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Qualified Opportunity Zone Structuring

Federal Income Tax Overview and Related Business Considerations

Coasis Coalition

Opportunity Zone SuperConference

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How does the tax incentive work?

- The QOZ program offers investors three incentives for putting their capital to work rebuilding economically distressed communities:

1. **A temporary deferral:** An investor can defer capital gains taxes until 2026 by putting and keeping unrealized gains in a QOZ Fund. Character is maintained. Last day to contribute is June 29, 2027.

2. **A reduction:** The original amount of capital gains on which an investor has to pay deferred taxes is reduced by 10% or 15%, respectively, if as of December 31, 2026 the QOZ Fund investment is held for 5 years or 7 years, respectively.

3. **An exemption:** Any capital gains on new investments made through the QOF accrue tax-free through 2047 as long as the investor holds them for at least 10 years and makes one-time election to increase basis in QOF interest.

What are the main QOZ/QOF restrictions?

- The benefit of the QOZ program is achieved by investing capital gains onto a Qualified Opportunity Fund (QOF) and holding onto the QOF interest for 5, 7, or 10 + years.

1. **Investing Capital Gains in 180 days:** Capital gain from third-party sales are invested in QOF within 180 days of recognition. Includes short-term capital gain and 25% capital gain, but character retained.

2. **QOF restrictions:** QOF's property must be original use or "substantially improved" in 30 months. Penalty tax to extent less than 90% of assets are not good QOZ property. BUT, lower-tier QOZ partnership only required to have 70% good QOZ property and written budget plan to spend cash on construction counts cash as good "working capital" if spent within 31 months.

3. **Liquidity and exit restrictions:** QOF debt-financed distributions expected to be limited to future value growth dollars only, but likely needed in 2026 to pay deferred tax. QOF 10-year exemption only applicable to sales of QOF interests so pressure for QOF-level Section 1031 exchanges at least through year 10. Absent regulatory change, may need to exit by friendly sale of QOF interest followed by asset sale.

Qualified Opportunity Zone Overview

Investor

Property sold
(basis $400,
value $1,000)

1

$1,000 cash
$600 gain

Unrelated buyer

2

$600 contribution (“rollover equity”)
Timing: within 180 days of step 1.
Effect: Deferral of entire $600 gain until earlier of 12/31/26 or disposition.

Qualified Opportunity Fund (QOF)

Tax Benefits

- Deferral of unrelated tax gain: the $600 is deferred until up to 12/31/26 (or earlier sale)
- Up to 15% exclusion of unrelated gain: after a 5-year hold investor increases basis by 10% of the $600, or $60; at 7-year point basis increases another 5% or $30.
- Potential complete exemption of post-contribution QOZ Property gain: If Investor has not sold within 10 years after Step 1, no tax on post-contribution appreciation in QOF interests.

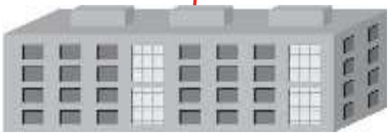
3

Working Capital (“WC”) Exception
Temporary cash held for property development over next 31 months pursuant to written plan is deemed QOZ property for purposes of 70% & 90% test.

At least 90% of $600 invested as equity in Qualified Opportunity Zone (“QOZ”) Property (reduced to 70% in qualified lower-tier entity).
Timing: 90% tested twice a year (6 month point and end of year).
Effect: Failure to satisfy QOF status results in penalty. Any shortfall on the 90% is penalized at the tax underpayment rate. Broader QOF disqualification risk if shortfall continues.

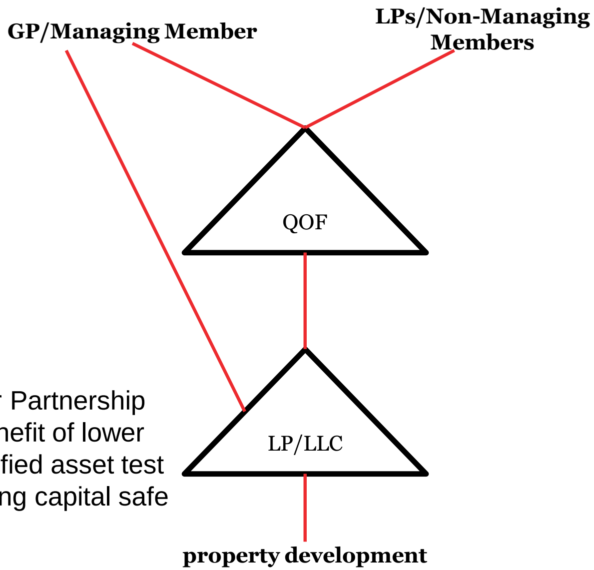
partnership

Corporation



QOZ Property is limited to equity investments in trade or business property (i) that is newly purchased from unrelated person; (ii) the original use begins in QOZ or QOF substantially improves property (building improvements exceed basis); and (iii) substantially all use of property is in a QOZ.

Typical Structure



Lower-tier Partnership allows benefit of lower 70% qualified asset test and working capital safe harbor.

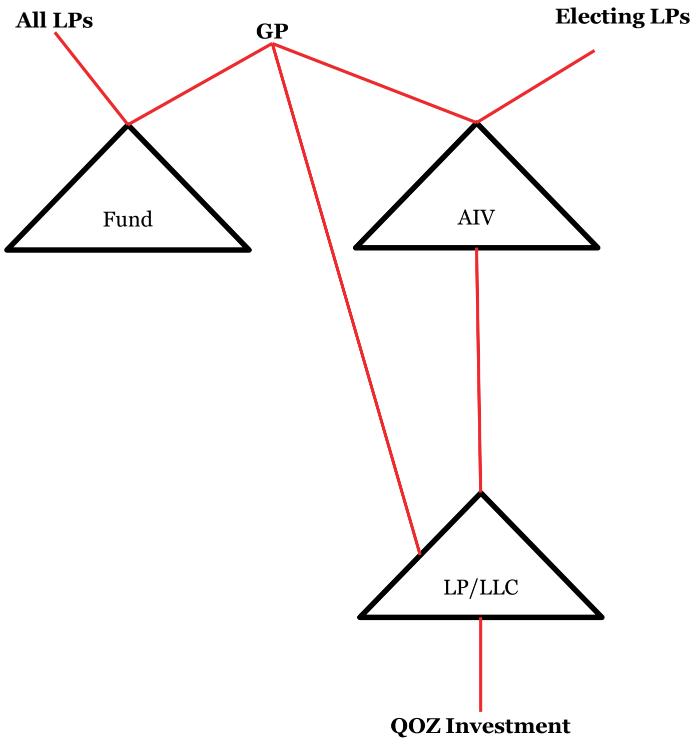
<u>QOF Holds an Interest in one or more LP/LLCs</u>

- QOZ Partnership Interest
  1. Acquired by QOF after 12/31/17 for cash
  2. LLC is a “QOZ Business”
  3. For substantially all of QOF’s holding period in LLC, LLC qualified as QOZ Business

<u>QOZ Trade or Business Considerations</u>

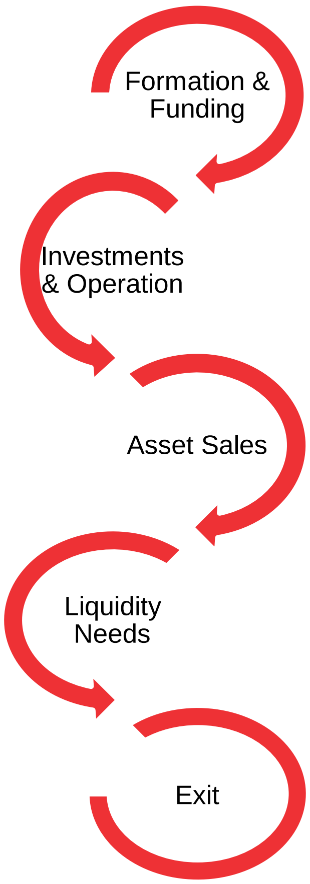
1. Substantially all (70%) tangible property owned or leased by taxpayer is QOZ Business Property
   1. Acquired after 12/31/17
   2. Original use or substantially improve (double basis)
   3. Substantially all use within QOZ
2. Satisfy the following:
   1. 50% or more gross income from active business
   2. Substantial portion of the LLC’s intangible property is used in the trade or business
   3. Hold less than 5% nonqualified financial property (excluding cash held under working capital safe harbor)

Fund Overlay



- Existing funds typically consist of a mixture of taxable and non-taxable limited partners.
- It is unlikely an existing fund can (or wants to) qualify as a QOF.
- If Fund has flexibility for AIV structures, it can form an AIV for those LPs interested in making QOF investments.
- **Caution**: IRS has not yet provided guidance as to whether an AIV can invest in a QOF rather than becoming a QOF. Until guidance is issued, the conservative approach is to assume the AIV must be a QOF.

QOF Life Cycle



- Form QOF
- Segregate non-deferral contributions

- Buy development property from unrelated party in QOZ
- Written business plan
- Document 90% test
- Less than 5% invested in financial assets

- Sales inside the QOF are taxable to partners; IRS guidance to address whether sale of interest is needed for QOF benefits.
- QOF can engage in 1031 transactions without accelerating gain.

- Tax owed in 2026 on deferred gains.
- Expect regulatory restriction that distributions cannot reduce original equity contributed.

- QOF available benefit through 2047
- May need to sell QOF equity to friendly partner who then sells property at exit.

Contribution Overview

- Can only contribute "capital gains" and deemed capital gains (e.g., Section 1231 gains) for tax benefits. Interests received for contributed cash have "zero basis", and we refer to the cash as "zero basis dollars."
- No tracing requirement for cash and only need to contribute cash equal to the gain (not the full proceeds as in a Section 1031).
- 180 days to rollover gain but partnership-level gain allows partners a second chance to rollover, with 180 day rollover window starting with end of partnership tax year.
- Although can contribute cash in excess of "rollover gain", no tax benefits result and will likely want to segregate to separately track "zero basis dollars" and "full basis" dollars.
- No apparent restriction on using partner-level financing to obtain cash investment.
- QOF can obtain normal property-level financing, which could provide debt basis to allow for flow-through of operating losses.

QOF Asset Sales

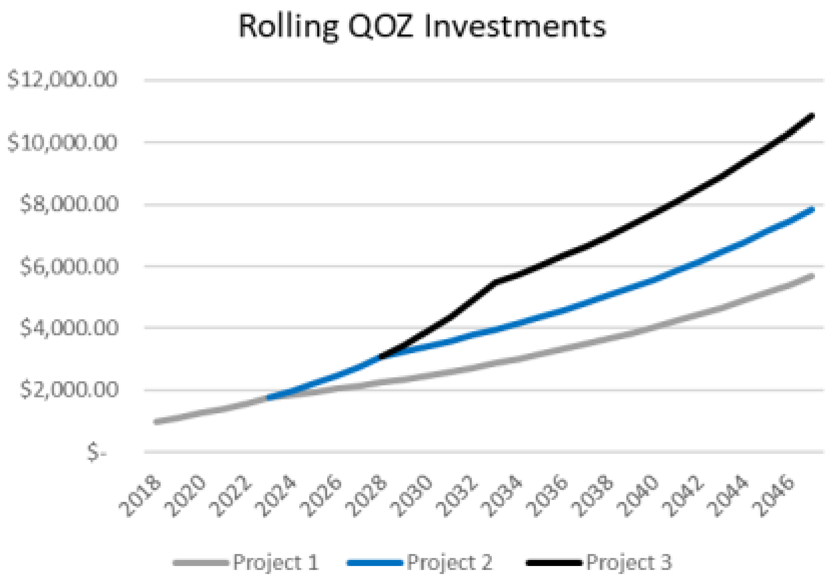
- Currently NO benefits for QOF-level asset sales.
    - Statute only steps up tax basis in QOF interest.
    - Commenters asking IRS to allow a “push down” of QOF basis step up to underlying assets, similar to basis adjustment upon purchase of a partnership interest.
    - Even with push down option, this would only help at end of the life of the QOF as the basis step up election is a one-time election and would likely be made just before taxpayer leaves the fund.
    - Thus, sales during the operational life of the fund are expected to be fully taxable.

- A QOF should be eligible to enter into a Section 1031 transaction and defer gain at the QOF level while continuing to allow investors to receive QOF benefits.

- Statute authorizes regulations to go beyond Section 1031 and provide QOF within a “reasonable period of time” to reinvest the return of capital from QOZ property into new QOZ property.

Rolling QOZ investments

- Project 1
  - Assume $1000 initial contribution to QOZ Fund.
  - 12% IRR for years 1-5.
  - 5% IRR for years 5+.
  - Only 1 QOZ property investment.
- Project 2
  - Years 1-5 IRR is 12% on QOZ property 1 investment.
  - At year 5, Fund sells QOZ property 1 interest and invests in another QOZ property.
- Project 3
  - Years 1-5 IRR is 12% on QOZ property 1 investment.
  - At year 5, Fund sells property 1 interest, and invests in QOZ property 2.
  - At year 10, Fund sells property 2 interest, and invests in QOZ property 3.
- Result: continual deferral of taxable gain.



Liquidity Needs

- Deferred gain from the original property disposition is triggered on December 31, 2026, subject to the 10%-15% reduction.

- Interest holders need cash to pay this tax, and selling a QOF interest may not be feasible.

- Potential solutions:
  - Debt financed distribution (“DFD”) from the QOF or borrow against QOF interest.
    - **Caution**: the IRS has not provided guidance on the amount of a DFD that would be permissible without treating the taxpayer as having impermissibly disposed of its QOF investment. As a conservative measure, it should be assumed that a DFD should not exceed the net appreciation in the QOF investment to avoid the risk of the IRS asserting the taxpayer has disposed of its QOF investment.

Exit

- The rules currently require a disposition of the QOF interest on exit to receive tax exemption.
- If the QOF interest is held for at least 10 years on the disposition date, there is a full gain elimination with respect to any appreciation since the time of the investment.
- Eligibility to eliminate gain on the QOF investment appreciation extends through December 31, 2047.
- Gain elimination achieved by taxpayer election to step up basis in QOF interest to fair market value any time after 10-year holding period.
- As a practical matter, if the tax benefit on exit requires sale of QOF interest, this may involve selling the QOF interest to a friendly party to exempt gain and then the QOF selling the asset. IRS guidance has been requested to avoid need for this extra step.

3 QOZ and QOF Mechanics

Glossary of Terms

- QOZ = Qualified Opportunity Zone

- QOF = Qualified Opportunity Fund

- QOZ Partnership Interest or QOZ Stock = Partnership (corporation) interest acquired by QOF at original issuance for cash (i) when partnership (corporation) is (or is being organized as) a QOZ Business, and (ii) the entity is a QOZ Business during substantially all of the QOF's holding period

- QOZBP = Qualified Opportunity Zone Business Property (directly held QOZ business property, QOZ Stock, or QOZ Partnership Interest)

Formation & Funding: Taxpayer Eligibility

- The taxpayer must have eligible capital gain.
  - Excludes Section 1245 and Section 1250 recapture or gains under Section 1221 (inventory/dealer property).
  - Includes Section 1231 gains (gain from the sale of property used in a trade or business), capital gain from carried interest, short term capital gain, and 25% rate real estate recapture capital gain. (Not clear if Section 1231 gain is determined before or after Section 1231 loss netting.)
- The taxpayer has to invest ***after*** the fund has certified itself as a QOF.
  - The investment must be made within 180 days of the date that the gain is recognized.
    - The proposed regulations provide that if a partnership sells a capital asset, the partner may begin the 180-period as of the last day of the partnership's taxable year.
- The taxpayer must comply with certain filing and election obligations.

Formation & Funding: Fund Eligibility

- A QOF:
  - Is an entity taxable as a partnership or a corporation
  - Must hold 90% of its assets as QOZBP (but see working capital safe harbor).
  - Must certify as a QOF and for the taxable year in which it makes a certification, can designate the month in which its QOF status begins (otherwise starts as first month eligible in election year).

Formation & Funding: Fund Eligibility

- A QOF:
  - Must self-certify every six months that it meets the 90% QOZBP test.
    - First year the 6-month period starts with effective date of QOF election (so if election effective 3/31, first 6-month period is 9/30 and if election after 6/30 first certification is 12/31).
    - Each year after its first taxable year, the 90% test must be met at the end of 6-months and at the end of the taxable year.
    - Certification requires documentation:
      - A financial statement verifying 90% QOZBP, or
      - If no financial statements are available, rely on the cost of the assets.

Investments & Operations

- During operations, the QOF:
  - Must holds 90% of its assets as QOZBP (but see working capital safe harbor).
  - QOZBP consists of:
    - Newly developed real estate
    - Purchased real estate after 12/31/17 from an unrelated party, but only if the QOF substantially improves existing property, which is defined as investing an amount at least equal to the basis apportioned to the purchased existing property.
    - QOZ partnership interests or stock, but only if such partnerships or corporations are engaged in a **QOZ business** for substantially all of the QOF's holding period in such stock or partnership interests.

Investments & Operations: QOZ Business

A trade or business where:

- Substantially all of the tangible property owned or leased is qualified opportunity zone business property (waiting on definition of “substantially all”).
- 50% plus of the gross income of the business is derived from the active conduct of such business (concerns NNN property might not be “active” business).
- A substantial portion of the intangible property of such business is used in the active conduct of such business.
- Less than 5% of the average of the aggregate unadjusted bases of the property of the business is attributable to nonqualified financial property (debt, stock, partnership interest, options and other financial instruments except for allowable amount of working capital cash).
- Disallowed businesses: golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

Investments & Operations: Working Capital Safe Harbor

- The proposed regulations provide a working capital exception for qualified opportunity businesses that allows a QOF to hold more than 5% nonqualified financial property (limited to cash, cash equivalents and short-term debt).

- To satisfy the requirement:

  - Amounts must designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in the OZ <u>(other type of businesses aren't eligible for the 31 month WC exception).</u>

  - A written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets must be prepared showing the capital spent within 31 months of receipt by the business. To satisfy 90% test, the plan should be in place within six months after first day that entity has certified it is a QOF.

- Will not fail solely because the scheduled consumption of the working capital is not yet complete.

Penalties for Failure to Comply with QOF Rules

- A penalty imposed for each month it fails to meet the requirement.
  - The excess of 90% of its aggregate assets *LESS* the aggregate amount of OZ property held by the fund *MULTIPLIED BY*
  - The underpayment rate established in section 6621(a)(2).
  - Reasonable cause exception.
- Waiting on guidance as to how extreme/frequent a failure has to be to disqualify entity as a QOF.

3 Timelines/Checklists

Tax and Business Checklist for Successful QOZ Investment

Investor Requirements

- ❑ Investor has appreciated capital assets that it will liquidate, and invest cash equal to part, or all, of the proceeds from such liquidation in to the QOF.
- ❑ Investor will make an election by filing Form 8949 with its federal income tax return.
- ❑ Investor will invest funds in to the QOF within 180 days of selling the appreciated capital assets.

Fund Requirements

- ❑ A partnership certifies as a Qualified Opportunity Fund (“QOF”) by filing Form 8996 with its federal income tax return.
- ❑ The QOF draws up a detailed business plan
- ❑ The QOF partnership forms a lower-tier entity taxed as a partnership that will hold a trade or business in the QOZ (the “QOZ Business”).
- ❑ The QOZ Business will own QOZ Business property.
- ❑ 90% of assets invested in QOZ Business property, subject to working capital safe harbor.

Timeline for Key QOF Dates – Investor Perspective

Day 0: Sell capital asset

Within 180 days of selling capital asset, invest proceeds in to a QOF

If partnership sells capital asset, each partner has 180 days from end of partnership's taxable year to invest proceeds in to a QOF

File Form 8949 to qualify for QOZ deferral benefits

Sample Timeline – Individual Investor

November 1, 2018: Sell capital asset

April 15, 2019: file Form 8949 with individual income tax return (assuming no extension)

April 30, 2019: deadline for contributing capital to QOF.

June 30, 2019: Deadline for contributing capital to a partnership if individual investor recognizes capital gain through a partnership.

Timeline for Key QOZ Dates – Fund Perspective

1. Day 0: If necessary, form partnership. An existing partnership may be a QOF
2. Day 0: Form Qualified Opportunity Zone business that will hold QOZ Business property (typically use lower-tier partnership)
3. Implement a written business plan for deploying funds in order to have 31-month runway to invest.
4. Make QOF election effective on or prior to the date QOF receives investor capital.

Sample Timeline – Fund

December 1, 2018: Receive funds from investors.

March 15, 2019/September 15, 2019: File Form 8996 to certify partnership as a QOF effective December 1, 2018.

Draft detailed written business plan no later than June 30, 2019

May 30, 2021: funds *must* be deployed to qualify for QOZ benefits

Document Checklist for QOF special forms

- Election to make QOF investment by investor
- Election to be a QOF Fund – Self Certification
- QOF "Fund" [for single property fund, this is the normal JV with QOF restrictions added]
- Lower-tier Operating Partnership: Required to receive benefit of Working Capital Exception and Lowering 90% threshold for to 70% for "good" assets
- Business Plan for WC Safe Harbor

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