

# Structuring Investment Funds for Qualified Opportunity Zones

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# Maximizing Tax Benefits and Preserving Flexibility

# Introduction

- Opportunity Zones provide capital gains relief to investors who invest gains from prior investments into a Qualified Opportunity Fund, which uses the invested cash to invest in Qualified Opportunity Zone Property in any of approximately 8,700 Qualified Opportunity Zones in the 50 states, District of Columbia, and 5 possessions.

# Introduction

- Economic development program created by the Tax Cuts and Jobs Act of 2017
- New section 1400Z-1 and 1400Z-2 of the Internal Revenue Code
- First set of guidance released October 19, 2018 addresses some of the issues raised by the statute
- Additional guidance package is anticipated in Q1 of 2019
- IRS and Treasury are seeking comments on the Proposed Regulations and for future guidance

# Who and What?

- **Who gets the benefits:**

A taxpayer that rolls over long or short term capital gain(s) within 180 days of sale (to an unrelated party) into a Qualified Opportunity Fund (“QOF”)

- A taxpayer includes individuals, corporations, partnerships, other pass-through entities such as S corporations, common trust funds, REITs, RICs, qualified settlement funds, and disputed ownership funds
- The taxpayer must acquire the interest by making a capital contribution to the QOF; acquiring an interest from another holder of an interest in the QOF does not qualify the taxpayer for the QOZ benefits

# Partnerships, Partners and Roll-Over Gain

- Either a partnership or its partners may roll-over gain(s) into a QOF
- If the partnership rolls-over the gain, the gain must be rolled over within 180 days of the partnership's sale of the asset
- If the partnership does not elect to defer the gain, one or more of the partners may elect to roll-over their share of the gain
- A partner's 180-day period starts on the last day of the partnership's tax year unless the partnership notifies the partner of the sale date, in which case, the partner can elect to use that date to start its 180-day period
- Similar rules apply to other pass-through entities

# Gain Eligible to be Deferred

- Only gain(s) treated as long-term or short-term capital gain(s) is eligible to be rolled-over for QOZ benefits
  - Such gain includes gain on the sale of Section 1231 property
  - Includes “unrecaptured Section 1250 gain”

# Qualified Investment in a QOF

- Must be equity, cannot be debt (loan to a QOF does not count as a Qualified Investment) - *Includes preferred stock and a partnership interest with special allocations*
- Deemed contributions as a result of the QOF's debt or a QOF partnership's subsidiary's debt are not treated as cash contributions for purposes of determining if an investor invested capital gains or other funds
- Can invest noncapital gain amounts, but such amounts are treated as a regular investment and no QOZ benefits are available
- Can borrow using QOF interest as collateral for the loan

# Qualified Investment in a QOF

All or part of the gain rolled over is recognized on the earlier of:

December 31, 2026

*or*

When taxpayer sells  
its interest in the  
QOF



# How Much Deferral?

- When the taxpayer contributes its money to the QOF, the taxpayer has a zero tax basis for the roll-over gain. Then, if the taxpayer holds its interest in the QOF for:
  - at least 5 years, 10% of the taxpayer's roll-over gain is eliminated because the taxpayer's basis for its interest in the QOF is increased by 10% of the taxpayer's roll-over gain
  - at least 7 years, another 5% (for a total of 15%) of the taxpayer's roll-over gain is eliminated because the taxpayer's basis for its interest in the QOF is increased by 15% of the taxpayer's roll-over gain

# How Much Deferral?

On December 31, 2026, if the taxpayer still holds its interest in the QOF, the taxpayer recognizes the lesser of:

1. the roll-over gain less the gain excluded if the taxpayer held its interest in the QOF for at least 5 or 7 years

*or*

2. the excess of fair market value of the taxpayer's interest in the QOF over the taxpayer's basis for its interest in the QOF

# Electing Deferral

- Election is made on IRS Form 8949
- Election must be filed with the QOF investor's tax return for the year in which the capital gain would have been recognized absent an election

# How Much Deferral?

## Example 1:

- Taxpayer sells stock on the market on August 1, 2018, for a \$1,000,000 gain and rolls-over \$1,000,000 into a QOF on December 1, 2018. The taxpayer initially has a basis of -0- for its interest in the QOF, and the gain is deferred. On December 31, 2026, the fair market value of the taxpayer's QOF interest is at least \$1,000,000
- If the taxpayer holds its interest in the QOF for 5 years until December 1, 2023, \$100,000 of taxpayer's \$1,000,000 deferred gain never will be recognized because taxpayer's basis is stepped-up
- If the taxpayer holds its interest in the QOF for 7 years until December 1, 2025, another \$50,000 of taxpayer's deferred gain (for a total of \$150,000) never will be recognized because taxpayer's basis is stepped-up
- If the taxpayer holds its interest in the QOF on December 31, 2026, the taxpayer includes \$850,000 in its 2026 income

# How Much Deferral?

## Example 2:

If in Example 1, on December 31, 2026, the fair market value of taxpayer's interest in the QOF is \$500,000 (instead of at least \$1,000,000) then, on December 31, 2026, Taxpayer would recognize \$350,000 of its roll-over gain which is the lesser of:

1. Taxpayer's \$1,000,000 roll-over gain less the \$150,000 excluded gain, or \$850,000

*or*

2. The excess of the fair market value of taxpayer's interest in the QOF (\$500,000) over taxpayer's basis for its interest in the QOF (\$150,000), or \$350,000.

# Deferral Observations

- All or a portion of the rolled-over gain will be recognized. If the taxpayer dies, the gain still is recognized as described above. There is no step up at death.
- Gain retains the character that exists when it is deferred. If the rolled-over gain is short-term capital gain or unrecaptured Section 1250 gain, when recognized, it will be short-term capital gain or unrecaptured Section 1250 gain, etc.
- Gain taxed at capital gains rate when recognized, not rate in effect when deferred

*Contrast this with a like-kind exchange of real estate. The gain deferred in a like-kind exchange can be eliminated forever if the exchanging taxpayer holds the replacement property until death.*

# Another Benefit: Gain Elimination

## No Tax on Appreciation of the QOF

If a taxpayer rolls-over capital gain into a QOF, properly elects to defer that gain, and holds its interest in the QOF for at least 10 years, none of the taxpayer's gain from a disposition of its interest **in the QOF** (appreciation in the QOF) is taxed

The 10-year holding period can extend beyond the expiration of the QOZs on December 31, 2028

If gain is rolled-over into a QOF by December 31, 2026, and the investor rolling-over the gain holds its QOF interest for at least 10 years, ultimately disposes of its QOF interest on or before December 31, 2047, the 10-year benefit is available

# Establishing and Qualifying a QOF

A QOF is self-certified by attaching an IRS Form 8996 to the QOF's tax return beginning with the first tax year of the QOF and continuing for each year the QOF exists

- To be a QOF, 3 tests must be satisfied on an ongoing basis:
  1. Organizational Test
  2. Purpose Test
  3. Asset Test



# What is a QOF?

- Organization Test:
- To be a QOF, an entity must be organized as a corporation or partnership, including an LLC treated as a partnership for tax purposes
  - A pre-existing entity can self-certify and establish an initial date as a QOF if the entity otherwise qualifies
  - Entity formed under laws of a possession can only invest in QOZ Property that relates to a business operated in that particular possession

# What is a QOF?

## Purpose Test:

- To be a QOF, the corporation or partnership must be an “investment vehicle” formed for the purpose of investing in QOZ Property
  - Form 8996 requires a certification that the QOF organizing documents include a statement of purpose to invest in QOZ Property and a description of QOZ business or businesses

# What is a QOF?

## Asset Test:

- To be a QOF, the corporation's or partnership's assets must be comprised of at least 90% QOZ Property
  - The 90% test is an average of (1) the QOZ Property held by the QOF on the last day of the first 6-month period of the QOF's tax year, and (2) the QOZ Property held by the QOF on the last day of the QOF's tax year
  - For a calendar year QOF, if the initial start date of the QOF in the first year is April, the first testing date is September 30 and the next is December 31
  - If the start date is after June, the only testing date is December 31

# What is a QOF?

- Failure to satisfy the 90% test, unless such failure is due to reasonable cause, will subject the QOF to a penalty equal to the federal income tax underpayment interest rate (divided by 12) multiplied by the excess of 90% of the QOF's aggregate assets over the aggregate amount of QOZ Property held by the QOF for each month the QOF fails the 90% test
- The calculation of the 90% test will be made annually on Form 8996
- A notice will be released explaining how the calculation is made

# What is a QOF?

- Valuation method of assets for 90% test depends on the nature of the QOF
  - If QOF prepares financial statements filed with the SEC or federal agency other than IRS, use value of assets on financial statements
  - If QOF has certified financial statements prepared in accordance with U.S. GAAP, use value reported in financial statements
  - All other cases, use QOF's cost basis of assets on date of acquisition
- Special rules permit using most favorable method for QOZ Business that is owned by multiple QOFs

# QOZ Property

- QOZ Property is:
  - QOZ Stock
  - QOZ Partnership Interest
  - QOZ Business Property
- Cash/Working Capital is *not* QOZ Property
- A QOF cannot invest in another QOF; there cannot be a QOF fund of QOFs

# QOZ Stock/QOZ Partnership Interest

## QOZ Stock/QOZ Partnership Interest

- Stock or a partnership interest acquired at original issuance solely for cash after December 31, 2017
- When the stock or partnership interest is issued, the corporation or partnership is a QOZ Business. In the case of a new entity, the entity is organized for purposes of being a QOZ Business
- During substantially all of the time the QOF owns the QOZ Stock or QOZ Partnership Interest, the corporation or partnership qualifies as a QOZ Business

# QOZ Business Property

- Tangible property used in a QOF's trade or business if:
  - The property was acquired by the QOF by purchase from an unrelated party (no more than 20% common ownership)
  - The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property



# QOZ Business Property

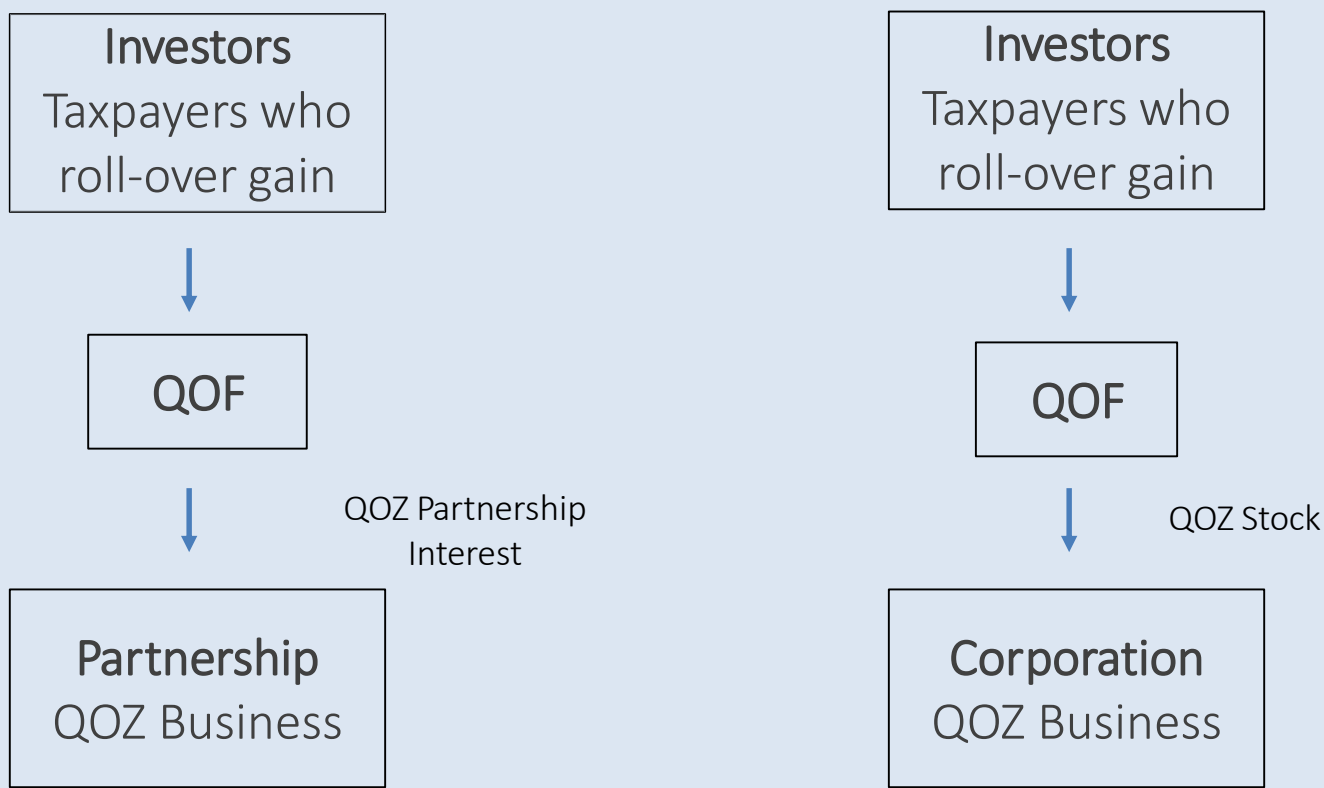
- Substantial improvement means that during *any* 30-month period after the QOF acquires the property, the QOF makes capital improvements in an amount that is more than the QOF's basis of the property at the beginning of the 30-month period
- If the QOF acquires land and improvements, only an amount more than the cost allocable to the improvements must be spent to constitute a substantial improvement, and the cost of the land is included in the numerator of the 90% test.

# QOZ Business Property

- During substantially all of the QOF's holding period for the property, substantially all of the use of such property was in a QOZ
- Property that ceases to be QOZ Business Property will continue to be treated as QOZ Business Property for the lesser of: 5 years after the property ceases to qualify, or the date the property no longer is held by a QOZ Business
- Working capital is not QOZ Business Property that can be held by a QOF. This means that a QOF cannot have more than 10% of its assets in non-qualifying property, which includes working capital. But a QOF's subsidiary can hold reasonable working capital, including the safe harbor in the Proposed Regulations

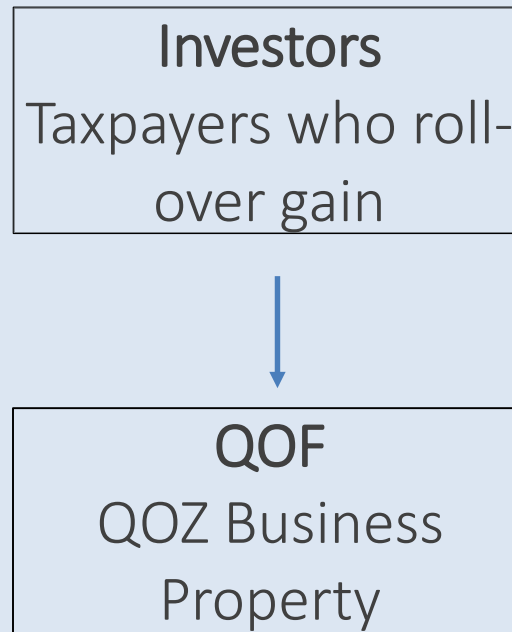
# QOF Investments

Direct investment in QOF Stock / Partnership Interest



# QOF Investments

Direct investment in QOF in QOZ Business Property



# QOZ Business Conducted by QOF Subsidiary

- If a QOF invests in a subsidiary, the subsidiary must be a QOZ Business
- For a subsidiary to qualify as a QOZ Business it must be an entity that is a corporation or partnership for tax purposes that is:
  - A trade or business that substantially all (at least 70%) of its tangible property (owned or leased) qualifies as QOZ Business Property. Property is QOZ Business Property if:
    - it was acquired by purchase from an unrelated person (no more than 20% common ownership) and
    - the original use of the property in the QOZ commences with the QOZ Business or the QOZ Business substantially improves the property

# QOZ Business Conducted by QOF Subsidiary

- property is substantially improved if during any 30-month period after the QOZ Business acquires the property, the QOZ Business makes capital improvements in an amount that is more than the QOZ Business' tax basis for the property (in the case of land and improvements, considering only the improvements) at the beginning of the 30-month period
- if both land and a building are acquired, both the land and building count toward the 70% test, if the building is substantially improved
- During substantially all of the QOZ Business' holding period for the property, substantially all of the use of such property was in a QOZ
- QOZ Business Property held by a Subsidiary QOZ Business continues to be treated as QOZ Business Property for the lesser of (i) 5 years after the date such tangible property ceases to be QOZ Business Property or (ii) the date such tangible property no longer is held by the Subsidiary QOZ Business

# QOZ Business Conducted by QOF Subsidiary

- At least 50% of the total gross income of the QOZ Business is derived from the active conduct of the QOZ Business
- A substantial portion of the QOZ Business' intangible property is used in the active conduct of its business
- Less than 5% of the aggregate adjusted basis of the QOZ Business' property is in "Nonqualified Financial Property." Nonqualified Financial Property is debt, stock, partnership interests, options, future contracts, forward contracts, warrants, national principle contracts, annuities, and other similar properties to be set forth in regulations. (See working capital below)

# QOZ Business Conducted by QOF Subsidiary

- The QOZ Business is not a “sin business”- a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, race track or other facility used for gambling, and any store the principal purpose of which is the sale of alcoholic beverages for consumption off the premises



# QOF Directly Conducts Business vs. QOF Conducts Business Through Subsidiary

## QOF Owns QOZ Business Property Directly

QOZ Business Property is:

- Tangible property used in QOF's business
- The tangible property was acquired from an unrelated person by purchase after December 31, 2017
- Original use of the tangible property in the QOZ commences with the QOF or the tangible property is substantially improved

## QOF Owns Subsidiary Partnership or Corporation that Conducts QOZ Business

- Substantially all of the QOZ Business' [which is conducted by the subsidiary partnership or corporation] tangible property (owned or leased) is QOZ Business Property (same as what QOF can do directly)
- At least 50% of the gross income of the QOZ Business is from the active conduct of the QOZ Business
- A substantial portion of the QOZ Business' intangible property is used in the active conduct of its business

# QOF Directly Conducts Business vs. QOF Conducts Business Through Subsidiary

## QOF Owns QOZ Business Property Directly

- During substantially all the QOF's holding period for the tangible property, substantially all the use of such property was in a QOZ

## QOF Owns Subsidiary Partnership or Corporation that Conducts QOZ Business

- QOZ Business:
- Less than 5% of the aggregate adjusted basis subsidiary's property is "Non-qualified Financial Property"
- **Reasonable working capital and accounts receivable are permitted**
- The QOZ Business is not a "sin business"

# Qualified Opportunity Zone Business

Examples of businesses that could qualify as a QOZ Business to be conducted by a QOZ Subsidiary:

- affordable and market rate rental housing
- mixed-use developments
- strip centers
- parking facilities
- retail-grocery stores
- research facilities
- sports facilities
- hotels
- restaurants
- health clinics
- offices buildings
- manufacturing business

# Qualified Opportunity Zone Business

## Businesses that do not qualify:

- bank/financial institution – fails nonqualified financial property limit
- branch of a business that is not a separate legal entity – nonqualified if fail test of at least 50% of gross income from the active conduct of a trade or business in a QOZ
- nonprofit corporation unless taxable subsidiary created or nonprofit is lessee not owner
- grocery or convenience store if large portion of business is liquor sales

# Reasonable Working Capital

- Proposed Regulations provide for a safe harbor for reasonable working capital that can be held by QOF's subsidiary, but not by a QOF:
  - Working capital may be held for 31 months if:
    - the amounts are designated in writing for acquisition, construction, and/or substantial improvement of tangible property in a QOZ,
    - there is a written schedule consistent with the ordinary start-up of a trade or business for spending the working capital, which working capital must be spent within 31 months of the receipt thereof, and
    - the working capital actually is used in a manner consistent with the prior two bullet points.

If these requirements are satisfied, gross income from the working capital is deemed to be from the active conduct of the QOF's subsidiary QOZ Business

# Churning

The Proposed Regulations state that soon to be released proposed regulations will provide guidance on a QOF's ability to continue to qualify as a QOF if it sells assets and reinvests the proceeds of such a sale in QOZ Property.

# Combining Tax Credits with QOZs - Increasing Yield

- **Low-Income Housing Tax Credits:**  
complementary 10-year credit period
- **Historic Tax Credits:** 5-year credit period, so typical investment could still reap some benefits
- **New Markets Tax Credits:** 7-year credit period, so typical investment could still reap some benefits

# Drafting Considerations

- Draft IRS Form 8996 (to be filed with the QOF's tax return) requires the QOF to certify that by the end of the QOF's first QOF year, the taxpayer's organizing documents include a **statement of the entity's purpose of investing in a qualified opportunity zone property and the description of the qualified opportunity zone business**



# Sample Statement of Purpose

**Purpose.** The purpose of the [QOF entity] is to invest as a member in [Subsidiary QOZ Business LLC] and to engage in other activities incidental or related thereto. The Partners intend to cause the Partnership to qualify as a Qualified Opportunity Fund and to cause [Subsidiary QOZ Business LLC] to meet the requirements for a QOZ Business.”

# QOZ Business – Drafting Considerations

- Form 8896 instructions do not require anything specific to be included in the operating agreement for the subsidiary QOZ Business
- However, where the subsidiary QOZ Business is a new entity, it must be organized for purpose of being a subsidiary QOZ Business
- Best practice: Include in statement of purpose
- Specifically prohibit sin businesses and too much Non-Qualified Financial Property

# QOF Drafting Considerations

- Obligate managing entity to operate QOF and Subsidiary QOZ Business in compliance with requirements:
  - Capital Contributions to the QOF must be timely contributed to the Subsidiary QOZB to meet asset test
  - Reserves must be limited to comply with the 90% asset test at the QOF level
  - QOF must not transfer its interest in the Subsidiary QOZB or cause or permit a transfer of the underlying assets of the Subsidiary QOZB, subject to churning rules
- Consider inclusion of drag-along to address exit issues

# QOZB - Additional Drafting Considerations

- Subsidiary QOZB must have at least 70% of its tangible assets invested in QOZB Property and conduct an active trade or business in the Zone
- Include requirement that the original use of the property in the QOZ must either commence with the QOZ Business or the QOZ Business must substantially improve the property (30 month test)
- Working capital safe harbor at QOZB level
- If representing the sponsor of the QOF, include protective language to address current uncertainties

# Locating Designated QOZs

- More than 8,700 census tracts located in each State, DC and possessions have been designated
- The QOZs meet basic low income criteria, but contiguous census tracts not meeting low income criteria also are designated
- List is final and essentially unchanging
- The list is available from IRS organized by state
- States also have interactive websites for confirming address in a QOZ
- <http://www.arcgis.com/home/webmap/viewer.html?webmap=0901a81958474a54a333f9cc180f1852&extent=-86.9909,30.8937,-78.8775,34.8282>

# QOF Guidance – More to Come?

- When does a QOF have to reinvest proceeds from a sale of one or more of its assets to continue to qualify as a QOF?
- What constitutes the active conduct of a trade or business, particularly in the context of a QOF's subsidiary QOZ Business that owns real estate?
- What does “original use” in the QOZ mean?
- What do the other uses of “substantially all” mean?
- What transactions cause the deferral to end?
- What are the administrative rules and applicable penalties if a QOF fails to satisfy the 90% test?