 - OK to divide a single eligible gain into multiple QOF investments and elect deferral for each investment
 - No need to trace funds from gain transaction to QOF investment
 - OK to invest more than the amount of the eligible gain (a “mixed investment”), but the excess is a separate investment and doesn’t obtain the tax benefits

1. Deferral of Invested Gains

- **Eligible Taxpayer**

- Any person that may recognize gains for federal income tax purposes
 - Individuals (U.S. or non-U.S. persons);
 - C corporations, including regulated investment companies (RICs) and real estate investment trusts (REITs);
 - Partnerships (including LLCs classified as partnerships);
 - S corporations; and
 - trusts and estates

1. Deferral of Invested Gains

- **Eligible Gains**

- Three requirements:

- Treated as capital gain for federal income tax purposes
 - Ordinary income gains (e.g., recapture) are not eligible gains
- Would otherwise be recognized before January 1, 2027
- Not from a sale or exchange with a related person within the meaning of section 267(b) or 707(b)(1) (applying a >20% ownership test)

- Eligible gains include short-term capital gain, capital gain dividends from RICs and REITs, net Sec. 1231 gains, and unrecaptured Sec. 1250 gains

- Gain on transfer of property for a QOF interest is not eligible gain

- Can T sell the property to the QOF for a note and then contribute the note?

- Sec. 1256 contracts: only capital gain component is eligible gain

- Gain from offsetting positions transaction is not eligible gain

1. Deferral of Invested Gains

- **Eligible Interest**

- Investments in QOF equity (e.g., stock or partnership interest)

- QOF debt is not an eligible interest, but
- QOF preferred equity is an eligible interest
- Can be acquired from the QOF or from a direct owner of the QOF

- Mixed investments

- Portion of investment in an eligible interest for which a gain deferral election is properly made is a “qualifying investment” (“QI”)
 - Initial basis for the qualifying investment is zero
- Portion of investment in an eligible interest in excess of gain and for which a gain deferral election is not or cannot be made is a “non-qualifying investment” (“Non-QI”) (i.e., does not obtain the tax deferral, reduction, or exclusion benefits)

1. Deferral of Invested Gains

- **180-Day Period**

- General rule: begins on the date the eligible gain would otherwise be recognized for tax purposes
- Installment sale gains:
 - Not specifically addressed in the proposed regulations
 - Default rule is probably 180-days from each recognition date
 - But seller should be able to elect out of the installment method and invest the entire eligible gain in the 180-day period from the sale date
- Net section 1231 gains: begins on the last day of the taxpayer's tax year
- RIC and REIT capital gain distributions: begins on last day of the RIC/REIT's tax year
- Pass-through entities: see slide 29

1. Deferral of Invested Gains

- **Investment Amount**

- Deemed contributions from partnership debt allocations do not count
 - Example: T invests \$100,000 in a QOF partnership. QOF borrows \$50,000 allocable to T under Sec. 752. T's investment in the QOF is \$100,000 (does not include T's \$50,000 share of partnership debt).
- Property contributions for QOF interests are permitted
 - Non-taxable contribution: the investment amount is the lesser of the basis or FMV of the equity received
 - Taxable contribution: the investment amount is the FMV of the contributed property, but any gain recognized on the contribution is not eligible gain
 - Any excess of FMV over basis in contributed property is treated as a non-qualifying investment (i.e., can't be used to defer other recognized gains)
 - A contribution to a QOF partnership that is characterized as a disguised sale is not an eligible investment
 - If T sells the property to the QOF and then invests the proceeds in the QOF, is the property eligible OZ property, is the gain eligible gain, and is the entire QOF interest an eligible investment?

1. Deferral of Invested Gains

- **Basis for the QOF Interest**

- The initial basis for the eligible interest (qualifying investment) is \$0
- The IRS has requested comments on inside-outside basis disparity
- Normal basis rules apply to any non-qualifying investment and to the QOF's basis for contributed property

1. Deferral of Invested Gains

- **Complete Dispositions of QOF Interests**

- If an investor's *entire interest* in a QOF is disposed of and the deferred gain is recognized, the originally deferred gain and any post-investment eligible gain recognized can be reinvested in a new QOF interest within 180-days from the disposition date under a new deferral/exclusion election
 - The new QOF investment has a new holding period for purposes of the 5, 7 and 10-year holding period rules (i.e., there is no “tacking” of the holding period for the original QOF interest onto the holding period for the new QOF interest)
 - Also, post-investment gain accrued at the reinvestment date is classified as pre-investment gain that can only be deferred and not excluded

1. Deferral of Invested Gains

- **Partial Dispositions of QOF Interests**

- No new deferral/exclusion election permitted
- Accounted for on a first in, first out (FIFO) basis, with pro-rata accounting for QOF interests acquired on the same day
- The accounting convention is relevant for determining
 - (a) Whether a gain deferral election applies to the QOF interests disposed of (if some QOF interests were acquired without a gain deferral election),
 - (b) character of recognized gain from QOF interests disposed of, and
 - (c) holding period for the QOF interests disposed of

1. Deferral of Invested Gains

- **Pass-Through Entities (Partnership, S Corp., Trust or Estate)**

- A pass-through entity can invest its eligible gains within 180 days of the date the gain would otherwise be recognized by the entity
 - An entity apparently cannot elect to defer its net section 1231 gain to the extent the entity's section 1231 gains and losses are flowed through to its owners and "capital gain net income" is determined at the owner level
- To the extent the entity does not elect deferral, the owners can make an election for owner-level investments of their allocable shares of the entity's eligible gains (a) within 180 days of the entity's year end, or (b) by election, within the entity's 180-day investment period
 - IRS has been asked to provide guidance on how this works
 - An owner must notify the entity of any election to use the entity's 180-day investment period
- *For 2018 gains from pass-through entities, the 180-day investment deadline is **6/29/2019***

2. Reduction of Deferred Gains

- **5-Year 10% Rule:** If investment in QOF is held for 5 years, basis is increased by 10% of gain deferred
- **7-Year 15% Rule:** If investment in QOF is held for 7 years, basis is increased by an additional 5% of gain deferred (15% total)
- **Implied Deadlines:**
 - **12/31/2019**: Last date to invest in a QOF and obtain the full 15% basis increase (if QOF interest is held until at least 12/31/2026)
 - **12/31/2021**: Last date to invest in a QOF and obtain the 10% basis increase (if QOF interest is held until at least 12/31/2026)

Rewards swift and sustained investment in QOFs.

3. Exclusion for Post-Investment Gain

- **10-Year 100% Rule:** If the taxpayer holds a QOF investment for at least 10 years, the taxpayer may elect to increase the basis of the investment to the fair market value of the investment on the date it is disposed of (i.e., no gain on sale)
 - The last date to invest in a QOF is 12/31/2028 (the date when all O-Zone designations expire)
 - A QOF interest can be held until 12/31/2047 and still qualify for gain exclusion
 - Facilitates holding the QOF investment for up to 19 years beyond the latest eligible investment date
 - Must dispose of the investment on or before 12/31/2047 to elect gain exclusion, but the IRS has asked for comments on a possible deemed stepped up basis election at 12/31/2047
 - IRS has been asked to eliminate the 12/31/2047 end date

Carried Interests

- A QOF carried/profits interest is not a qualifying investment
- Example:
 - T invests \$50,000 in a QOF LLC, and has a \$50,000 eligible gain. M invests \$950,000 in the LLC. After return of capital, LLC profits are distributed 70% to M and 30% to T. The LLC is sold after 12 years for \$3,000,000. T recognizes a gain of \$670,000 $[(30\% + 50/1,000 \times 70\%) \times \$2,000,000]$.
 - T has a “mixed investment”: the portion of the QOF interest received for cash is a qualifying investment (QI) and the remainder of the interest (i.e., the “carried” interest) is a Non-QI
 - Gain allocable to T’s Non-QI is based on T’s highest share of residual profits, and gain allocable to T’s QI is based on T’s relative share of capital
 - Only \$70,000 of T’s \$670,000 gain is eligible for exclusion $[50/1,000 \times 70\% \times \$2,000,000 = \$70,000]$

Debt Financed Interests

- An investor can acquire a QOF interest using borrowed funds (including borrowed funds secured by the QOF interest)
- Example:
 - T has a \$50,000 allocable share of capital gain from a partnership, but the partnership does not make any corresponding distribution to T. Within the applicable 180-day period, T borrows \$50,000 and invests in a QOF. T should be eligible for deferral of the \$50,000 allocable share of partnership capital gain.
 - Same result if T pledges the partnership interest and the QOF interest as security for the borrowing
- The QOF can also borrow to finance its investment in qualifying property (i.e., a “levered” QOF is permitted)
 - Will lenders participate without their own incentives?

Coordination with Other Tax Incentives

- Federal O Zone tax incentives are not affected by other federal, state, or local tax incentives (e.g., local property tax abatements, tax favored financing, LIHTC, energy credits, etc.)
 - Sec. 1202 qualified small business stock?
- States that impose income tax based on federal taxable income (i.e., “federal conformity” states) generally will allow deferral and exclusion of gain for state income tax purposes based on the federal rules
 - Not all states conform to federal taxable income (e.g., CA)
 - Some states are providing specific incentives (e.g., state income tax credits)

Qualified Opportunity Funds

Qualified Opportunity Funds

- **Qualified Opportunity Fund (“QOF”) Requirements**

- **Organization test**: organized as a corporation or partnership/LLC
- **Purpose test**: purpose of the entity is to invest in qualified opportunity zone property (“**OZ Property**”), other than another QOF
 - *The QOF’s organizing documents must include a statement of the entity’s purpose of investing in OZ Property and a description of the intended business*
 - The prohibition on investing in another QOF (i.e., on “fund-of-fund” structures) appears to be intended to prevent dilution of the 90% assets test using multiple tiers of entities
- **Assets test**: At least 90% of its assets = OZ Property (90% Assets Test)

Qualified Opportunity Funds



- **QOF Reporting**

- Annual self-certification on IRS Form 8996
 - Type of entity and confirmation of purpose
 - Average assets test calculation (and penalty calculation if fail)
 - Possible expanded reporting requirements for 2019 (e.g., EIN of subsidiaries and amounts invested in specific census tracts)
- Investor remedies for fund's failure to satisfy tests?
- Is social impact reporting coming?
 - Regulations?
 - Legislation?
 - State/local requirements?
 - Industry practice/coercion?

Qualified Opportunity Funds

- **QOF Jurisdiction of Organization**

- In general: To qualify as a QOF, an eligible entity must be organized in one of the 50 states, the District of Columbia, or a U.S. possession
 - Includes an entity organized under the law of a Federally recognized Indian tribe if the entity's domicile is located in one of the 50 states (allows tribes to charter corporations and partnerships that are QOFs)
- U.S. possessions: If the eligible entity is organized in a U.S. possession only, it must be organized for the purpose of investing in OZ Property that relates to a trade or business operated in the U.S. possession in which the entity is organized (e.g., Puerto Rico)

Qualified Opportunity Funds



- **90% Assets Test**

- Test: QOF must hold at least 90% of its assets in OZ Property
- Testing dates:
 - Average percentage of OZ Property held by the QOF measured on:
 - last day of first 6-month period of the QOF's taxable year, and
 - last day of the QOF's taxable year
 - The fund can specify the taxable year and month in which it first becomes a QOF; investments before such first month do not qualify for benefits
 - If first month is after the sixth month of the year, testing dates are the last day of the each taxable year
 - Example 1: A calendar year QOF having a start date in April 2019 has testing dates of September 30, 2019, December 31, 2019, and each December 31 thereafter
 - Example 2: A calendar year QOF having a start date on or after July 1, 2019 has testing dates of December 31, 2019 and each December 31 thereafter

Qualified Opportunity Funds

- **90% Assets Test (con't)**

- Funds held for investment (new capital):

- Exclude amounts held in cash, cash equivalents, and <18 month debt and received ≤ 6 months prior (i.e., up to 12-month investment period)
 - Example: for 12/31/19 testing date, funds received after 6/30/19 and continuously held in qualified investments can be excluded from the 90% assets test at 12/31/19, but would be counted at the 6/30/20 testing date.

- Inventory

- In transit to/from O Zone - treated as in O Zone
 - Warehoused outside the O Zone - ?

Qualified Opportunity Funds

- **90% Assets Test (con't)**

- Asset valuation methodology:

- General rule: QOF can annually elect to value assets using either –

- Carrying value as reported on the QOF's "applicable financial statement" (as defined in Reg. 1.475-4(h)), if applicable
 - Otherwise, cost basis
 - Elected method must be applied consistently to all assets valued for that year

- Leased Assets

- If the applicable financial statement method is elected, use the value assigned to the leased asset under GAAP (if required to be so stated)
 - Otherwise, the value of each leased asset is the present value of the applicable lease payments, calculated at the time QOF enters into the lease and using the IRS prescribed "applicable federal rate"
 - » Once the leased asset's value is calculated under the present value method, it stays constant thereafter

Qualified Opportunity Funds

- **90% Assets Test (con't)**

- Reinvestment (recycling) rule

- A QOF's proceeds from the disposition of OZ Property is treated OZ Property to the extent the proceeds are
 - reinvested by the QOF in OZ Property by the last day of the 12-month period beginning on the date of disposition and
 - continuously held in cash, cash equivalents, and \leq 18-month debt prior to reinvestment
- If reinvestment is delayed by waiting for governmental action on a completed application, that delay does not cause a failure of the 12-month requirement
- No rollover of gain on disposition unless some applicable deferral provision applies (e.g., a like-kind exchange under Sec. 1031, exchange of OZ Stock in a tax-free reorganization under Sec. 354, etc.)
- No similar reinvestment (recycling) rule for an OZ Business
 - But OZ Business may be able to distribute cash to the QOF owner for reinvestment

Qualified Opportunity Funds

- **OZ Property**

- **Direct**: qualified opportunity zone business property (“**OZ Business Property**”)
- **Indirect**: qualified opportunity zone stock (“**OZ Stock**”) or qualified opportunity zone partnership interest (“**OZ Partnership Interest**”)

Qualified Opportunity Funds

- **Direct: OZ Business Property**

- Tangible property used in a trade or business of the QOF
- Acquired by the QOF by purchase after 12/31/17
- Either:
 - the original use of the property in the O Zone commences with the QOF, or
 - the QOF substantially improves the property
- During substantially all (90%) of the QOF's holding period for the property, substantially all (70%) of the use of the property is in an O Zone

Qualified Opportunity Funds

- **Direct: OZ Business Property (con't)**

- Trade or business of a QOF

- Trade or business determined under Sec. 162 (business expenses)
 - Property leased under a triple net lease (tenant pays taxes and fees, insurance, and all maintenance costs, in addition to utilities) is generally not treated as used in a business

- Acquired by purchase or lease after 12/31/17:

- Property acquired by purchase from related persons excluded (20% ownership overlap test, with attribution rules)
 - Property can be leased from related persons with limitations (see below)

Qualified Opportunity Funds

- **Direct: OZ Business Property (con't)**

- Original use in the O Zone

- Use commences on the date the purchaser or a prior person first places the property in service in the O Zone for depreciation purposes (or first uses the property in the O Zone in a manner that would allow depreciation if that person were the property's owner).
- *Imported used property*: property not previously used in “the” O Zone can qualify (i.e., original use for previously used property can occur in the O Zone)
- *Vacant property*: property that is vacant for at least 5 years can qualify
- *Lease improvements*: considered purchased property and satisfy original use
- *Land*: original use requirement not applicable [Rev. Rul. 2018-29]

Qualified Opportunity Funds

- **Direct: OZ Business Property (con't)**

- Substantial improvement: Additions to basis during any 30-month period following acquisition exceed basis at start of the 30-month period
 - Land:
 - Substantial improvement requirement not applicable [Rev. Rul. 2018-29]
 - Must be used in a business (no speculation)
 - Anti-abuse rule (no “land banking”): OZ Property excludes unimproved or minimally improved land acquired with an expectation, intent, or view to not improve it by more than an insubstantial amount within 30 months of purchase (e.g., ranch or farm)
 - Asset by asset test (but IRS considering aggregation rules)
- Location of use:
 - No guidance how the 90% of holding period and 70% of use requirement applies to real property that straddles an O Zone (e.g., sewer system or broadband system that serves areas both within and outside the O Zone)
 - Compare rule for OZ Business entity real estate straddling an O Zone (slide 55)

Qualified Opportunity Funds

- **Direct: OZ Business Property (con't)**

- Leased property used in the QOF's business:

- Leased after 12/31/17
 - Original use or substantial improvement test not applicable
 - Substantially all (70%) of the use of the property is in an O Zone during substantially all (90%) of the period the QOF leases the property
 - Must be a market rate lease
 - Lessor can be a related person, but in such a case
 - No prepayment for period > 12 months
 - If the original use of the property in an O Zone does not commence with the lessee, the lessee must acquire/own OZ Business Property in the same O Zone, or in a substantially overlapping O Zone, within the first 30 months of possession under the lease (or, if sooner, the last day of the lease) with a value not less than the leased property value
 - Anti-abuse rule for real property with a below-market purchase option

Qualified Opportunity Funds

- **Indirect: OZ Stock**

- Stock in a domestic corporation if –
 - The stock is acquired by the QOF after 12/31/17 at original issue from the corporation (or through an underwriter) for cash
 - At time of issuance, the corporation was a qualified opportunity zone business (“**OZ Business**”), or was being organized for the purpose of being such
 - The corporation qualified as an OZ Business during substantially all (90%) of the QOF’s holding period for the stock
- Governing documents must include an express statement of purpose to conduct an OZ Business, and will likely include covenants in favor of QOF investors to maintain such status
- Redemption anti-abuse rules apply

Qualified Opportunity Funds

- **Indirect: OZ Partnership Interest**

- A capital or profits interest in a domestic partnership if –
 - The interest is acquired by the QOF after 12/31/17 from the partnership solely in exchange for cash
 - At time of acquisition, the partnership was an OZ Business, or was being organized for the purpose of being such
 - The partnership qualified as an OZ Business during substantially all (90%) of the QOF's holding period for the stock
- Governing documents must include an express statement of purpose to conduct an OZ Business, and will likely include covenants in favor of QOF investors to maintain such status
- Redemption anti-abuse rules apply

Qualified Opportunity Funds

- **OZ Business**

- Context: Corporate stock is OZ Stock, and a partnership interest is an OZ Partnership Interest, only if the corporation or partnership (entity) is a “qualified opportunity zone business” (“**OZ Business**”)
- Definition: A trade or business –
 - where substantially all ($\geq 70\%$) of the tangible property owned or leased by the trade or business is **OZ Business Property** (substituting OZ Business for QOF) *;
 - that satisfies certain “**enterprise zone tests**” (slide 54); and
 - that is not a “**disqualified business**” (slide 60)

*Note that the 70% test applies only to the entity’s *tangible property*, whereas the 90% assets test for a QOF applies to the QOF’s *total assets*, meaning that a OZ Business has greater flexibility to hold working capital, up to 5% other financial assets, and ancillary non-financial assets.

Qualified Opportunity Funds

- **OZ Business (con't)**

- 70% of tangible property test:

- Valuation of assets:

- See QOF valuation rules above (slide 42)

- A QOF owner can value the OZ Business entity's assets using the QOF owner's valuation method if no other QOF owns $\geq 5\%$ of the entity

- If there are two or more QOF owners and at least one is a $\geq 5\%$ owner, the OZ Business entity's assets are measured using the method used by a $\geq 5\%$ owner that produces the highest percentage of OZ Business Property

- Contributed property

- Cannot qualify as OZ Business Property, so need to have 2.3x ($70\% \div 30\%$) in qualifying tangible property before next testing date to avoid flunking the 70% test

- Limits the ability to contribute existing property in an O Zone to an OZ Business entity for development

Qualified Opportunity Funds

- **OZ Business (con't)**

- Enterprise zone tests

- Gross income test. At least 50% of the entity's gross income is derived from the active conduct of a trade or business in the O Zone (including income on reasonable working capital)
 - Intangible property test. A substantial portion (40%) of the entity's intangible property is used in the active conduct of a trade or business in the O Zone
 - Nonqualified financial property test. <5% of the aggregate unadjusted bases of the entity's property is nonqualified financial property (NQFP)
 - NQFP includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations
 - ***Working capital exception. NQFP excludes (a) reasonable amounts of working capital held in cash, cash equivalents, or short-term debt (≤18 months), and (b) trade receivables (see also 31-month working capital safe harbor below)***

Qualified Opportunity Funds

- **OZ Business (con't)**

- Real property that straddles an O Zone

- When it is necessary to determine the location of services, tangible property, or business functions under the Enterprise Zone tests, if the business uses real property outside the O Zone that is contiguous to part or all of real property used within the O Zone, and if the portion (based on square footage) within the O Zone is substantial in relation to the portion outside the O Zone, then all of the real property is deemed to be located within the O Zone
 - Effect of this rule is that services, tangible property, and business functions with respect to the portion of the real property outside the O Zone are deemed to be performed or located within the O Zone
 - “Substantial” is not defined for in either the E Zone or O Zone rules
 - The preamble to the April 2019 proposed O Zone regulations says substantiality “should be” satisfied if the unadjusted cost basis of property inside exceeds the unadjusted cost basis of property outside
 - NB: substantial generally means something less than 50%

Qualified Opportunity Funds

- **OZ Business (con't)**

- Gross income test

- Gross income test safe harbors:

- *Hours.* ≥50% of services performed (based on hours) for the business by employees and contractors (and their employees) are within an O Zone
 - *Compensation.* ≥50% of services performed (based on compensation) for the business by its employees and contractors (and their employees) are within an O Zone
 - *Property and functions.* The tangible property of the business in an O Zone and the management or operational functions performed for the business in the O Zone are each necessary to generate 50% of the gross income of the business
 - If the safe harbors don't apply, a facts and circumstances test is used

Qualified Opportunity Funds

- **OZ Business (con't)**

- Intangible property test

- No guidance on determination of whether $\geq 40\%$ of the use of intangible property in the active conduct of a trade or business is in the O Zone
 - Trade or business means a trade or business as defined in Sec. 162 (relating to business expenses)
 - Ownership *and operation* (including leasing) of real property is a business
 - Merely entering into a triple net lease of real property is not a business
 - Definition apparently also applies for gross income test
 - “Active conduct” of a trade or business not defined (reserved)

Qualified Opportunity Funds

- **OZ Business (con't)**

- 31-month working capital safe harbor: qualified working capital assets are reasonable if three requirements are satisfied:
 1. *Written designation*. The assets are designated in writing for the development of a business, including when appropriate the acquisition, construction, or substantial improvement of tangible property in an O Zone.
 2. *Written schedule*. There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets within 31 months of the receipt by the business
 3. *Consistent use*. The working capital assets are actually used in a manner that is substantially consistent the written designation and schedule
- Multiple overlapping or sequential uses of safe harbor permitted
- Extension of 31-month period for reasonable cause
 - Delay waiting for government action on a completed application permitted
 - Unexpected weather delays or other?

Qualified Opportunity Funds

- **OZ Business (con't)**

- Safe-harbors related to the 31-month working capital safe harbor:
 - Gross income safe harbor: for purposes of 50% gross income requirement, income from working capital assets is counted as qualifying income
 - Intangible property safe harbor: the use requirement for intangible property is treated as satisfied during the time that the business is proceeding in accordance with the working capital safe harbor
 - Tangible property safe harbor: the entity's tangible property is treated as OZ Business Property if the property is expected to so qualify taking into account the scheduled expenditures of working capital assets
- OZ Business Property disqualification safe harbor: Tangible property that ceases to be OZ Business Property is treated as OZ Business Property for the lesser of (a) 5 years from the date it ceases to be OZ Business Property or (b) the date the property is no longer held by the OZ Business

Qualified Opportunity Funds

- **OZ Business (con't)**

- Disqualified businesses (a/k/a “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 for consumption off premises
 - A cannabis-related business is not a disqualified business
 - If a QOF directly operates a disqualified business in an O Zone, the disqualified business property can qualify as OZ Property, but if the QOF operates the disqualified business through a subsidiary corporation or partnership, the subsidiary stock or partnership interest would not qualify as OZ Property
 - Did Congress intend this?

Qualified Opportunity Funds

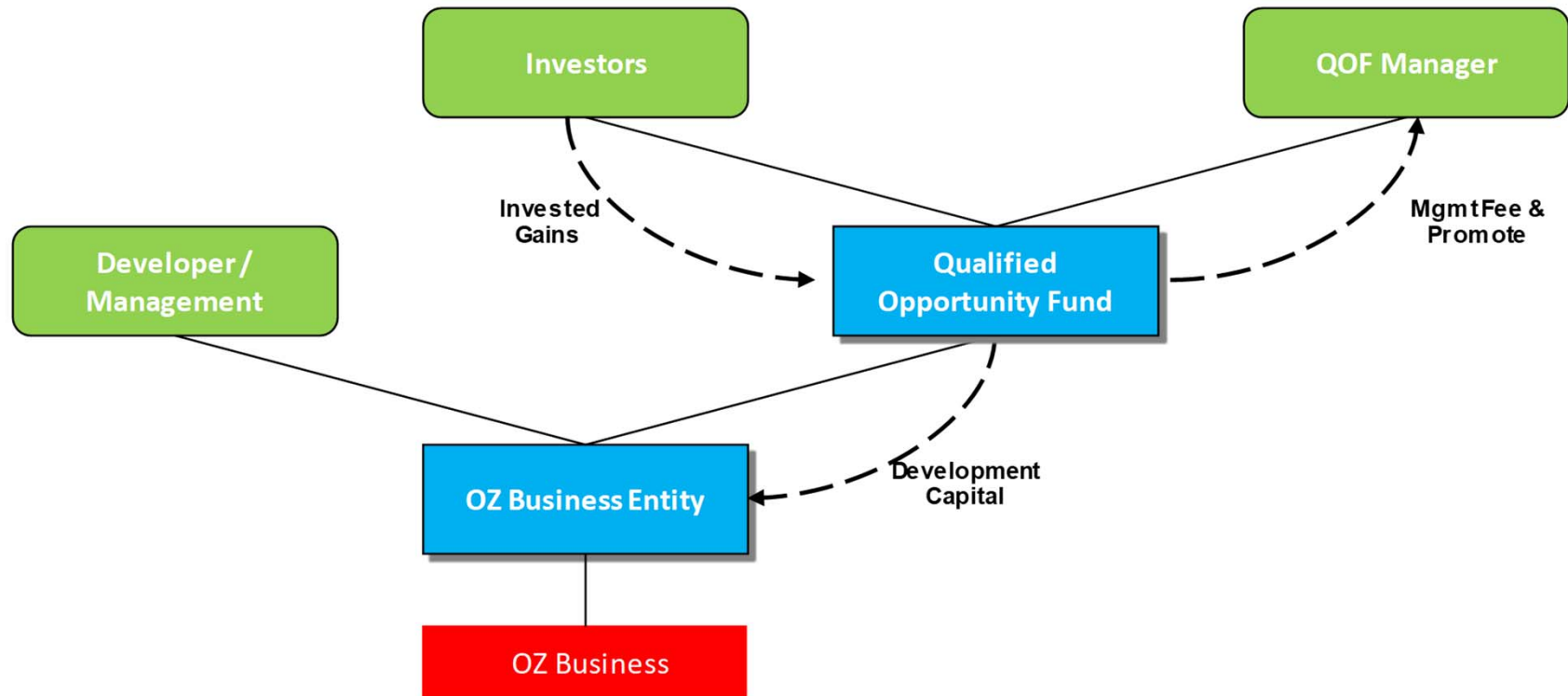
- **Tiered Investment Structures**

- A QOF investment in an OZ Business entity (Cat. 1 or 2) is OZ Property
 - Allows more non-qualifying assets (30%+ vs. 10%)
- A QOF investment in another QOF is not OZ Property
- An OZ Business entity's investment in a subsidiary corporation or partnership holding only OZ Property is not OZ Property
- These limitations are apparently intended to prevent excessive dilution of the 90% assets test
 - **Example:** QOF #1 invests 90% of its assets in QOF #2, which invests 90% of its assets in OZ Stock. The issuer of the OZ Stock invests 70% of its assets in a subsidiary which invests 70% of its assets in OZ Property. Assuming each entity's only funds originated from QOF #1, the consolidated percentage investment in OZ Property is less than 40% (90% x 90% x 70% x 70%).

Qualified Opportunity Funds

- **Typical Tiered Investment Structure**

- Example of a permitted two-tier structure:*



*An Investor or manager can be a multi-tiered pass-through entity.

Qualified Opportunity Funds

- **Tiered Investment Structures (con't)**
 - **Factors favoring two-tier investment structure**
 - 70% OZ Business Property test (versus 90% Assets Test)
 - IP used in the business is eligible property
 - Working capital safe harbor, including 31-month investment period
 - **Factors favoring direct investment by QOF**
 - No prohibition on disqualified business
 - Simple (for investments that easily meet the OZ Business Property test)

Qualified Opportunity Funds

- **Multiple Investors**

- There is no limitation on an OZ Business entity accepting investments from multiple QOFs
- There is no limitation on an OZ Business entity accepting investments from both QOFs and other investors
 - Extra reporting by OZ Business entity to QOFs

Qualified Opportunity Funds

- **Penalty for Failure to Meet 90% Assets Test**

- Penalty = (90% of assets – OZ Property) x 6621(a)(2) underpayment rate
 - 6621(a)(2) underpayment rate currently 6%
 - Computed monthly
 - *Effectively forfeit an implied 6% return on excess nonqualified assets*
- Applied at the partner level in the case of a QOF partnership
- Reasonable cause exception
 - No current guidance on reasonable cause, but IRS might draw from rules for REITs; see, e.g., Reg. § 1.856-7(c), including reliance on expert advice
- Reinvestment grace period (12 months; see slide 43)
- No statutory de-certification procedure

Inclusion of Deferred Gains

Inclusion of Deferred Gains

- The deferred gain is included in income on the earlier of
 - the date of an “inclusion event”* or
 - 12/31/2026
- Character of recognized gain tracks character of deferred gain
- Tax rate is the ***rate in effect on the recognition date*** (e.g., 2026 for gains deferred for the maximum deferral period)
- Investors will need to plan for payment of tax prior to liquidation of their qualifying investment

* The statute says “sale or exchange,” but the IRS believed Congress intended to include any transaction that amounts to a “cashing out” of the taxpayer’s equity investment. The statute gives Treasury authority to prescribe “such regulations as may be necessary or appropriate to carry out the purposes of this section.”

Inclusion of Deferred Gains

Handwritten mathematical notes and diagrams:

- Top left: $f(u) = \int f(x) dx$
- Top right: $H = \sum_{i=1}^n p(x_i) \log p(x_i)$
- Middle left: $TC(Q, q, m) = \sum_{i=1}^n [S_i + c_i \cdot D_i + \frac{q_i \cdot H_i}{2} (\ln(1 + \frac{2}{q_i}) - 1 + \frac{2}{q_i})]$
- Middle right: $\begin{bmatrix} \frac{d \Delta p(s, \phi)}{d \phi} \\ \frac{d \Delta M(s, \phi)}{d \phi} \end{bmatrix} = \begin{bmatrix} \gamma & -E \\ -\beta & 0 \end{bmatrix} \begin{bmatrix} \Delta p(s, \phi) \\ \Delta M(s, \phi) \end{bmatrix}$
- Bottom: $\int \frac{d \Delta p(s, \phi)}{d \phi} ds = \frac{d}{d \phi} \int \Delta p(s, \phi) ds$

- **Inclusion Events – General Rule**
 - T’s equity direct interest in the qualifying investment (“**QI**”) is reduced;
 - T receives property as a distribution from the QOF; or
 - T claims a worthlessness loss for the QI
- **Specified inclusion events and special rules:**
 - A transfer to a disregarded entity or grantor trust is not an inclusion event
 - A Sec. 351 contribution to a corporation generally is an inclusion event, but a Sec. 721 contribution to a partnership generally is not
 - May facilitate QOF “aggregator” partnerships
 - A transfer by gift generally is an inclusion event, but a transfer at death generally is not
 - Many other highly complex rules (slides 69 – 72)

Inclusion of Deferred Gains

- **Specified Inclusion Events and Special Rules**

- Termination or liquidation of the QOF
- Distribution of a QI in a taxable corporate liquidation under Sec. 336(a), but not in a tax-free liquidation under Sec. 337(a) (80% corporate shareholder)
- A transfer of a QI by gift (including a charitable contribution)
 - Gift to grantor trust is not an inclusion event
 - A transfer of a QI at death is not an inclusion event, but no basis step-up (IRD)
- Change in grantor trust status (other than at death)

Inclusion of Deferred Gains

- **Specified Inclusion Events and Special Rules (con't)**

- Partners and partnerships

- A transfer of a QI in a QOF partnership is generally an inclusion event
- Sec. 721 contribution of a QI is not an inclusion event unless it causes a QOF partnership termination
- Sec. 708(b)(2)(A) merger or consolidation of a partnership holding a QI is not an inclusion event if no sale or exchange
- A distribution by QOF partnership is an inclusion event to the extent the amount distributed (FMV)
 - exceeds the partner's basis in the QI (including debt basis and basis adjustments, or
 - is a disguised sale (treating any cash investment as a property contribution, which will generally capture debt-financed distributions within two years of investment)
- For mixed investments, the non-qualifying investment is treated as a separate partnership interest (only for O Zone purposes)
- Analogous rules for tiered partnerships (i.e., equity in a partnership that holds a QI or in an upper-tier partnership); indirect partner must notify QI owner
- Any transaction reducing remaining deferred gain is an inclusion event

Inclusion of Deferred Gains

- **Specified Inclusion Events and Special Rules (con't)**

- S corporations

- Not inclusion events: election, revocation, or termination of S corporation status; conversion of QSST to ESBT; modification of a trust; $\leq 25\%$ change in ownership; disposition of assets by QOF S corporation
- Inclusion events:
 - Distributions by an QOF S corporation with respect to a QI to extent of shareholder gain
 - >25% change in ownership of S corporation directly holding a QI, measured relative to ownership on original election date; entire deferred gain triggered
 - Taxable conversion to a partnership
- In the case of a mixed investment, for purposes of the S corporation one class of stock rule, QI stock is not a separate class from Non-QI stock
- Rules apply whether S corporation is a QOF or a QOF shareholder

Inclusion of Deferred Gains

- **Specified Inclusion Events and Special Rules (con't)**

- C corporation distributions to the extent shareholder gain is recognized
- Sec. 302(d) dividend-equivalent redemptions
- A transfer of QOF assets in an (A), (C), (D) or (F) corporate reorganization is generally not an inclusion event if the acquirer is a QOF, except to the extent of “boot”
- A transfer of QOF shareholder assets in such a reorganization is not an inclusion event except to the extent a shareholder’s QI is retained
- Certain Sec. 355 (corporate spin-off) transactions
- Certain corporate recapitalizations (to the extent of boot)
- Sec. 304(a) acquisition of stock by related corporations
- Worthlessness loss claimed
- Other determined in IRS published guidance

Inclusion of Deferred Gains

- **Holding Periods**

- General rule: no “tacking” of holding periods when property is exchanged for a QI in an non-taxable exchange
- Exceptions
 - QOF stock received in a qualifying reorganization
 - QOF stock received in a qualifying Sec. 355 spin-off
 - QI received in a gift that was not a inclusion event
 - QI received by reason of owner’s death
- Similar exceptions for “original use” with respect to assets transferred in corporate reorganizations and Sec. 355 spin-offs

- Analogous rules for partnership non-inclusion transactions

Inclusion of Deferred Gains

- **Basis Adjustments**

- Timing

- *Gain reduction basis adjustments.* The basis adjustments under the 5-Year 10% Rule and 7-Year 15% Rule are made automatically on the dates the QI is held for the specified period, but only to the extent of the portion of the QI that has not been subject to previous gain inclusion
 - *Deferred gain basis adjustments.* The basis adjustment is made immediately after the deferred gain inclusion (i.e., earlier of an inclusion event or 12/31/2026), but before determining the other tax consequences of the applicable inclusion event
 - *Gain exclusion basis adjustments.* The basis adjustment is made immediately prior to disposition of the interest

Inclusion of Deferred Gains

- **Basis Adjustments**

- *Amount*. Gain reduction basis adjustments are computed only on that portion of the qualifying investment that has not been subject to previous gain inclusion
- *Partnerships*. Any basis adjustments to a qualifying investment held by a partnership is matched by an adjustment to the partners' basis in their partnership interests
- *S corporations*. Any basis adjustments to a qualifying investment held by an S corporation is matched by an adjustment to the shareholders' basis in their stock, but only upon an inclusion event with respect to the qualifying investment

Inclusion of Deferred Gains

- **Amount Includible**

- *General rule*: lesser of remaining deferred gain or actual gain (apportioned for partial dispositions)
- *Distributions and boot*: lesser of remaining deferred gain or amount that gave rise to the inclusion event
- *Gain recognized 12/31/2026*: lesser of remaining deferred gain and unrealized gain taking into account only the gain reduction basis adjustments
- *Partnerships and S corporations*: for a qualifying investment in a QOF partnership or S corporation, lesser of remaining deferred gain (less any gain reduction basis adjustments) and actual/unrealized gain
- *Limitation after gain reduction basis increases*: amount includible can't exceed deferred gain less gain reduction basis adjustments

Inclusion of Deferred Gains

- 1.1400Z-2(b)-1(f) Example 3 (partial sale at a gain)

Date	Item	A	B	C	Total
10/1/2018	Qualifying investment	200	200	600	1,000
	Percentage interest	20%	20%	60%	100%
	Debt	200	200	600	1,000
	Basis	200	200	600	1,000
7/31/2024	FMV	1,000	1,000	3,000	5,000
	Owners equity	800	800	2,400	4,000
	Gain reduction basis adjustment (10%)	20	20	60	100
	Adjusted basis	220	220	660	1,100
	A sells 50% to B for \$400	(400)	400		-
	Owners equity	400	1,200	2,400	4,000
	Percentage interest	10%	30%	60%	100%
	1 A's remaining gain	180			
	2 Portion attributable to sale (50%)	90			
	3 A's actual gain	390	<< 50% x (debt + equity - basis)		
	4 Amount includible	90	<< lesser of 2 and 3		
	5 Additional gain recognized	300	<< 3 - 4		
	6 Remaining gain after sale	90	<< 1 - 2		

Inclusion of Deferred Gains

- 1.1400Z-2(b)-1(f) Example 4 (partial sale at a loss)

Date	Item	A	B	C	Total
10/1/2018	Qualifying investment	200	200	600	1,000
	Percentage interest	20%	20%	60%	100%
	Debt	200	200	600	1,000
	Basis	200	200	600	1,000
7/31/2024	FMV	300	300	900	1,500
	Owners equity	100	100	300	500
	Gain reduction basis adjustment (10%)	20	20	60	100
	Adjusted basis	220	220	660	1,100
	A sells 50% to B for \$400	(50)	50		-
	Owners equity	50	150	300	500
	Percentage interest	10%	30%	60%	100%
	1 A's remaining gain	180			
	2 Portion attributable to sale (50%)	90			
	3 A's actual gain	40	<< 50% x (debt + equity - basis)		
	4 Amount includible	40	<< lesser of 2 and 3		
	5 Additional gain recognized	-	<< 3 - 4		
	6 Remaining gain after sale	90	<< 1 - 2		

Post-Investment Gain Exclusion

- **Dispositions of 10-Year QOF Partnership Interest**

- Any gain exclusion basis adjustment to a partner's qualifying investment in a QOF partnership (outside basis) is matched by an adjustment to the basis of the partnership's assets (inside basis) calculated as for Sec. 743 basis adjustments
- The outside basis adjustment can apparently eliminate income otherwise taxable under Sec. 751 (relating to partnership ordinary income assets, a/k/a "hot assets"), and the corresponding inside basis adjustment can likewise be applied to partnership hot assets
 - See 1.1400Z-2(d)-1(d)(2), Example 2
 - Very significant for investors in renewable energy projects in O Zones

Post-Investment Gain Exclusion

- **Exclusion for Flow-Through Gains of 10-Year Investors**
 - *Partnerships and S corporations.* If T has held a qualifying investment in a QOF partnership or QOF S corporation for at least 10 years, and the entity disposes of OZ Property after such 10-year holding period, T can elect to exclude some or all of the entity's *capital gain* from the disposition of such OZ Property and attributable to T's qualifying interest
 - Election can apply to net section 1231 gains
 - Election does not apply to ordinary gains (e.g., depreciation recapture) or capital gain from non-OZ Property
 - Creates a preference for sale of partnership or S corporation equity rather than assets
 - Election is not available for sales of assets by OZ Business entities
 - *REIT capital gain dividends.* A holder of QOF REIT shares that are qualifying investments can receive tax-free capital gain dividends to the extent the holder held the REIT shares for at least 10-years as of the date specified by the REIT as the date of the capital gain with respect to underlying OZ Property

Rollovers / Recycling

- **No Rollover Exception**

- Taxpayers had asked for a rule that allowed a QOF to sell OZ Property and then reinvest in other OZ Property on a tax deferred (carryover) basis
- The IRS determined that it didn't have statutory authority to grant any such gain exclusion
- Normal Sec. 1031 like-kind exchange transactions and similar tax deferred transactions would continue to apply

Miscellaneous

Miscellaneous



- **General Anti-Abuse Rule**

- The rules must be applied in a manner consistent with the purposes of the statute
- If, based on all the facts and circumstances, the IRS determines that a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of the statute, the IRS can recast a transaction (or series of transactions) for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of the statute
- In short, no gaming the system!

Miscellaneous

- **Corporate Consolidated Groups**

- QOF stock is not stock for affiliated group purposes
- O Zone rules apply separately to each member of a consolidated group
 - The effect is that gains of one member may not be used to support a QOF investment by another member
- Gain reduction basis adjustments treated as non-taxable income for stock basis adjustments
- Gain exclusion basis adjustment so treated when basis of the qualifying investment is adjusted
- For purposes of the anti-loss duplication rules of 1.1502-36(d), a member's basis in a qualifying investment cannot be reduced.

Miscellaneous

- **Effective Date**

- The preamble to the April 2019 proposed rules says they generally apply to taxable years ending after the publication date
- The October 2018 preamble, and the actual proposed rules, say they generally apply to taxable years that begin on or after the date the rules are finalized
- In either case, taxpayers can rely on the rules for earlier periods, but only if the rules are applied in their entirety and in a consistent manner

Miscellaneous

- **IRS Request for Information**

- Seeks public input on the development of public information collection and tracking related to investment in QOFs
- Six questions:
 - What data would be useful in tracking the effectiveness of the incentives?
 - Is there tax form information that would be helpful in measuring effectiveness?
 - What data would be useful to measure investment amount due to incentives?
 - What data would help ensure that O Zones remain an attractive investment?
 - What are the costs and benefits of various methods of data collection and who should perform the data collection?
 - What factors should IRS consider in analyzing incentives' effectiveness and over what time period should the analysis occur?

Miscellaneous

- **Forthcoming Guidance and Rules**

- No further proposed regulations expected
- Possible sub-regulatory rules for a QOF that flunks the 90% Assets Test
- Information reporting requirements for eligible taxpayers (investors)
- Revisions to Form 8996 (QOF certification) for 2019 to require additional information (which could include tax identification numbers of OZ Business entities and amount invested by QOFs and OZ Business entities in particular O Zone census tracts)
- Legislation regarding data collection and public reporting (S. 1344)?

Miscellaneous

- **Open Questions**

- Possible reduction of 5-year vacancy period for original use test
- Aggregation of assets for substantial improvement test
- Possible relaxation of original use / substantial improvement requirements for near-new property or other circumstances
- Inventory warehoused outside an O Zone
- Determination of market rate for a lease
- QOF's location of use for OZ Business Property that straddles an O Zone
- Definition of trade or business and "active conduct"
- Delays in investment of working capital, or reinvestment of sale proceeds, due to reasons other than governmental approvals (e.g., contract disputes, supply embargoes, labor stoppage, unexpected weather events, and national disasters)
- Exclusion for post-investment ordinary gains on asset sales
- Exclusion for 10-year holder's share of OZ Business entity asset sale gains
- Other?

Summary

Summary

- O Zones cover a large swath of the country
- Attractive tax incentives to invest in those areas
 1. **Deferral** of invested gains to 12/31/2026
 2. **Reduction** of deferred gains after 5 years (10%) and 7 years (15%)
 3. **Exclusion** of post-investment gain after 10 years
- Pressure to invest prior to 12/31/2019 to maximize tax benefits
- Forming a QOF and investing in one are easy; compliance with the various assets and operational tests can be very complex
- Exit event rules also very complex
- **Buyer Beware: the tax benefits can't make a bad deal good**

Questions