

# Opportunity zones



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Although the Internal Revenue Service (“IRS”) and Treasury have issued proposed regulations that help to clarify some aspects of the statute discussed herein (*i.e.*, Section 1400Z-2 of the Internal Revenue Code), there still remains uncertainty with respect to the application of the statute and issued proposed regulations. In addition, the proposed regulations are not effective until Treasury adopts the proposed rules as final regulations but investors are generally permitted to rely on the regulations immediately but only if they apply the regulations consistently and in their entirety.

No assurance can be made that a fund will qualify as a “qualified opportunity fund” or that any Investor will achieve any tax benefit under any applicable law, including, without limitation, the so-called Tax Cuts and Jobs Act passed by the United States Congress in December 2017.

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## Overview

- A provision in the December 2017 tax act (“Tax Cuts & Jobs Act”) introduced a federal tax incentive for taxpayers<sup>1</sup> to invest capital in certain economically-distressed communities.
- This provision keys off the fact that many taxpayers have unrealized capital gains by offering capital gains tax deferral, and possibly forgiveness, to those who redeploy capital gain realized from any source into long-term investments in “qualified opportunity zones” (“QOZ”).
- QOZs are low-income community population census tracts nominated by state governors earlier this year and certified by the Secretary of the U.S. Treasury. QOZs have been approved in all 50 states, the District of Columbia, and all U.S. territories.<sup>2</sup>
- Taxpayers who reinvest capital gain from the sale or exchange of assets into “qualified opportunity zone funds” (“QOFs”) may be eligible for several tax benefits, depending on their holding period, including:
  - deferral of capital gains tax recognition arising from the sale or exchange of the original investment;
  - forgiveness of up to 15% of the original gain; and
  - forgiveness of any new gain in the QOF.

1. “Taxpayers” includes individuals, corporations, partnerships, and trusts, etc. 26 CFR § 1400Z-2(b)(1).

2. These tracts retain their status as opportunity zones for a 10-year period. A list of approved opportunity zones can be found in IRS Notice 2018-48, available here: <https://www.irs.gov/pub/irs-drop/n-18-48.pdf>.

## Tax attributes

- Unlike previous incentives offered to taxpayers to make certain investments in low-income communities, which were often in the form of limited tax credits, the opportunity zone provision may allow for advantageous federal tax treatment on potentially an unlimited amount of capital gain regardless of income level:
  - **Temporary Gain Deferral** | A taxpayer may elect to defer recognition of an unlimited amount of capital gain from the sale or exchange of property with an unrelated person<sup>1</sup> if that capital gain is reinvested in a QOF within 180 days.<sup>2</sup>
  - **QOF Basis Adjustments** | The Opportunity Zone provision seeks to reward long-term investment—the longer a QOF is held (and the earlier the investment is made prior to December 31, 2026), the bigger the benefit:
    - **Year 0** | A taxpayer's basis in the QOF is initially zero.
    - **Year 5** | If the taxpayer holds the QOF for at least 5 years (prior to December 31, 2026), his or her basis in the QOF may be increased by 10% of the original deferred gain (effectively resulting in forgiveness of 10% of the original gain).
    - **Year 7** | If the taxpayer holds the QOF for at least 7 years (prior to December 31, 2026), his or her basis in the QOF may be increased by an additional 5% of the original deferred gain (effectively resulting in the forgiveness of a cumulative 15% of the original gain).
  - **Recognition of Deferred Gain** | A taxpayer may be able to defer the (remaining) gain until the earlier of the date on which the QOF is sold or exchanged or December 31, 2026.
    - At the time of sale or exchange, or the 2026 recognition date, the taxpayer recognizes tax on the remaining original deferred gain (or the difference between the fair market value of the investment on the recognition date and the taxpayer's basis in the QOF, adjusted as described above, if that amount is less due to negative investment performance)
  - **Forgiveness of Tax on New Gain** | A taxpayer holding a QOF for at least 10 years may elect to exclude from income all new capital gains arising from the QOF investment, whenever it is subsequently sold or exchanged.

1. Parties are generally considered related if there is at least 20% common ownership. IRC § 1400Z-2(e)(2).

2. To the extent a taxpayer invests more than gain realized from recent sales or exchanges into a QOF, the investment will be bifurcated into two investments—one eligible for QOF benefits, and another that is not. There does not appear to be a tracing doctrine regarding the realized capital gain, so cash from any source may be able to be invested in a QOF. IRC § 1400Z-2(e)(1).

## What is a Qualified Opportunity Fund?

- A **Qualified Opportunity Fund (QOF)** is a corporation or partnership organized for the purpose of investing in QOZ property. What qualifies as QOZ property is determined by layered definitions (see *QOZ Property: Requirements & Definitions*, p. 9), but there are three threshold categories of QOZ property:
  - **QOZ stock**;
  - **QOZ partnership interests**; and
  - **QOZ business property**.
- A QOF must hold at least **90%<sup>1</sup> of its assets** in such QOZ property or face a material monthly penalty<sup>2</sup> unless reasonable cause for failure to meet the test can be shown.
- An eligible taxpayer can self-certify to become a QOF, with no IRS approval required.
  - The taxpayer merely completes **Form 8996** and attaches it to his, her, or its timely-filed federal income tax return.
    - As such, many QOFs likely will be created by a single investor who invests gain into QOZ projects they personally select (e.g., a corporate form dry cleaning business in a designated zone in the Bronx).
    - However, as guidance emerges, many QOFs are expected to take the form of investment pools through which multiple taxpayers may invest gains into a single QOF that invests in QOZ projects that are identified and vetted by fund managers (somewhat like the traditional private equity fund model).

1. Measured by the average percentage of QOZ property in the fund as measured on i) the last day of the first 6-month period of the fund's taxable year and ii) the last day of the fund's taxable year. IRC § 1400Z-2(d)(1).

2. Equal to the short-term applicable federal rate + 3% on the shortfall, applied on a monthly basis. IRC § 6621(a)(2).

## QOZ Property: Requirements and definitions

QOZ Stock REQUIREMENTS	QOZ Partnership Interest REQUIREMENTS	QOZ Business Property REQUIREMENTS	QOZ Business DEFINITION
<p>Any stock in a domestic corporation acquired by the QOF in 2018 or later</p> <p>Must be original issue from corporation acquired solely in exchange for cash<sup>i</sup></p> <p>At issue, corporation was a QOZ business, or was newly organized to be a QOZ business</p> <p>During substantially all of the QOF's holding period for the stock, the corporation qualified as a QOZ business</p>	<p>Any capital or profits interest in a domestic partnership acquired by the QOF in 2018 or later</p> <p>The interest must have been acquired from partnership solely in exchange for cash</p> <p>When the interest was acquired, the partnership was a QOZ business or newly organized to be a QOZ business</p> <p>During substantially all of the QOF's holding period for the interest, the partnership qualified as a QOZ business</p>	<p>Must be tangible property used in a trade or business</p> <p>Acquired in 2018 or later</p> <p>The original use of the property in the QOZ commences with the QOF, or the QOF substantially improves the property<sup>ii</sup></p> <p>During substantially all of the QOF's holding period for the property, substantially all of the use of such property was in a QOZ</p>	<p>A trade or business in which:</p> <p>Substantially all of the tangible property owned or leased by the taxpayer is QOZ business property, substituting "QOZ business" for "QOF" in that definition, i.e.:</p> <ul style="list-style-type: none"> <li>• Tangible property used in a trade or business</li> <li>• Acquired in 2018 or later</li> <li>• The original use of the property in the QOZ commences with the QOZ business, or the QOZ business substantially improves the property<sup>ii</sup></li> <li>• During substantially all of the QOZ business's holding period for such property, substantially all of the use of such property was in a QOZ</li> </ul> <p>50% or more of the total gross income is derived from the active conduct of such business</p> <p>A substantial portion of the intangible property is used in the active conduct of such business</p> <p>Less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property<sup>iii</sup></p> <p>Trade or business is not engaged in various "sin businesses"<sup>iv</sup></p>

- i. The definition of "QOZ stock" also contains an anti-avoidance rule related to the corporate repurchase and reissuance within a four-year period beginning two years before the issue date that has no corollary in the definition of "QOZ partnership interest." IRC § 1400Z-2(d)(2)(B)(ii).
- ii. The substantial improvement requirement is met if, during any 30-month period after acquisition of the property, there are additions to the QOF's basis of such property that exceed the QOF's adjusted basis of the property at the beginning of that 30-month period. IRC § 1400Z-2(d)(2)(D)(ii).
- iii. Nonqualified financial property means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations; except that such term shall not include (1) reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or (2) debt instruments described in § 1221(a)(4). I.R.C. § 1397C(e).
- iv. 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. I.R.C. § 144(c)(6)(B).

## QOF federal taxation benefits illustrated

### *Example of Julie*

On June 1, 2018, Julie sold a concentrated stock position with a basis of \$200,000 for \$1.2 million, realizing \$1 million of capital gain. On July 5, 2018, she invested the \$1 million gain in a QOF. Julie elected to defer recognition of the \$1 million capital gain so that it won't be recognized as income on her federal tax return filed in 2019. Because no gain is recognized, her basis in the QOF is zero.

- **Less than five years** | If Julie sells her QOF interest before July 5, 2023 (five years from the date of her QOF investment), she will recognize gain on the difference between the market value of the QOF and the basis of zero;
  - e.g., if Julie sells on July 5, 2022, when the QOF is worth \$1.1 million, she will recognize tax on the entire \$1.1 million (\$1.1 million market value - \$0 basis).
    - That is \$1 million attributable to the original deferred gain and \$100,000 attributable to appreciation in the QOF.
- **From five to seven years** | If Julie holds the QOF through July 5, 2023, her basis in the QOF will be increased by 10% of the original deferred gain of \$1 million (\$100,000).
  - If she sells her QOF interest between July 5, 2023, and July 5, 2025, she would recognize gain on the difference between the market value of the QOF and her basis of \$100,000;
  - e.g., if Julie sells on July 5, 2024, when the QOF is worth \$1.2 million, she would recognize tax on \$1.1 million (\$1.2 million - \$100,000).
    - That's \$900,000 attributable to the original deferred gain and \$200,000 attributable to appreciation in the QOF.

For illustrative purposes only. Hypothetical example. Stated returns may not be achieved. Assumptions: All QOF requirements are met. Maximum tax benefits achieved, including 15% reduction in gain which is only possible for investments acquired before the end of 2019. No assurance can be made that the a fund will qualify as a "qualified opportunity fund" or that any Investor will achieve any tax benefit under any applicable law, including without limitation, the Tax Cuts and Jobs Act passed in December 2017.

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## QOF federal taxation benefits illustrated

### *Example of Julie, continued*

- **After seven years but before December 31, 2026** | If Julie holds the QOF through July 5, 2025 (seven years from the date of her QOF investment), her basis in the QOF will increase by an additional 5% of the original deferred gain of \$1 million, or \$50,000, for a total basis of \$150,000.
  - If she sells her QOF interest between July 5, 2025, and December 31, 2026, she would recognize gain on the difference between the market value of the QOF and her basis of \$150,000;
    - *e.g., if Julie sells on July 6, 2026, when the QOF is worth \$1.3 million, she would recognize tax on \$1.15 million (\$1.3 million – \$150,000).*
      - *That is \$850,000 attributable to the original deferred gain and \$300,000 attributable to appreciation in the QOF.*
- **December 31, 2026** | If Julie holds the QOF on December 31, 2026, she would recognize the remaining 85% of the original gain—the difference between her original deferred gain of \$1 million and her basis of \$150,000. Because of this gain recognition, her basis in the QOF is increased by the remaining 85% of the original deferred gain, to \$1 million ( $\$150,000 + (85\% * \$1 \text{ million})$ );
  - *e.g., even if the QOF is worth \$1.4 million at this time, she would recognize tax only on her remaining original deferred gain, which is the excess of \$1 million over her basis of \$150,000, or \$850,000, and her basis would be stepped up to \$1 million.*
    - *No federal tax is owed on the \$400,000 unrealized appreciation within the QOF.*

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## QOF federal taxation benefits illustrated

### *Example of Julie, continued*

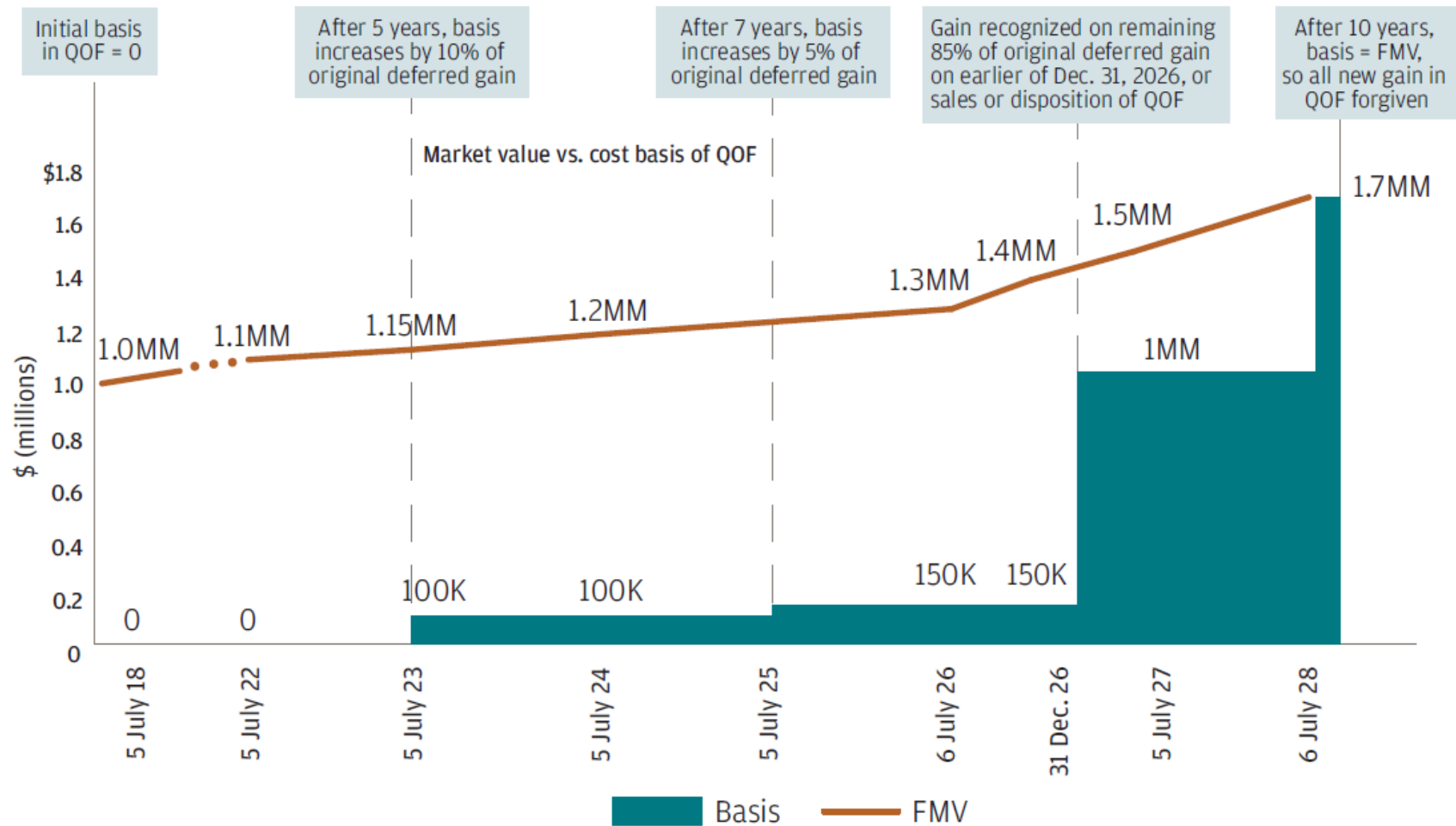
- **After December 31, 2026, but before 10 years** | If Julie sells after December 31, 2026, but before July 5, 2028, she would recognize gain on the difference between the market value of the QOF and her basis of \$1 million;
  - *e.g., if Julie sells on July 5, 2027, when the QOF is worth \$1.5 million, she would recognize tax on \$500,000 (\$1.5 million – \$1 million).*
    - *All gain is attributable to appreciation in the QOF.*
- **After 10 years** | If Julie holds the QOF through July 5, 2028 (10 years from the date of her QOF investment), when she ultimately sells the investment, she can elect to have her basis equal the fair market value of her investment in the QOF, such that all new gain in the QOF is forgiven;
  - *e.g., if Julie sells on July 6, 2028, when the QOF is worth \$1.7 million, she could sell and recognize no gain on the \$700,000 of QOF appreciation because she can elect that her basis would also be \$1.7 million.*

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## QOF federal taxation benefits illustrated

Example of Julie, continued



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The fair market value (FMV) of the QOF investment is demonstrated by the orange line. QOF FMV growth is purely hypothetical and not representative of expected returns. Although the IRS and Treasury have issued proposed regulations that help to clarify some aspects of the statute discussed herein (i.e., Section 1400Z-2 of the Internal Revenue Code), there still remains substantial uncertainty with respect to the application of the statute and issued proposed regulations. In addition, the regulations are not effective until finalized and investors are generally permitted to rely on the regulations immediately only if they apply the regulations consistently and in their entirety.

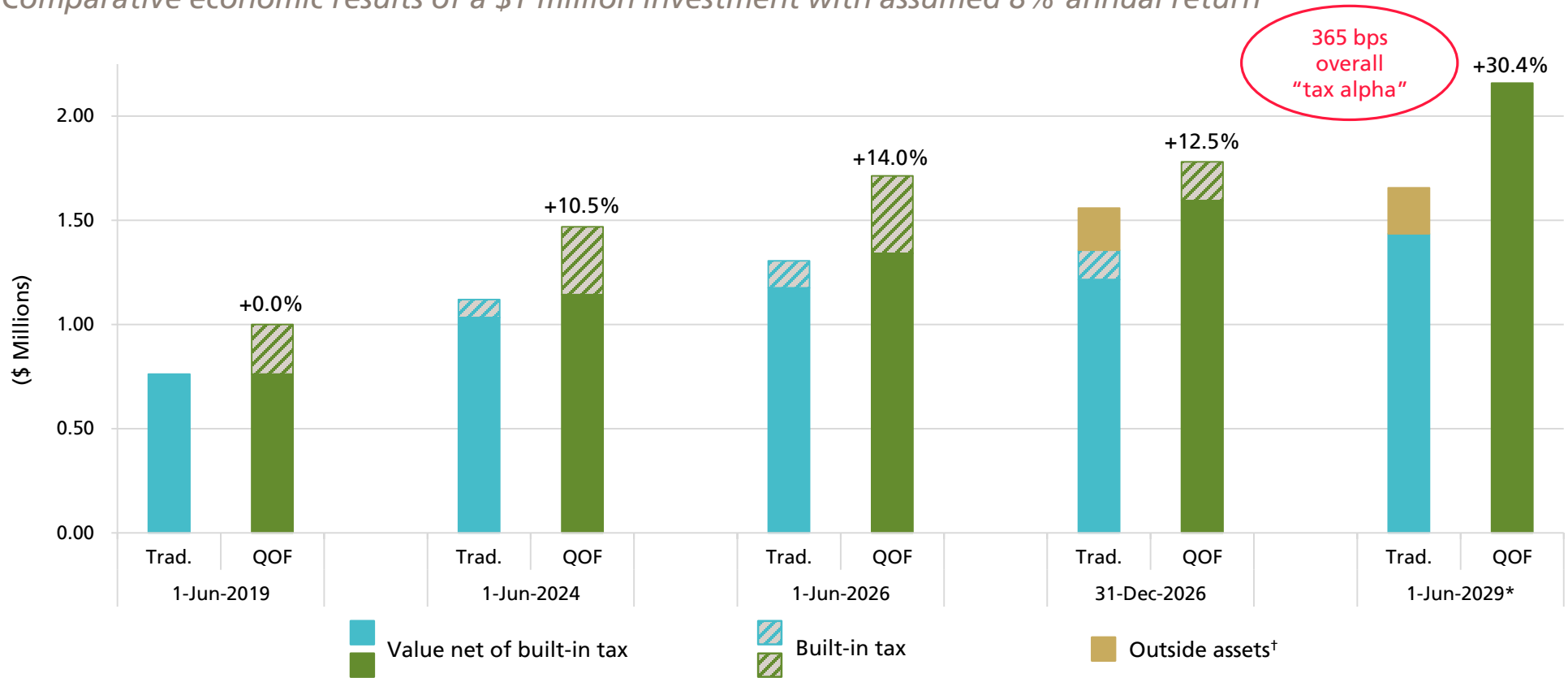
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# Traditional fund investing versus QOF investing

Comparative economic results of a \$1 million investment with assumed 8% annual return



\* Assumes taxpayer sells the investment on June 1, 2029. In QOF scenario, taxpayer makes election to have basis equal market value.

† Outside assets are included in the traditional investment scenario for an apples-to-apples comparison with the QOF, for which imputed income taxes recognized in 2026 would need to be paid with non-QOF assets.

Assumes \$1 million of initial capital gain.

In QOF scenario, on June 1, 2019 taxpayer elects to defer capital gains recognition on sale or exchange of asset giving rise to capital gain.

Investment is held for 10 years.

Annual return = 8% (all capital appreciation).

U.S. capital gains tax rate of 20%. Medicare tax of 3.8%. No state taxes are assumed.

Initial basis in QOF = 0; Year 5 QOF basis stepped up to \$100,000; Year 7 QOF basis stepped up to \$150,000.

In QOF scenario, imputed income tax event on December 31, 2026 on \$850,000 of original remaining deferred gain. These imputed income taxes are paid with non-QOF assets, which also grow at 8%. State taxes also may apply, depending on the taxpayer's particular circumstances.

The region shaded with diagonal lines represents the capital gains tax that would be due based on the current market value and adjusted basis of each investment.

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**First round of opportunity zone regulations – released October 29, 2018**

## First round of opportunity zone regulations – released October 29, 2018

### *What happened?*

On Friday, October 19, the Treasury Department and IRS released the first round of guidance on Qualified Opportunity Zones (QOZs). This guidance included proposed regulations, a draft IRS form and accompanying instructions, and a Revenue Ruling. The guidance is generally considered taxpayer-friendly and addressed numerous questions that the statute had left open, but the guidance left unresolved issues.

### *What now?*

A comment period of 60 days for the proposed regulations closed in December. Until regulations are finalized, taxpayers may rely on the proposed regulations.

### *What was clarified?*

- Details for investors on who can defer federal tax on realized capital gain and what types of gain qualify for deferral
- Some clarification of the definitions of qualified property (e.g., as it relates to real estate investments, the value of land is excluded from the computation in determining compliance with the “substantial improvement” test; addition of a “working capital” exception from nonqualified financial property test; some intelligence on the 90% qualified property test)
- Clarification on timing of initial QOF investment to be eligible for deferral, as well as time limits on the forgiveness of the new gain for QOZ assets held more than 10 years

## 1st round of regulations

What was clarified

*Which taxpayers are eligible for opportunity zone tax benefits?*

- **Taxpayers** include individuals, C corporations (including regulated investment companies (RICs) and real estate investment trusts (REITs)), partnerships, and certain other pass-through entities.
- The proposed regulations include **special rules for partnerships** and other pass-through entities.
  - If a pass-through entity (e.g., a partnership) does not elect to defer taxation of realized capital gain, there are rules that allow the **pass-through owner** (e.g., a partner) to do so.
    - A partner's 180-day period generally begins on the last day of the partnership's taxable year, although there is an alternative for situations in which the partner knows (or receives information) regarding both the date of the partnership's gain and the partnership's decision not to elect deferral under section 1400Z-2. In that case, the partner may begin its own 180-day period on the same date as the start of the partnership's 180-day period.

*What type of gain is eligible for tax benefits if reinvested in a QOF?*

- **Capital gain** (both short- and long-term), including collectibles gain, capital gains dividends from RICs and REITs, and the *net* gain from all Section 1256 contracts (e.g., regulated futures contracts).
  - Apart from the Section 1256 contract context, there does not appear to be a requirement for a taxpayer to defer only net capital gains.
- Capital gain arising from **offsetting positions** such as certain hedges (*i.e.*, straddles) is not eligible.
- Capital gain from a sale or exchange with a **related person** is not eligible.

## 1st round of regulations

What was clarified

### *How to make elections?*

- A taxpayer can make deferral elections on **Form 8949**, which should be attached to his/her/its federal income tax return.
- A corporation or partnership can self-certify as QOF on **Form 8996**, which should be filed with its federal income tax return.
- A taxpayer can **roll between QOFs** by making a new election to continue to defer previously deferred gain.

### *What type of QOF investment is an eligible interest?*

A QOF investment must be **equity** (including preferred stock and partnership interests which may have special allocations), not debt.

### *Can a limited liability company (LLC) be a QOF?*

- A QOF must be an entity which is classified as a **corporation or partnership** for tax purposes.
  - This means an **LLC** may be an eligible QOF entity type.

### *What is qualifying property?*

- A QOF must have 90% of its assets invested in qualified property, or else face a penalty. What qualifies as “qualified property” has been an open issue.
- Definition of **“substantially all”**
  - The definitions of qualified property use the undefined term “substantially all” in several places.
    - The guidance defines “substantially all” as meaning **70%** in one place (*i.e.*, if  $\geq 70\%$  of the tangible property owned or leased by a trade or business is QOZ business property, the trade or business passes one of the requirements for being a QOZ business), but it remains undefined in others.
- Rules for **“substantial improvement”**
  - One way to meet the definition of qualified property is through “substantial improvement” of tangible property. The statute had limited the definition of “substantial improvement” to the doubling of the basis of property within 30 months of acquisition.
    - The guidance clarifies that for purposes of that calculation, **the basis attributable to land** on which a building sits **may be excluded** in determining whether the building has been substantially improved.

## 1st round of regulations

What was clarified

### *When the 180-day clock starts*

- The statute requires that investors must reinvest capital gain into a QOF within **180 days** of its realization to be eligible for QOZ tax benefits.
- The guidance clarifies that the first day of the 180-day period is the date on which the gain **would be recognized for federal income tax purposes** and gives **examples** of when the 180-day clock starts in different scenarios.
  - For instance, the clock starts for:
    - stock sales — on the trade date
    - capital gain dividends from RIC or REIT — when the dividend is paid
    - partners — on the last day of the partnership's taxable year, unless the partner elects to use the date the partnership recognized the gain
    - Section 1256 contracts — on the last day of the taxable year



## 1st round of regulations

What was clarified

### *Issues around the 90% qualified property test*

- **“Working capital” exception**
  - Under proposed regulations, investors still have to reinvest capital gain into a QOF within 180 days. However, QOFs that use and hold the equity in certain subsidiaries that qualify as QOZ businesses may qualify for a 31-month working capital safe harbor. This safe harbor makes it easier to qualify as qualified property for purposes of the 90% test (e.g., by providing limited relief from the general requirement that a business have less than 5% of property in “nonqualified financial property” such as cash). However, the QOF must have:
    - A written plan identifying such property as held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone, AND
    - A written schedule showing the property will be used within 31 months, AND
    - The business must substantially comply with that schedule.
- **Valuation method** for applying the 90% test
  - The guidance clarifies that the 90% qualified property test is based on asset values reported on the QOF’s applicable financial statement for the taxable year (uncertain if using GAAP), or, if there is none, the property’s cost basis (uncertain if unadjusted).
- **Annual reporting** of compliance with the 90% test
  - Investors must use **Form 8996** (the same form for initial QOF self-certification) to annually report compliance with the 90% test.

## 1st round of regulations

What was clarified

### *Issues around the 90% qualified property test, continued*

- **Designating when a QOF begins** and the designation's effect on timing for the 90% test
  - The guidance allows a QOF both to identify the **taxable year in which it becomes a QOF and to choose the first month in that year to be treated as a QOF**. It also provides the effect of that choice on the **testing dates** for purposes of the 90% test. For example:
    - If a QOF created in February chooses April as its first month as a QOF, test dates are end of September and end of December.
    - If a QOF chooses a month after June as its first month as a QOF, its only testing date for that year is the last day of the QOF's taxable year.
- Other 90% test timing
  - The guidance provides leeway for a QOF that sells qualified property right before a testing date a reasonable amount of time to get itself into compliance.
- **Penalty rate**
  - Form 8996 suggests the monthly penalty is the annual underpayment rate (currently in excess of 5%) divided by 12.

### *Issues with debt*

- Using the QOF interest as **collateral** will not impact the tax benefits
- **Fund-level debt**
  - An example in the proposed regulations may be helpful from a fund-level debt perspective: it provides that a partner's share of partnership liabilities does not result in a partner's having a "mixed investment" (with one part qualifying for tax attributes, and one part not).

## 1st round of regulations

What was clarified

### *Rules for partial dispositions*

- If a taxpayer disposes of less than all of its interests in a QOF, the proposed regulations provide that the QOF interests disposed of must be identified using a **first-in, first-out (FIFO)** method (oldest interests are treated as sold first).
  - Where the FIFO method does not provide a complete answer (such as where gains with different attributes are invested in indistinguishable interests at the same time), a **pro-rata method** must be used.

### *Character of gain at end of deferral period for old gain*

When gain is recognized (earlier of December 31, 2026, or the disposition of the QOF interest), the gain **retains the character** it would have had in the year it was originally realized had it not been deferred (e.g., collectibles gain taxed at 28%).

### *Ending point for 10+ year forgiveness of new gain*

- When a taxpayer has held a QOF for more than 10 years and subsequently disposes of the interest, he/she/it may elect to have basis equal to market value such that all new gain in the QOF is forgiven.
  - It was previously unclear how long the taxpayer could hold that interest before making that election.
  - The proposed regulations preserve the ability to make this election through December 31, 2047.
- Note that because the latest gain subject to deferral would be at the end of 2026, the last day to invest that gain into a QOF would be in late June 2027.

### *Miscellaneous*

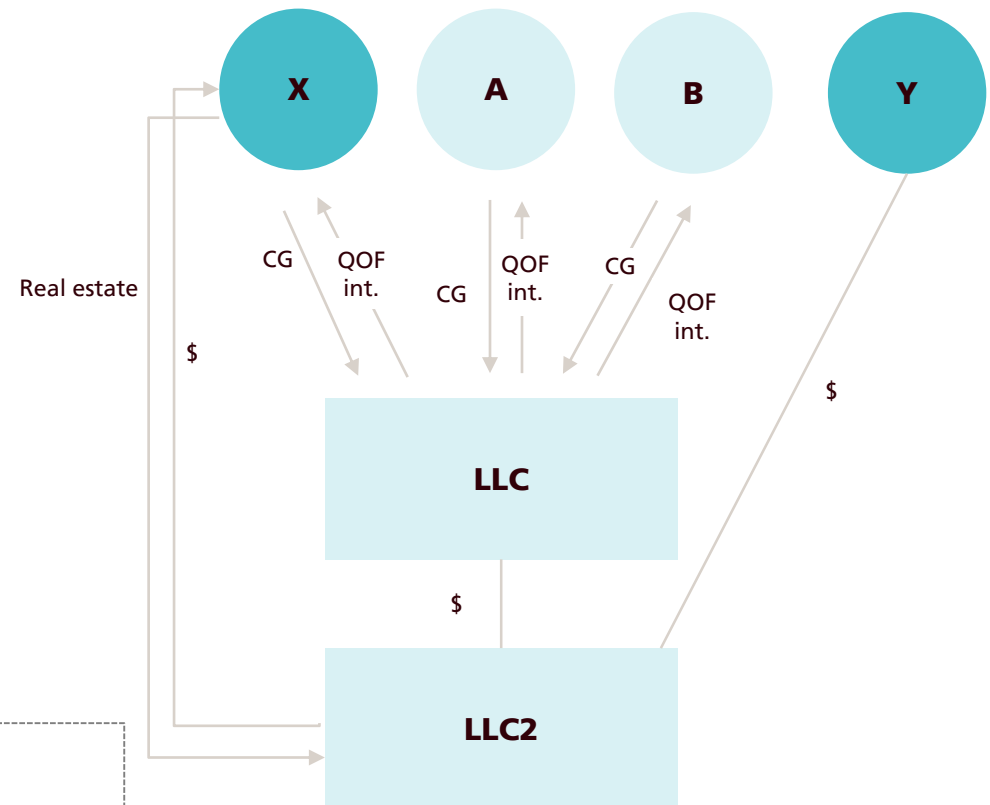
- The guidance provides rules around qualification of **pre-existing entities** as QOFs or qualified property.
- There is still no allowance for the use of a **fund-of-funds structure** (common for other forms of private equity investing) through which a taxpayer could invest and gain the benefits of the QOZ deferral.

## Example: QOZB subsidiaries and the working capital exception

1. Within 180 days of realizing capital gain (CG), investors A and B invest eligible gain into an LLC
2. The LLC forms LLC2, which is capitalized with cash from both the LLC and third-party investors
3. Investor X **sells** real estate to LLC2 for cash and invests some or all of the gain she realizes for a capital account position in LLC
4. The LLC self-certifies as a Qualified Opportunity Fund (QOF)
5. For X's investment to be eligible for QOF tax benefits, X must have a <20% interest (directly or indirectly) in the capital and profits of LLC2
6. In addition, the real estate may be a "bad" asset for purposes of LLC's 70% test if X is "related" to LLC2
7. LLC and LLC2 must meet all the other QOF requirements (e.g., substantial improvement) for LLC to avoid penalty and/or disqualification

### Subsidiary Entity Benefits Safe Harbor:

- QOZBs – reasonable working capital cash exception for 31 months
- QOZBs – define "substantially all" tangible assets to meet test as 70% rather than fund level 90% test
- Real estate sold at arms-length to QOF qualifies as good asset for purposes of 90% test (subject to compliance with related party rules). Property contributed in kind may be eligible for QOZ benefits (subject to mixed investment rules), but would not be a good asset for purposes of the 90% test
  - Note: leasing arrangements have different related party rules



**Key**  
 CG = Capital Gain  
 QOF int. = Qualified Opportunity Fund interest  
 \$ = money

For illustrative purposes only. Hypothetical and subject to change. Not an actual fund.

**Second round of opportunity zone regulations – released April 17, 2019**

## **Second round of opportunity zone regulations – released April 17, 2019**

### Overview

- On April 17, 2019, the U.S. Treasury Department and IRS released a highly anticipated second round of proposed regulations on qualified opportunity zones (QOZs). The regulations provided additional clarity on investment in and operation of qualified opportunity funds (QOFs). Treasury will accept comments on the proposed regulations, most of which may be relied upon, over a 60-day period. Additional guidance is expected in the next few months regarding administrative rules and information-reporting requirements for QOFs.
- The first round of guidance, released October 29, 2018, left several important questions unanswered. Below, we provide answers to those questions, where available. Also addressed are additional clarifications and changes in the regulations.

## 2<sup>nd</sup> round of regulations

Open questions, addressed

**Q | How will pre-December 31, 2026 distributions from a QOF affect the deferral of capital gains?**

**A |** In general, distributions from QOFs will constitute an “inclusion event” (accelerating the recognition of deferred gains) only to the extent they exceed basis. Distributions from QOFs organized as partnerships will be taxed to the extent the distributed property has a fair market value in excess of the partner’s outside basis (which initially is zero, but may be increased by the partner’s share of partnership liabilities, among other adjustments). A special rule applies to distributions made within two years of a taxpayer’s investment. Such distributions may be treated as a “disguised sale,” disqualifying a portion of the original QOF investment from the QOZ tax benefits.

Distributions from QOFs organized as C corporations will constitute an inclusion event to the extent they are treated as gain from the sale or exchange under corporate tax rules (i.e., they are non-dividend distributions in excess of the shareholder’s basis in his or her stock).

**Q | What are the consequences of employing debt at the QOF-level?**

**A |** Although the proposed regulations do not explicitly address the full scope of the consequences of fund-level debt, there is some good news for investors. A partner’s allocable share of debt increases his or her basis in a QOF investment. That rule, coupled with the rule that distributions are taxable to a partner only to the extent they exceed basis, means that investors in a QOF organized as a partnership should be able to take advantage of tax-free leveraged distributions after the first two years.

Losses (e.g., from depreciation) would be suspended until an investor (whose basis in the QOF investment is initially zero), acquires basis (e.g., through debt or the 5- and 7-year step-ups).

## 2<sup>nd</sup> round of regulations

Open questions, addressed

**Q | What happens if a QOF sells an investment in qualified property and **reinvests** in other qualified property?**

**A |** A QOF's sale of qualified property and reinvestment into other qualified property raised several questions: Could that be done without tax consequences for the QOF? For the QOF investor? Would it affect the QOF investor's 5-, 7-, and 10-year holding periods? Would interim proceeds compromise the 90% qualified property test for the QOF? The regulations provide guidance on all of these questions. Starting backwards, proceeds from sale or disposition of qualified assets by the QOF are treated as qualified property for purposes of the 90% test so long as the QOF reinvests the proceeds within one year (subject to a government inaction exception), and the proceeds are held in cash, cash equivalents, or debt instruments with a term of 18 months or less. Treasury did not feel they had the authority to make such dispositions of, and reinvestments into, qualified property tax-free. This means the realization within the QOF would be subject to normal income tax recognition rules. But QOF realization and reinvestment into other qualified property will not affect a taxpayer's 5-, 7-, and 10-year holding periods in the QOF, nor, seemingly, the deferral of his original gain.



## 2<sup>nd</sup> round of regulations

Open questions, addressed

### Q | What does “substantially all” mean in the various places it is used in the definition of qualified property?

A | The term “substantially all” is used in multiple places in the definitions of qualified property. Qualified property can be QOZ stock, QOZ partnership interests or QOZ business property (see their full definitions on p. 3 of our previous piece, [here](#)). Below are relevant excerpts from each definition, with the quantifications in the new definitions highlighted in **blue**.

- QOZ Stock
  - During substantially all **(90%)** of the QOF’s holding period for the stock, the corporation qualified as a QOZ business
- QOZ Partnership Interests
  - During substantially all **(90%)** of the QOF’s holding period for the interest, the partnership qualified as a QOZ business
- QOZ Business Property (QOZBP)
  - During substantially all **(90%)** of the QOF’s holding period for the property, substantially all **(70%)** of the use of such property was in a QOZ
- QOZ Business (QOZB)
  - Substantially all (previously defined as **70%**) of the tangible property owned or leased by the taxpayer is QOZBP
  - A substantial **(40%)** portion of the intangible property is used in the active conduct of such business
- The regulations suggest that these layered quantifications are compounded. Thus, a QOF could satisfy the QOZ requirements with as little as 40% of its tangible assets effectively in use within a QOZ. This would result from 90% of QOF assets being invested in a QOZB, in which 70% of the tangible assets of that business are in QOZBP, and that QOZBP is only 70% in use in a QOZ for 90% of the holding period for such property ( $0.9 \times 0.7 \times 0.7 \times 0.9 \cong 0.4$ ).

## 2<sup>nd</sup> round of regulations

Open questions, addressed

### Q | How does a QOF satisfy the “original use” test?

**A |** Qualified property generally has to have either its original use in the QOZ commencing with the QOF (or QOZB), or the QOF (or QOZB) has to “substantially improve” the property. Until now, what “original use” meant was undefined. The regulations clarified that property will be considered to be original use when a person first places the property in service in the QOZ in a manner that would allow for depreciation/amortization. Treasury received several comments about allowing property that had been vacant for some time to qualify as original use property. The regulations grant that if property has been vacant for at least five years prior to being purchased by a QOZ or QOZB, the original use test will be satisfied.

### Q | How does the “substantial improvement” test apply to raw land?

**A |** The substantial improvement test requires that, after a QOF acquires tangible property, it must double its adjusted basis in the property over any 30-month period. Earlier guidance had suggested that the basis of land could be excluded from this calculation. That left an open question of whether, and how, this test applied to raw land. The regulations clarify that Treasury did not want to impose a uniform substantial improvement requirement on unimproved land because of the differing degrees to which such improvements would be wise for different industries. Thus, there is no per se substantial improvement requirement for raw land. But anti-abuse rules will prevent tax benefits for QOFs that do not invest any new capital improvement or increase any economic activity/output of the land (e.g., acquiring land currently utilized for crop production, without any improvements).

The regulations also stipulated that the substantial improvement test should be applied on an asset-by-asset basis, but Treasury is requesting comments on whether the test should be applied on an aggregate basis.

## 2<sup>nd</sup> round of regulations

Open questions, addressed

### Q | How is “trade or business” defined?

**A |** A QOF must hold, directly or indirectly, assets used in a trade or business. “Trade or business” is defined by a large body of case law and administrative guidance around Internal Revenue Code Section 162 (relating to trade or business expenses). Among other things, that requires that a taxpayer 1) undertake an activity with the intent to make a profit, 2) be regularly and actively involved in a considerable activity (by scope and extent), and 3) have business operations that had actually commenced. Holding land for investment does not give rise to a trade or business.

### Q | What does a QOZB have to do with comply with the requirement that at least 50% of the business’ gross income be derived from the active conduct of the business?

**A |** The QOZB definition provides a requirement that 50% or more of the total gross income of the trade or business is derived from the active conduct of such business. Some language in the first round of regulations made practitioners question whether that meant gross income had to be sourced from within the zone, as opposed to the business merely being conducted in the zone. The regulations provide three safe harbors and one facts-and-circumstances test for this requirement.

The safe harbor tests are as follows:

- At least 50% of services performed (based on hours) performed within the QOZ
- At least 50% of the services performed for the business (based on amounts paid for services) are performed in the QOZ
- The tangible property of the business in a QOZ and the business’ management or operational functions in the QOZ are each necessary to generate 50% of the gross income of the trade or business

If none of these safe harbors are met, there is an alternative facts and circumstances test. This test is satisfied, if, based on all the facts and circumstances, at least 50% of the gross income of a trade or business is derived from the active conduct of a trade or business in the QOZ.

## 2<sup>nd</sup> round of regulations

Open questions, addressed

### Q | Can an interest in a QOF be transferred?

**A |** Until now, the treatment of a taxpayer's lifetime gifts of QOF interest was unclear. Similarly unclear was, if a taxpayer died holding a QOF interest, whether their beneficiaries would be able to take advantage of the QOZ provisions. Guidance turned out unfavorable for lifetime gifts, but favorable for testamentary transfers. The regulations clarify that lifetime gifts of a QOF interest will trigger recognition of the taxpayer's deferred gain and loss of the QOZ benefits for the recipient. This includes a gift to a charitable organization. There is an exception for gifts to grantor trusts, but if the trust ceases to be a grantor trust (other than by reason of death), tax will be recognized on the deferred gain at that time and the QOZ benefits will be lost. There is a similar exception for transfers to disregarded entities (such as a single-member LLC).

On the other hand, if a gift of a QOF interest is made upon a taxpayer's death, it will not trigger immediate inclusion of deferred gain. Instead, the deferred gain becomes an "income in respect of decedent" (IRD) asset. That means gain would remain deferred (with no step-up in basis) until the earlier of December 31, 2026, or when the decedent's estate or beneficiaries dispose of the QOF interest. Capital gains taxes would be due at that time, but the estate or heirs would be entitled to deduct any estate taxes paid on the IRD asset. Beneficiaries appear to be eligible for the QOZ tax attributes even though they're not the ones that originally deferred gain, and they can tack onto decedent's holding period for purposes of the 5-, 7-, and 10-year rules.

With regard to transfers for value, an investor can acquire a QOF interest from an existing investor rather than from the fund. For purposes of the opportunity zone tax attributes, the investment is equal to the amount paid for the eligible interest.

## 2<sup>nd</sup> round of regulations

Open questions, addressed

### **Q | Does a QOZ have to own qualified property, or can it be leased?**

**A |** Treasury wanted to achieve parity among different business models, whether they involved owning or leasing property. Therefore, the regulations provide that leased property can be treated as satisfying 90% test and QOZB substantially all test if it meets certain criteria: 1) Leased tangible property must be acquired by lease entered after 12/31/17, and 2) substantially all of the use of the leased property must be in a QOZ during substantially all of the period for which the business leases the property.

The original use and substantial improvement tests do not apply to leased property (although improvements to leased property by the lessee satisfy the original use requirement). An alternative test provides that the lease must be at arms-length, market rates. There is also no related party test for leased property, but leased property will not be QOZBP if a related party makes a prepayment of rent (relating to use more than 12 months out). Also, leased tangible property will only be considered QOZBP if, within a certain period, the lessee acquires additional QOZBP at least equal to the value of the leased property.

The regulations contain an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement for purchases of real property. This rule applies if there was a plan, intent, or expectation for the real property to be purchased by the QOF under certain circumstances.

For purposes of a QOF's 90% qualified property asset test, leased property is valued in one of two ways: 1) at the value reported on applicable financial statement prepared in accordance with GAAP, or 2) at the present value of the leased property.

For purposes of qualifying as a trade or business, ownership and operation, including leasing, of real property used in a trade or business is treated as qualifying.

## 2<sup>nd</sup> round of regulations

### Additional changes

#### **Investments of *in-kind* property**

The regulations appear to allow for non-cash (i.e., in-kind contributions) to QOFs. Based on the regulations, these investments appear to qualify for the QOF benefits. The amount of the qualifying investment, however, would generally be limited to the basis of the contributed property (or its fair market value, if lower), with the remaining amount being ineligible for the QOZ benefits (resulting in a mixed investment). The regulations seem silent on whether such contributions of property in-kind would be “good assets” for purposes of the 90% test. (The statute generally requires that “good assets” be acquired by purchase from an unrelated party.)

#### **More flexibility on *exit* for 10+ year investors**

Until now, it appeared that a taxpayer had to sell his QOF interest (not the underlying property in a QOF), or receive a liquidating distribution from the QOF, which had to terminate, in order to be eligible for the forgiveness of new gain after 10 years. Because it would be more difficult to get “top dollar” for several properties bundled in a single QOF interest, fund managers have considered isolating each project in its own QOF. That may not be necessary (but may still be preferable). New guidance provides additional flexibility on exit for taxpayers in QOFs organized as partnerships in which taxpayers who have held their interest for at least 10 years. Those taxpayers can make an election, subject to the finalization of these proposed regulations, to exclude some or all of the capital gain from the sale of underlying QOF property, and can elect the 10-plus year forgiveness on separate capital assets. The added flexibility reduces the need to isolate each property in its own QOF. There may still be benefits to so segregating projects, however, including isolating the 10-year clock for each fund/project and considerations around depreciation recapture.

Also, the regulations provide that taxpayers in QOFs organized as REITs in which taxpayers have held their interest for over 10 years may receive tax-free capital gain dividends.

## 2<sup>nd</sup> round of regulations

### Additional changes

#### **Other changes related to the 90% test**

Other changes in the regulations include a change that expanded the 31-month working capital exception to be friendlier to businesses. Whereas previously that exception required a written plan relating to the acquisition, construction, and substantial improvement of tangible property, there is now also an option for a written plan for the use of working capital in the development of a trade or business.

There was also concern that recently invested money, for which there was not adequate time to deploy, would hurt a QOF under the 90% qualified property asset test. The regulations provide relief for such newly contributed assets. The 90% test is applied without regard for investments received by the QOF in the 6 month period in advance of a testing date (if the investments are held in cash, cash equivalents or debt instruments with a term of 18 months or less).

#### **Potential reporting requirements**

Treasury also released a request for information on what data would be useful in tracking the effectiveness of the QOZ provisions in bringing economic benefits to distressed communities. We can expect information reporting requirements for QOFs in the future.

#### **KEEP IN MIND**

The law contains a general anti-abuse rule. If a significant purpose of a transaction is to achieve a tax result inconsistent with the purposes of the QOZ provisions, the Commissioner of Internal Revenue can recharacterize the transaction to achieve appropriate tax results.

We will continue to monitor changes to the opportunity zone landscape as intelligence evolves.

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# Examples



## Examples of QOFs we've seen

### Third-party pooled vehicle offerings

#### Pooled vehicle partnership

- ~400 million multi-asset QOF organized as a partnership
- QOF investing in mixed use (multi-family/retail) projects diversified across U.S. cities in conjunction with a leader in the hospitality industry
- Multiple capital calls – more suitable for investors who have control over timing of realized gains

#### Pooled vehicle REIT

- ~\$1 billion multi-asset QOF organized as a REIT
- QOF investing in mixed use (multi-family/retail) projects in a handful of tri-state area sites in conjunction with a proven real estate developer
- One capital call

#### Small Reg D offering

- ~\$55 million single-asset private placement Reg D QOF organized as a partnership
- QOF investing in mixed use (retail/commercial residential) project in conjunction with a proven real estate developer
- One capital call

### Private client self-certified QOFs

#### Shovel-ready, self-certified QOF

- 3 local real estate developers/property managers acquire mixed-use, commercially-zoned warehouse on waterfront through their self-certified QOF
- They had completed due diligence and targeted the property for acquisition before enactment of IRC § 1400Z
- Subject to completion of substantial improvement through debt financing, individuals intend to place in service and actively manage the property

#### Related party lease self-certified QOF

- Principals own vacant land in a QOZ through an LLC
- Principals self-certify a QOF and capitalize it with unrelated gains
- QOF enters into a 90-year ground lease with LLC holding QOZ land
- QOF constructs/develops debt-financed, commercially-zoned building on vacant land and actively manages it

#### Self-certified QOF for manufacturing operations of closely-held operating business

- Principals of successful, closely-held medical device manufacturer holding several patents self-certify QOF and capitalize it with unrelated gain
- QOF forms a QOZB subsidiary structured as an LLC
- LLC acquires site in large urban QOZ area and uses it for manufacturing operations
- Discrete LLC used for manufacturing operations not consolidated with other business operations in order to comply with QOZ requirements concerning original issue equity, newly organized OZ business and  $\geq 50\%$  gross income requirements

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