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Qualified Opportunity Zones – Where Are We Now?

May 22, 2019


Form 8996 (December 2018) Department of the Treasury Internal Revenue Service

Qualified Opportunity Fund

► Go to *www.irs.gov/Form8996* for the latest information.

► Attach to your tax return. See instructions.

OMB No. 1545-0123

Attachment Sequence No. 996

Name | Employer identification number

Part I **General Information and Certification**

1 Type of taxpayer: ☐ Corporation ☐ Partnership

2 Is the taxpayer organized for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund)?

☐ **No. STOP.** Do not file this form with your tax return.

☐ **Yes.** Go to line 3.

3 Is this the first period the taxpayer is a Qualified Opportunity Fund?

☐ **Yes.** By checking this box, you certify that by the end of the taxpayer's first qualified opportunity fund year, the taxpayer's organizing documents include a statement of the entity's purpose of investing in qualified opportunity zone property and the description of the qualified opportunity zone business. See instructions.

☐ **No.** Go to Part II.

4 If "Yes" on line 3, list the first month in which the fund chooses to be a Qualified Opportunity Fund.

DRAFT AS OF

Welcome and Introductions

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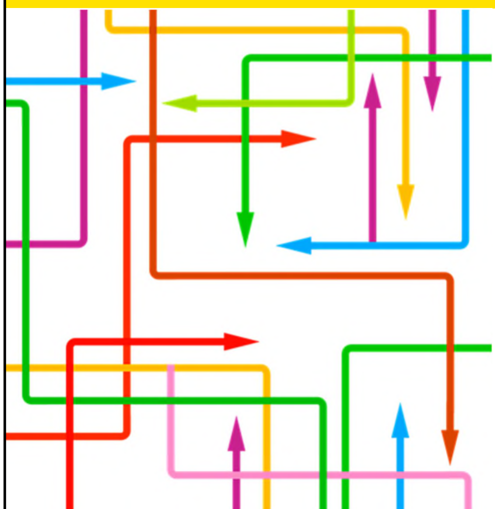
QOZ Program



Intended to be accessible
but it is very complicated

Introduction

- New section 1400Z-1 and 1400Z-2 of the Internal Revenue Code
- First set of guidance released October 19, 2018, addressed some of the issues raised by the statute (October 2018 Proposed Regulations)
- Second set of proposed regulations released April 17, 2019 (April 2019 Proposed Regulations)
- More guidance in some form is expected but the timing is not known – Treasury is not anticipating another set of proposed regulations

Introduction

- IRS and Treasury are seeking comments on the Proposed Regulations and for future guidance
- Executive Order 13853 established White House Opportunity and Revitalization Council on December 18, 2018, to coordinate federal agency efforts
- The guidance from the April 2019 Proposed Regulations is in bold in these slides

Introduction

- Opportunity Zones provide **capital gains** relief to investors who invest an amount equal to all or part of capital gains they recognized into a **Qualified Opportunity Fund,** which uses the invested amount to invest in **Qualified Opportunity Zone Business Property** and/or stock or partnership interests in a **Qualified Opportunity Zone Business** in any of approximately 8,700 **Qualified Opportunity Zones** in the 50 states, District of Columbia, and 5 possessions.

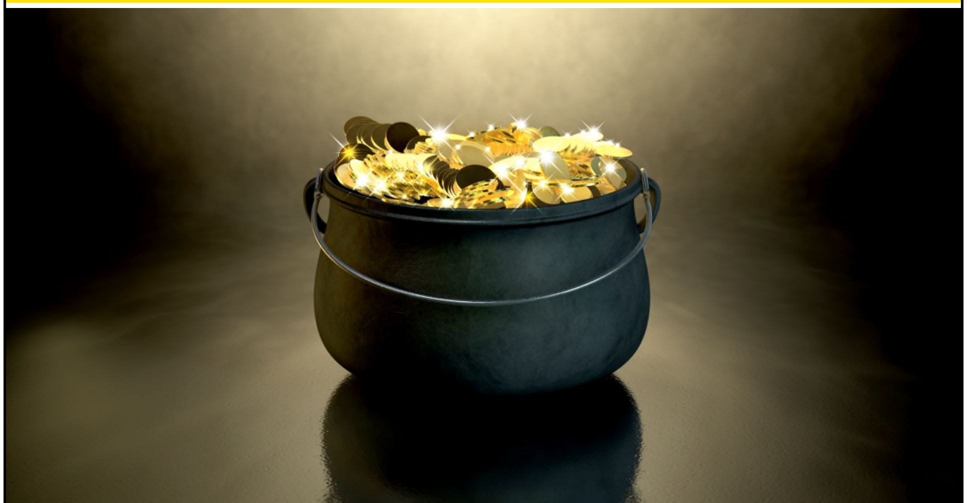
Locating Designated QOFs

- More than 8,700 census tracts located in each State, DC and possessions have been designated
- 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

Vocabulary

- QOZ – qualified opportunity zone
- QOF – qualified opportunity fund
- QOZBP – qualified opportunity zone business property
- QOZB – qualified opportunity zone business

Tax Benefits of Investing in a QOF



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Eligibility

- Taxpayer recognizes *capital gain* from sale to an unrelated person
- Within *180 days* (counting the day the gain is recognized and with special rules for capital gains recognized by pass-through entities)
- Acquires a qualifying interest in a *QOF* from the QOF **or the owner of an interest in a QOF**
  - A carried interest or capital interest acquired for services is not a qualifying interest in a QOF

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Eligibility

- 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

Qualified Investment in a QOF

- Must be equity, cannot be debt
  - Includes preferred stock and a partnership interest with special allocations (but not a carried interest or a capital interest received for services)
  - Can invest property in a QOF and the investment is a qualified investment up to the adjusted tax basis, not the fair market value of the contributed property, unless the fair market value is less than the adjusted basis, and the holding period starts at the time of the contribution (there is no tacking)
  - **Can acquire a qualifying QOF interest from a holder of such interest, not just from the QOF**

Qualified Investment in a QOF

- Can invest noncapital gain amounts, but such amounts are treated as a regular investment as part of a "mixed fund" and no QOZ benefits are available for that portion of the investment
- Can borrow using QOF interest as collateral for the loan

Partnerships, Partners and Roll-Over Gain

- Either a partnership or its partners may roll-over gain 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

1231 Gain

- Taxpayers do not know until the end of their tax years whether they have net 1231 gains
- **The April 2019 Proposed Regulations clarify that all net 1231 gain is treated as if the sale occurred on the last day of the taxpayer's tax year and the 180-day roll-over period starts on the last day of the taxpayer's tax year**

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1231 Gain

- **The April 2019 Proposed Regulations allow a partnership to roll over net 1231 gain and the 180-day roll-over period starts on the last day of the partnership's taxable year**
- **Unlike other capital gains, only net 1231 gain is eligible to be rolled-over**
- 1231 property is depreciable property used in a trade or business held for more than 1 year and real property used in a trade or business held for more than 1 year

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1231 Gain

- Net 1231 gains are treated as long-term capital gain (subject to certain recapture rules) and net 1231 losses are treated as ordinary losses
  - Net 1231 gains and losses are determined at the taxpayer level (in the case of a partnership, at the partner level from all sources)

Tax Benefits of Investing Gains Into QOFs

- Deferral
- Gain Elimination

Tax Benefits of Investing Gains in QOFs

- Deferral of roll-over gain until the earlier of December 31, 2026 or **an Inclusion Event**
- Gain Elimination –
  - 10% of deferred gain if QOF interest is held for at least 5 years on or before December 31, 2026
  - 15% of deferred gain if QOF interest is held for at least 7 years on or before December 31, 2026
  - All gain on appreciation in QOF interest if the QOF interest is held for at least 10 years and there is a taxable disposition on or before December 31, 2047

Deferral Observations

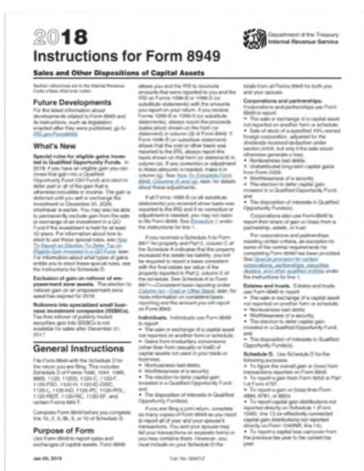
- Only QOF interests received in exchange for eligible roll-over gain are eligible for QOZ benefits
- At least 85% of the rolled-over gain will be recognized
- **The April 2019 Proposed Regulations clarify that if the taxpayer dies, the gain still is recognized as described above. There is no step up at death. A decedent's beneficiaries step into the decedent's shoes**

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.

Deferral Observations

- Gain retains the character that exists when it is deferred, *i.e.*, if the rolled over gain is short-term capital gain, when recognized, it will be short-term capital gain, etc.
- Gain is taxed at rates when recognized, not rates in effect when deferred

Electing Deferral


2018
Instructions for Form 8949
Sales and Other Dispositions of Capital Assets
Department of the Treasury Internal Revenue Service
Future Developments
What's New
General Instructions
Purpose of Form

- 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

End of Deferral

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

or Upon an Inclusion Event

End of Deferral – Inclusion Events

- **The April 2019 Proposed Regulations provide extensive detail on transactions that end deferral - "Inclusion Events"**
- **Inclusion events generally are events that reduce or terminate a QOF investor's direct or indirect QOF interest or cash out the QOF investor's investment**

End of Deferral – Inclusion Events

- **Among the Inclusion Events are:**
  - **Taxable dispositions of QOF interests**
  - **A more than 25% change in ownership of an S corporation that owns a qualifying interest in a QOF. In such event, the S corporation recognizes all of its deferred gain and is disqualified from the 10-year benefit**
  - **Gifts**
  - **Distribution by a corporate QOF or partnership QOF that results in gain to the owner of the QOF interest**

End of Deferral – Inclusion Events

- **Distribution by a partnership QOF or a direct or indirect partnership owner of a QOF of cash or property to a partner that exceeds a partner's tax basis for its partnership interest (the purpose of this rule is to preclude direct and indirect partners from reducing the amount of deferred gain they must recognize)**
- **Partnership disguised sale transactions**
  - **Generally, certain transfers of property to a partnership followed by an actual or deemed distribution to the contributor partner can be treated as a taxable sale**

End of Deferral – Inclusion Events

- ***The April 2019 Proposed Regulations provide that debt-financed distributions by a partnership QOF within 2 years of a roll-over contribution is an Inclusion Event***

- **A QOF investor may roll-over gain realized on a disposition of a QOF interest into another QOF; however the holding period for the second investment in a QOF begins when the second investment is acquired**

10-Year QOZ Benefit

- If a QOF investor holds its QOF interest for at least 10 years and disposes of that interest on or before December 31, 2047, the QOF investor will not recognize gain equal to the appreciation in its QOF interest
- Several issues were raised by this language and many early QOFs were intended to own only a single property to more easily facilitate a sale by the QOF investors of their interests in the QOF

10-Year QOZ Benefit

- Will a QOF investor avoid gain recognition if instead of the investor selling its QOF interest, the QOF sells its assets?
  - **The April 2019 Proposed Regulations allow a QOF investor in a pass-through QOF to exclude capital gain from a QOF's sale of QOZBP or its interest in a QOZB if the gain is reported on a K-1**
  - **The gain exclusion does not extend to other property sold by a QOF or to ordinary income (such a depreciation recapture) recognized by the QOF**
  - **This gain exclusion applies *only* to gain recognized by a QOF, not by a QOZB**

10-Year QOZ Benefit

- If a partner in a QOF partnership that has debt sells its QOF interest, will it recognize gain?
  - When a partner in a partnership sells a partnership interest, the sales price, for tax purposes, is the sum of the cash received by the partner plus the partner's share of the partnership's liabilities
  - Technically, when a QOF investor sells its QOF interest after holding such interest for at least 10 years, immediately before the sale, the investor's tax basis for its QOF interest steps up to its fair market value

10-Year QOZ Benefit

- The fair market value of the interest in the partnership QOF is the fair market value of the equity, not the unencumbered fair market value of the partnership QOF's property
- **The April 2019 Proposed Regulations solve this problem by stepping-up the QOF investor's tax basis for its partnership QOF interest immediately before the sale to the sum of (x) the fair market value of the partnership QOF interest and (y) the investor's share of the partnership QOF's liabilities**

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 that the entity is a QOF and continues 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
  - A QOF cannot be a disregarded entity

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 (QOZBP or an interest in a QOZB)
  - 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?

- **Preamble to the April 2019 Proposed Regulations states that IRS Form 8996 will be revised to require additional information such as the EIN of any QOZB owned by the QOF and the amounts invested by the QOFs and QOZBs in particular census tracts**

Organizing the QOF

- Not necessarily a "fund" but an investment vehicle
- No limit on the number of investors in the QOF or amount that may be invested in the QOF
- Investment must be an equity interest in QOF
  - May establish different/preferential classes of equity
- Both roll-over gain investors and others permitted
- QOF can own any percentage in subsidiary QOZBs
- Economics of interest in QOF and governance of QOF left to negotiation

What is a QOF?

- **Asset Test:**
  - To be a QOF, the corporation's or partnership's assets must be comprised of at least 90% QOZBP and/or interests in a QOZB
  - A QOF may not invest in another QOF
  - Cash and working capital is not a "good asset" for purposes of the QOF 90% test
    - **But the April 2019 Proposed Regulations provide a 6-month grace period during which contributions to a QOF are ignored for purposes of the QOF 90% asset test, provided that such amounts are held by the QOF in cash, cash equivalents or debt instruments with a term of 18 months or less**

What is a QOF?

- The 90% test is an average on two snapshot dates (1) the last day of the first 6-month period of the QOF's tax year, and (2) 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
- The calculation of the 90% test will be made on Form 8996, but guidance yet to come on calculation specifics

What is a QOF?

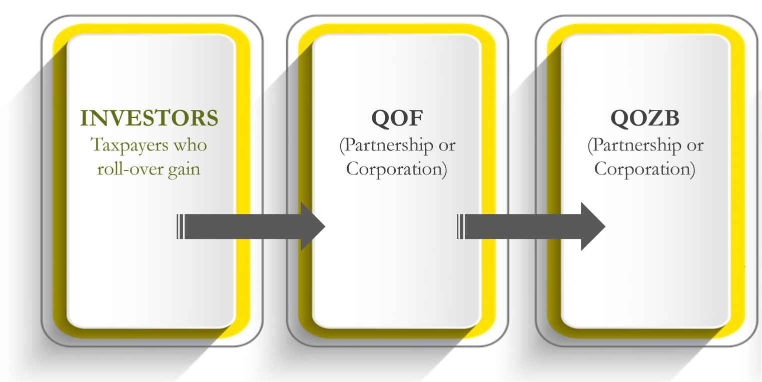
- Valuation methods
  - Applicable Financial Statements–use value reported on financial statements filed with the SEC or federal agency other than IRS, or financial statements prepared in accordance with U.S. GAAP
    - **For leased property, the value reported on a GAAP financial statement may be used if GAAP assigns a value to the leased property OR**
  - Use QOF's cost basis of assets on date of acquisition
    - **For leased property, value is determined at the start of the lease by calculating the present value of the lease payments using the AFR as the discount rate (and using that value for the entire lease term)**

What is a QOF?

- **QOF may elect each taxable year which method to use and must use a consistent method each taxable year for all assets**

QOF Investments

QOF investment in QOF Stock / Partnership Interest



QOZB - QOZ Stock/QOZ Partnership Interest

QOZ Stock/QOZ Partnership Interest

- Stock or a partnership interest in a subsidiary of the QOF acquired at original issuance solely for cash after December 31, 2017
- When the stock or partnership interest is issued, the subsidiary is a QOZB. If the subsidiary is a new entity, the subsidiary is organized for purposes of being a QOZB

QOZB - QOZ Stock/QOZ Partnership Interest

- During "substantially all" (at least 90%) of the time the QOF owns the interest in the subsidiary, the subsidiary qualifies as a QOZB. The Treasury seems to believe this is an annual test, not a test applied over the life of the QOZB, but acknowledges the rules are not clear

Partnership QOF

- Will the ordinary rules applicable to inclusion of partnership liabilities in a partner's tax basis for its partnership interest apply to a partner in a partnership QOF?
- **The answer is yes according to the April 2019 Proposed Regulations**
- **This generally means a QOF investor in a partnership QOF that has leverage will be able to receive debt-financed distributions and (subject to other loss limitations), deduct losses allocated to it from the partnership QOF**

Partnership QOF

- **The April 2019 Proposed Regulations provide that debt-financed distributions by a partnership QOF within 2 years of a roll-over contribution is an Inclusion Event**
- Limiting possibility of Inclusion Events, including debt-financed distributions, should be a focal point of negotiation at QOF formation and investment into QOZB

Standard Formation Issues

- QOFs involve traditional entity formation issues inherent in any partnership agreement, operating agreement, investor rights agreement, buy-sell agreement
- Standard topics for negotiation:
  - Board, manager, general partner appointment, removal, scope of authority, compensation
  - Protective provisions, equity holder approvals
  - Rights of first refusal, co-sale, tag along/drag along rights, participation rights

QOF Formation Issues

- Intense focus in QOF formation on:
  - Approvals over events that (1) disqualify QOF; (2) result in QOF investors not meeting 5/7 year holding periods; and (3) result in QOF investors not meeting 10-year holding period
  - Approvals over changes in business that may disqualify QOZB subsidiary
  - Trend toward QOZ investor class approvals on these items
  - Consequences for failure to qualify as a QOF, assessment of non-compliance penalties
- Clash between long-term requirements of QOZ program and shorter-term aims of investors

Churning

- The October 2018 Proposed Regulations promised 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
- That promise was fulfilled somewhat disappointingly in the April 2019 Proposed Regulations:

Churning

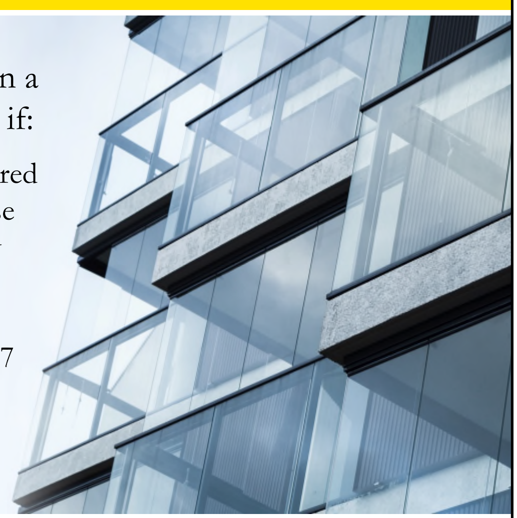
- **A QOF may reinvest (x) a return of capital from the QOF's investment in a QOZB and (y) proceeds from a sale or disposition by the QOF of QOZBP or an interest in a QOZB into other QOZBP or a QOZB provided that:**
  - **The reinvestment is made within 12 months**
  - **During the 12-month period, the proceeds are invested in cash, cash equivalents, or debt instruments with a term of 18 months or less**

Churning

- **If these rules are satisfied, the QOF investor's holding period for its QOF interest is not reset, the QOF investor's deferred gain is not recognized, and the QOF's 90% asset test is not impacted**
- **But – and this is a BIG but – a QOF investor in a pass-through QOF or a corporate QOF must recognize the gain on such sale**

QOZ Business Property (QOZBP)

- 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) after December 31, 2017



QOZ Business Property (QOZBP)

- “Purchase” does not include property acquired by a QOF from a capital contribution—such property is not QOZBP
- **The property is leased under a lease entered into after December 31, 2017**

QOZBP – Original Use

- The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property
  - **According to the April 2019 Proposed Regulations, original use means placed in service by any person**
    - o **Subject to certain vacancy rules, if property has been placed in service by any person, it has been originally used and, if that original use was in a QOZ, the property must be substantially improved**
    - o **Improvements made to leased property are treated as originally used**

QOZBP – Original Use

- **Relief from the original use requirement is provided by the April 2019 Proposed Regulations for property, including a building or other structure, that has been vacant or unused for at least 5 years before acquisition by the QOF or QOZB**
  - **Because this is original use when acquired by the QOF or QOZB, such property is not required to be substantially improved**

QOZBP – Substantially Improved

- 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 tax basis for the property at the beginning of the 30-month period
- If the QOF acquires land and improvements, only an amount equal to the cost allocable to the improvements must be spent to constitute a substantial improvement, and the cost of the land is included QOF's 90% test or the QOZB's 70% test

QOZBP – Substantially Improved

- **Land purchased from an unrelated person after December 31, 2017, or leased under a lease entered into after December 31, 2017, is not required to be substantially improved**
- **The Preamble to the April 2019 Proposed Regulations provides that whether tangible property is QOZBP and must be substantially improved is determined on an <u>asset-by-asset basis</u>**
  - **The asset-by-asset test causes challenges for existing businesses in a QOZ**

QOZBP

- During at least 90% of the QOF's holding period for the property, at least 70% of the use of such property was in a QOZ
- A QOF cannot have more than 10% of its assets in "bad assets," which includes working capital. But a QOF's subsidiary QOZB can hold reasonable working capital.

QOZBP and Leased Property

- **Leased property is QOZBP if:**
  - The property is leased under a lease entered into after December 31, 2017
  - When the lease is entered into, its terms are arms-length
  - During at least 90% of the QOF's or QOZB's holding period for the leased property, 70% of the leased property's use is in a QOZ

QOZBP and Leased Property

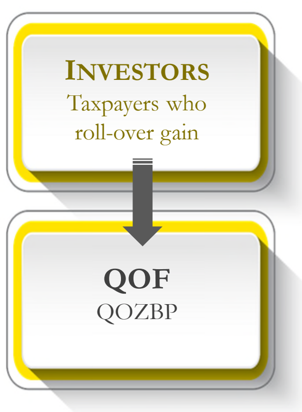
- **Property may be leased from a related party if the QOF or QOZB meets special rules**
  - Lessee cannot prepay rent for a period exceeding 12 months
  - If the leased property is tangible *personal* property and the original use of such property in the QOZ did not commence with the lessee, the lessee must become the *owner* of tangible property with a value at least equal to the value of the tangible *personal* property leased from the related person within the earlier of (a) 30 months after the lessee receives possession of the property or (b) the end of the lease term

QOZBP and Leased Property

- There must be a substantial overlap in the QOZs where the leased property and the property acquired to satisfy the second test is used

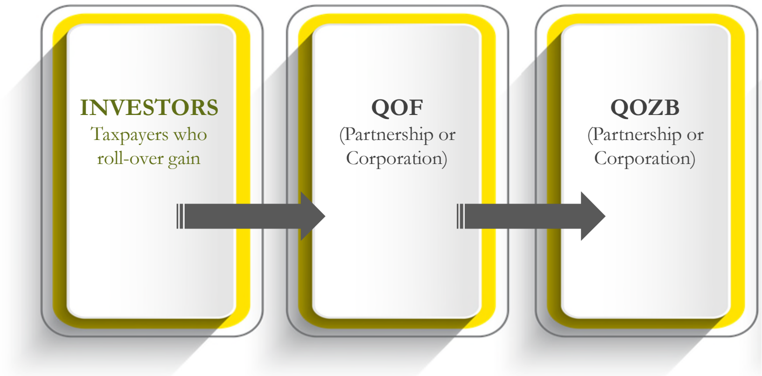
Structuring QOF Investments

Direct investment by QOF in QOZBP



QOF Investments

QOF investment in QOZB



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QOZB Conducted by QOF Subsidiary

- If a QOF invests in a subsidiary, the subsidiary must be a QOZB for substantially all (at least 90%) of the time the QOF owns an interest in the subsidiary. Treasury acknowledges that it is not clear how this test is applied. Apparently, the intention is annually

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QOZB Conducted by QOF Subsidiary

- For a subsidiary to qualify as a QOZB it must be:
  - A trade or business that at least 70% of its tangible property (owned or leased) qualifies as QOZBP
  - For property held by a QOZB, but not a QOF, property that ceases to be QOZBP will continue to be treated as QOZBP for the lesser of: (a) 5 years after the property ceased to qualify or (b) the date the property no longer is held by a QOZB
  - At least 50% of the total gross income of the QOZB is derived from the active conduct of the QOZB's business in the zone
  - A substantial portion **(at least 40%)** of the QOZB's intangible property is used in the active conduct of its business in the zone

QOZB Conducted by QOF Subsidiary

- Less than 5% of the aggregate adjusted basis of the QOZB's 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
  - Reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less are not nonqualified financial property

QOZB Conducted by QOF Subsidiary

- QOZBP owned or leased by QOZB that ceases to be QOZBP will continue to be treated as QOZBP (for a QOZB) for the lesser of (a) 5 years after the QOZBP ceases to qualify or (b) the day the property no longer is held by the QOZB

QOZB Conducted by QOF Subsidiary

- The QOZB 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

Active Conduct

- At least 50% of a QOZB's gross income must be from the active conduct of a trade or business in a QOZ
  - **The April 2019 Proposed Regulations reserve on what constitutes an active trade or business**
  - **Special Rule for Real Estate**
    - **Ownership and operation, including leasing, of real property used in a trade or business is treated as the active conduct of a trade or business**
    - **Merely entering into a triple net lease is not the active conduct of a trade or business**

Active Conduct - Sourcing

- **The April 2019 Proposed Regulations provide 3 safe harbors for sourcing gross receipts to a QOZ**
  - **Hours Test – at least 50% of a QOZB's services are performed by the QOZB's employees, independent contractors and the employees of independent contractors in the QOZ**
  - **Compensation Test – at least 50% of the amount paid by a QOZB to its employees, independent contractors, and employees of independent contractors is for services performed in the QOZ**

Active Conduct - Sourcing

- Qualitative Test – the tangible property of the QOZB <u>and</u> the managerial/operational functions of the QOZB that are necessary to produce at least 50% of the QOZB's gross income are in the QOZ
- Facts and Circumstances indicate that at least 50% of the QOZB's gross income is sourced to the QOZ

Active Conduct - Property Straddling a QOZ

- For purposes of determining if at least 50% of a QOZB's gross income is generated in a QOZ, real property is deemed to be located in a QOZ if the QOZB's real property located within the QOZ is substantial as compared to the QOZB's real property located outside of the QOZ. (The relief provided for contiguous property is only for purposes of the 50% gross income text, not the QOZB's 70% asset test or the QOF's 90% asset test)

Active Conduct - Property Straddling a QOZ

- The April 2019 Proposed Regulations provide a QOZB's real property outside of the QOZ will be deemed to be located in a QOZ if (1) the square footage of property within the QOZ is substantial as compared to the square footage outside of the QOZ and (2) the real property located outside of the QOZ is contiguous to all or part of the property located within the QOZ
- However the preamble to the April 2019 Proposed Regulations describe a different test. Real property owned by a QOZB outside of a QOZ will be deemed to be located within a QOZ if the unadjusted cost of the real property within the QOZ is greater than the unadjusted cost of the real property outside of the QOZ

QOF Directly Conducts Business vs. QOF Conducts Business Through QOZB

QOF Owns QOZBP <u>Directly</u>

QOZBP is:

- Tangible property used in QOF's business
- The tangible property was acquired from an unrelated person by purchase after December 31, 2017 or leased under a lease entered into 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 <u>that Conducts QOZB</u>

- Substantially all of the QOZB's tangible property (owned or leased) is QOZBP (same as what QOF can own or lease directly)
- At least 50% of the gross income of the QOZB is from the active conduct of the QOZB
- A substantial portion of the QOZB's intangible property is used in the active conduct of its business

Directly Conducts Business vs. QOF Conducts Business Through QOZB

QOF Owns QOZBP Directly (Continued)

- 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 QOZB (Continued)

QOZB:

- 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"

Reasonable Working Capital

- The October 2018 Proposed Regulations and the April 2019 Proposed Regulations provide a safe harbor for reasonable working capital that can be held by a QOZB, 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 **or the development of a business in a QOZ,**
    - there is a written schedule consistent with the ordinary start-up of a trade or business for spending the working capital,

Reasonable Working Capital

- o the working capital must be spent within 31 months of receipt, and
- o the working capital is actually used in a manner consistent with the above

- If these requirements are satisfied:
  - For purposes of determining if at least 50% of a QOZB's gross income is sourced to a QOZ, gross income derived from the reasonable working capital is deemed to be from the active conduct of the QOZB's business in the QOZ
  - For purposes of determining if at least 40% of a QOZB's intangible property is used in the QOZ, the reasonable working capital is deemed to satisfy this requirement

Reasonable Working Capital

- The tangible property or business that the working capital is intended to develop does not fail to be QOZBP solely because the scheduled consumption of the working capital is not completed

Case Studies

Putting it all together

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Case Study 1

On June 1, 2019, Joe realizes $20 million of section 1231 gain from the sale of his shopping center. Joe is approached by Karen to invest in a Qualified Opportunity Zone project to be owned by QOZB LLC. Joe had attended a Ballard Spahr webinar on Qualified Opportunity Zones.

Within 180 days of the end of Joe's tax year, Joe invests the entire $20 million in QOF LLC. Karen is the managing member of QOF LLC. Karen will have a profits interest in QOF LLC. QOF LLC's organizing documents reflect that it is intended to be a QOF. QOF LLC contributes $20 million to QOZB LLC in exchange for a membership interest in QOZB LLC, an entity treated as a partnership for federal income tax purposes.

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Case Study 1

QOZB LLC is a real estate developer that has written plans to acquire land in a QOZ on which it plans to construct a commercial building for lease to multiple tenants. In 2023, QOZB LLC places the building in service and the building is fully leased to multiple tenants.

Case Study 2

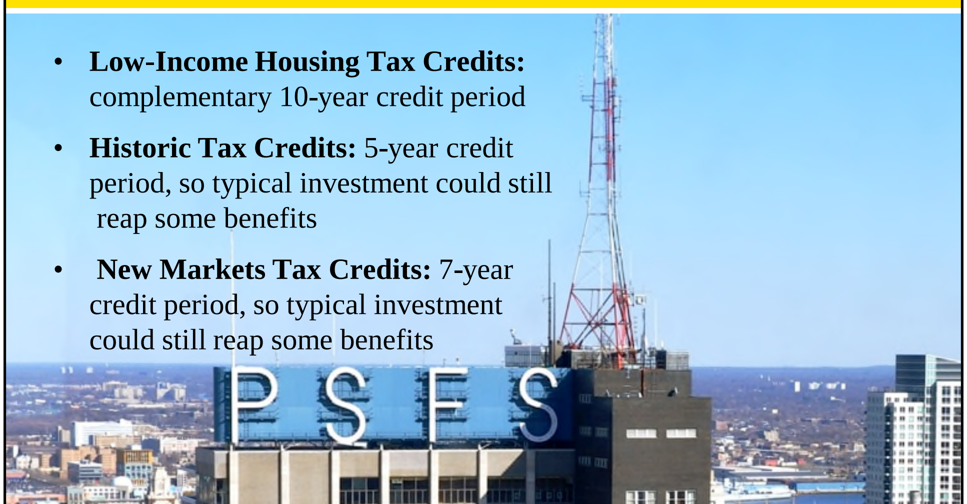
- QOF creates a QOZB. QOZB intends to start a new technology company. Investors invest $10 million of roll over gain in QOF and QOF contributes that $10 million to QOZB for an interest in QOZB on September 1, 2019. In addition to QOZB's rapid deployment of capital received from other equity investors, QOZB writes a plan with a 3-month schedule for the use of the $10 million invested by QOF. The plan describes use of the cash to research and develop a new technology, including paying salaries for engineers and other scientists to conduct the research, purchasing, and leasing equipment to be used in research and furnishing office and laboratory space.

Case Study 2

- On March 1, 2021, QOF contributes additional cash (from additional roll over investments) to QOZB, and QOZB writes a second plan. This new plan has a 25-month schedule for the development of a new application of existing software, to be marketed to government agencies. Among QOZB's planned uses for the cash received on March 1, 2021 are paying development costs, including salaries for software engineers, other employees, and third-party consultants to assist in developing and marketing the new application to the anticipated customers across the nation. QOZB intends to invest the undisbursed amounts that were scheduled for development of the technology in short-term investments, such as a money market fund.

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



Capitalizing the QOFs

Funding of QOFs Involves Offering of Securities

- Traditional securities exemption analysis applies
- Securities Act of 1933, state securities ("blue sky") laws, Investment Company Act of 1940, broker-dealer registration
- Three kinds of offerings: (1) registered, (2) exempt and (3) illegal

Consequences of Unregistered, Non-Exempt Offering

- Remedy of rescission
- Private right of action
- Enforcement actions
- Jeopardize future capital raising
- Reputational risk
- Liability to individual D&Os, controlling persons

Securities Strategies

- Illegal is not an option
- Exempt Offerings – only a few workable
  - Section 4(a)(2) – transaction not including a public offering
  - Regulation D – safe harbor limits investor recourse
  - Regulation A+ – requires SEC filing and mandated disclosure

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Review of Particular Exemptions

- Rule 506(b)
  - unlimited dollars, max 35 non-accredited
  - no general solicitation or advertising
  - restricted, covered security (limits "blue sky" issues)
  - reasonable belief of accredited status (check the box)
  - If non-accredited investors, must provide Rule 502 information
  - no "bad actors"
  - no specific information requirements if all investors are accredited
- Rule 506(c)
  - unlimited dollars, only accredited
  - general solicitation and advertising permitted
  - restricted, covered security (limits "blue sky" issues)
  - must "verify" accredited status – additional burden/challenge
  - no "bad actors"
  - no specific information requirements

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Definition: Accredited Investor

- "Accredited Investor"
  - For individuals
    - Income: $200,000/$300,000
    - Net Worth: $1 million (excluding principal residence)
    - Status: director, executive officer, general partner
  - For entity
    - Assets: $5 million in assets / not formed for purpose of the investment
    - Ownership: all equity owners are accredited
    - Status: banks, broker/dealer, insurance company

Definition: General Solicitation, General Advertising

- "General Solicitation" or "General Advertising"
  - advertisements, articles, notice or communication published in newspaper, magazine, or broadcast
  - any seminar or meeting whose attendees have been invited by any general solicitation or advertising
  - Social media, open websites are de facto "general solicitation" and "general advertising"
  - To avoid, show "pre-existing, substantive relationship"

Offering Information in QOF Context

Antifraud Provisions

- Untrue statement of material fact
- Any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading
- Consider what information has been provided (or not provided) to prospective investors
- Best practices in disclosure documents become even more critical in QOF context

Areas of Risk for QOFs

- Financial Information
- Projections, Pro Formas
- Returns to Investors
- Use of Proceeds
- Explanation or Assurances Re: Tax Consequences to Investor or QOZ Program
- Related Party Transactions

QOF Offering Issues

- QOF offerings are time sensitive / fact intensive
  - Escrows for minimums can be challenging with 180 day requirement
  - 90% of QOFs assets must be QOZBP or invested in subsidiary QOZB
  - Subsidiary QOZB's tangible assets must be composed substantially all (at least 70%) of QOZBP/ "active conduct" tests

QOF Offering Issues

- Securities, tax lawyers must work hand-in-glove with client to understand:
  - Profile of target investors
  - Current and future compensation to finders/agents
  - Use of proceeds to purchase QOZBP or invest in subsidiary QOZB
  - Governance decisions of subsidiary
- Assumptions that drove formation governance decisions will be tested, possibly necessitating changes mid-offering

QOF Guidance – More to Come?

- Will a QOF or QOZB be able to aggregate assets for purposes of the substantial improvement test?
- How will the substantial improvement test apply in the context of an operating business?
- Can a QOZB, as opposed to only a QOF, reinvest proceeds from a disposition of QOZBP or other assets?
- What additional information will the IRS require from QOFs so that it may track how the QOZ program is working?
- What are the administrative rules and applicable penalties if a QOF fails to satisfy the 90% test?

Resources

For updates on this topic and more visit:
https://www.ballardspahr.com/trac

A copy of these slides and a recording of the presentation will be available at: *https://www.ballardspahr.com/opportunityzones*

To contact a member of Ballard Spahr's QOZ team:
https://www.ballardspahr.com/practiceareas/initiatives/qualified_opportunity_zones/people.aspx

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Questions?

Thank you for your time!