

Qualified Opportunity Zones

November 1, 2018

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: <input type="checkbox"/> Corporation <input type="checkbox"/> Partnership		
2 Is the taxpayer organized for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund)? <input type="checkbox"/> No. STOP. Do not file this form with your tax return. <input type="checkbox"/> Yes. Go to line 3.		
3 Is this the first period the taxpayer is a Qualified Opportunity Fund? <input type="checkbox"/> 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. <input type="checkbox"/> 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.		

Welcome and Introductions

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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
- Two additional guidance packages are expected, one this year and the other in the spring of 2019
- IRS and Treasury are seeking comments on the Proposed Regulations and for future guidance

Benefits of Investing Gains Into Opportunity Funds

- Deferral
- Gain Elimination

Who and What

- **Who gets the benefits:**

A taxpayer that rolls over long or short term capital gain 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

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

Gain Eligible to be Deferred

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

Qualified Investment in a QOF

- Must be equity, cannot be debt
 - 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

Deferral

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



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

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 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 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 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 at least equal to 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 equal to 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.

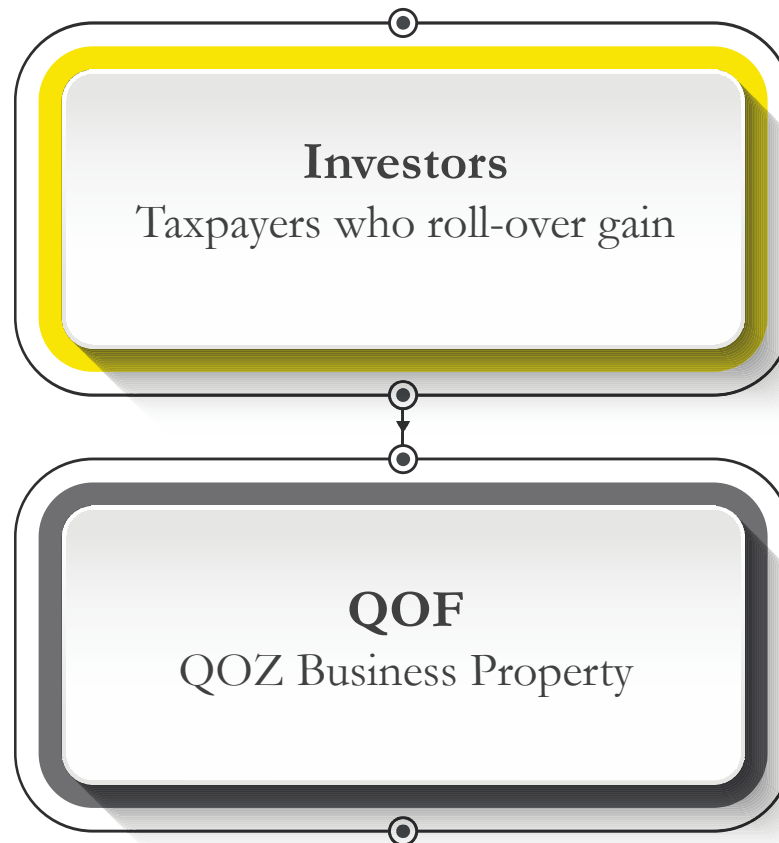


QOZ Business Property

- 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 ceased 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.

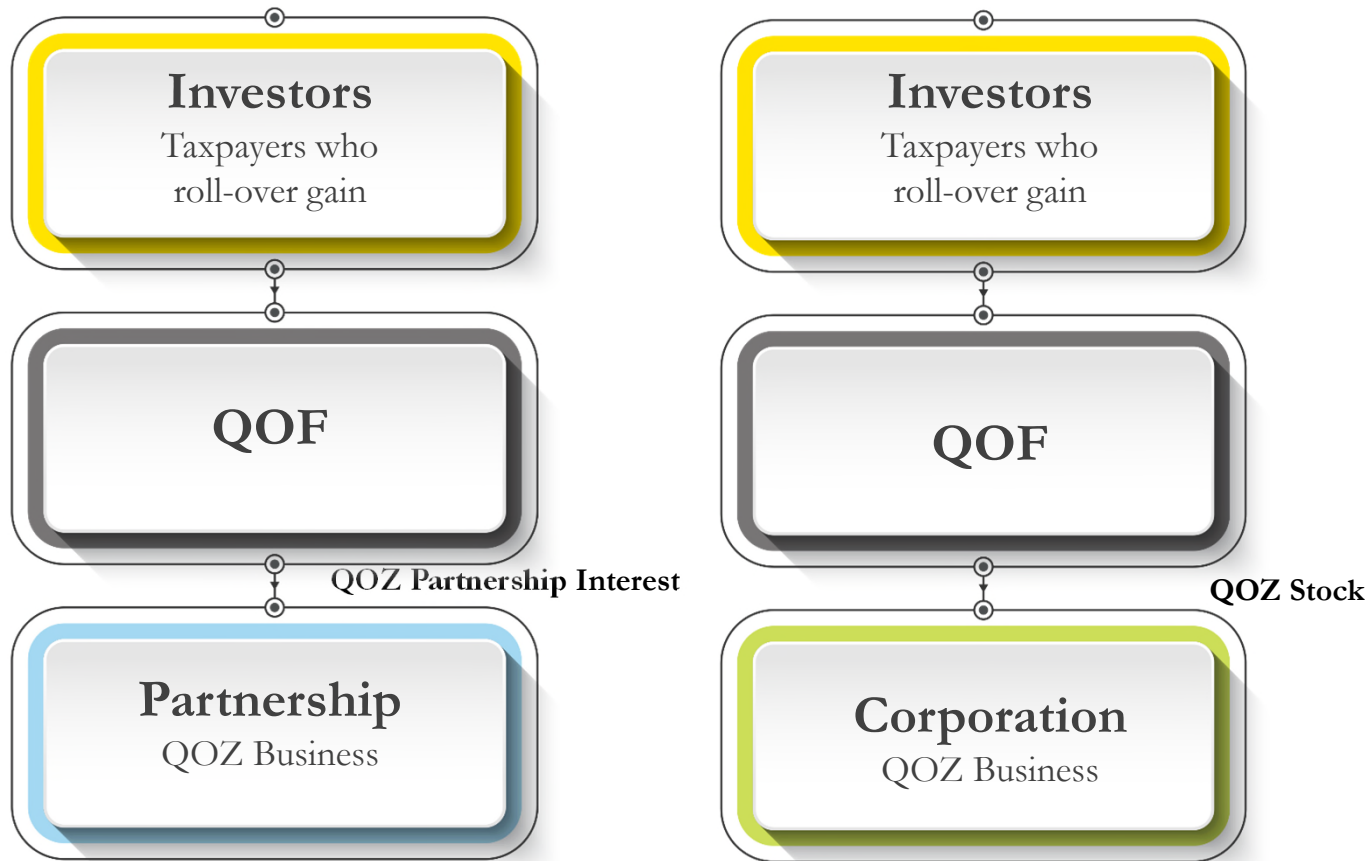
Structuring QOF Investments

Direct investment by QOF in QOZ Business Property



QOF Investments

Direct investment in QOF Stock / Partnership Interest



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:
 - 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 at least equal to 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
- The same rule about property ceasing to be QOZ Business Property applies

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

QOZ Business Conducted by QOF Subsidiary

- 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)
- 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:

- 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 50% of gross income or property in the 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's 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

Capital Raising Regulatory Framework - General

- Securities Act of 1933, as amended
- State securities laws (“blue sky”)
- Three kinds of offerings:
 - registered
 - exempt
 - illegal



Capital Raising Regulatory Framework - General

- Private right of action and remedy of rescission; enforcement; jeopardize future capital raising; reputational risk
- State and Federal Broker Dealer Laws / Regulations – generally, any person or entity paid a transaction based “commission” on investment must be registered
- Investment Company Act of 1940
- Investment Advisers Act of 1940 / Comparable State Laws

Capital Raising - Regulatory Framework – Important Definitions

- “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

Capital Raising - Regulatory Framework – Important Definitions

- “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 business relationship”

Capital Raising – QOFs

- Given Facts/ Observations
 - QOF investors with significant capital gain are likely to be “accredited investors”
 - QOF holding period requirements mean near term liquidity may not be a priority
 - Unique QOF investor profile may require general solicitation
 - Evolving QOF tax regulations mean increased uncertainty and investor risk
- Registered offering is costly and primary benefits are ability to include non- accredited investors and increased liquidity

Capital Raising – QOFs

- Illegal is not an option
- Exempt Offerings
 - Section 4(a)(2) – transaction not including a public offering
 - Crowd funding – limited to \$1 million in a 12-month period
 - Regulation D – safe harbor limits investor recourse
 - Regulation A+ – requires SEC filing and mandated disclosure

Capital Raising – Regulation D

Rule 506(b)

- unlimited dollars, max 35 non-accredited investors
- *no* general solicitation or advertising
- restricted, covered security (limits “blue sky” issues)
- reasonable belief of accredited status
- 4(a)(2) safe harbor
- no “bad actors”
- limited information requirements if all investors are accredited

Rule 506(c)

- unlimited dollars, only accredited investors
- general solicitation and advertising *permitted*
- restricted, covered security (limits “blue sky” issues)
- must “verify” accredited status – additional burden
- safe harbor
- no “bad actors”
- limited information requirements

Capital Raising – QOFs

- Avoid “commission” on procurement of investors or use registered broker dealer
- QOF may be subject to the registration under the Investment Company Act of 1940 - exempt if less than 100 beneficial owners, or more if all are “qualified purchasers” (investments of \$5 million for individuals/\$25 million for entities)
- Sponsor may need to register under Investment Advisers Act of 1940 and comparable state laws, although short form registration available for funds up to \$150 million, and registration may be determined unnecessary, particularly for real estate funds

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?

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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.asp

X

Questions?

Thank you for your time!