Qualified Opportunity Zone Session

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Qualified Opportunity Fund (QOF)

New program to encourage social advancement and private investment in low-income community businesses that was included in the Tax Cuts & Jobs Act.

- Goal – Taxable investors to sell appreciated assets and reinvest capital gains proceeds into QOF

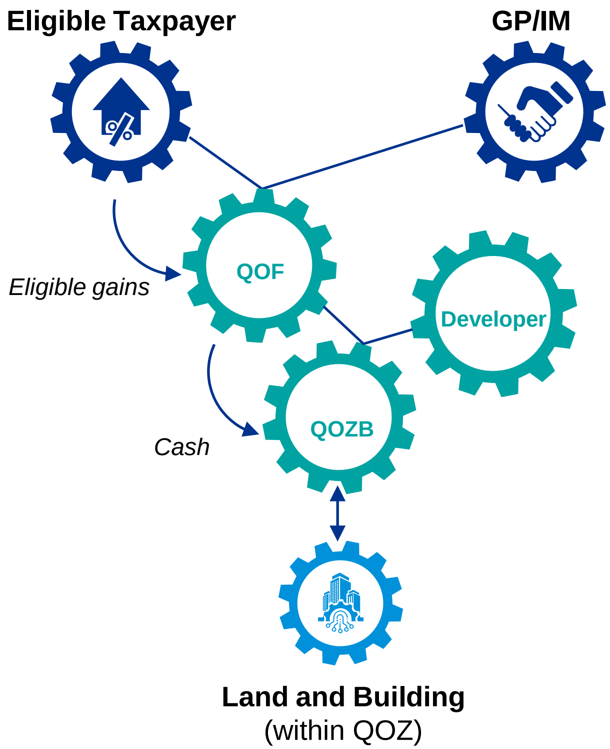
- 8,700 census tracks identified
- Self-certification of QOF (Form 8996)
- Rollover capital gains can be from nearly any source
- Rollover capital gain must be invested in QOF within 180 days (Form 8949)
- QOF must be invested in QOZ property or QOZ business within 180 days
- 31 month safe harbor for working capital invested in a QOZ business or QOZ tangible property
- Substantial improvements to QOZ property within 30 months (Improvements must be equal to cost of Building – Excluding Land)
- QOF must have at least 90% of their assets in QOZ properties or QOZ businesses

What are the potential federal tax benefits (“DRE” benefits)?

Deferral (“D”) (Benefit #1)	**Gain deferral: Taxpayer defers capital gains tax on gains invested in the QOF (“deferred gains”). Taxpayer does not receive any initial basis for the deferred gains invested in the QOF.** **Estimated benefit: Capital gains deferred until December 31, 2026** **Benefit description: Time-value of money until December 31, 2026**
Reduction (“R”) (Benefit #2)	**Basis step-up: Taxpayer steps-up its basis with respect to the deferred gains invested in the QOF** **Estimated benefit: Basis with respect to deferred capital gains invested in the QOF stepped-up 10% of the deferred gain after 5 years and additional 5% after 7 years of QOF investment** **Benefit description: Amount of deferred gains invested in the QOF that is ultimately recognized is reduced by 10-15%.***
Exclusion (“E”) (Benefit #3)	**Appreciation exclusion: Taxpayer excludes appreciation gain through basis step-up upon disposition of QOF investment after 10 years (or under the proposed regulations, on capital gains allocated from QOZ property dispositions).** **Estimated benefit: 100% basis step-up** **Benefit description: Elimination of tax on appreciation of QOF investment upon disposal after 10 years**

***The deferred gain recognized may be further reduced to the extent the fair market value of the investment is less than the deferred gain on December 31, 2026.**

Illustrative two-tier structure for a single development project



- QOF contributes cash to a QOZB, which purchases and develops the project
- QOZB may rely on the "working capital safe harbor"
- Developer may take a promote at the QOZB level
- QOZB may hold intangibles that are used in the business

Special Rules for Land and Buildings

Land

- Land in a QOZ acquired after 2017 generally qualifies as QOZ business property (and can be excluded from a taxpayer's required substantial improvement calculation).
- Unimproved land that is acquired without a view or intention to improve the land by a "more than insubstantial amount" within 30 months does not qualify as QOZ business property.
- Land in a QOZ that is leased pursuant to a FMV lease entered into after 2017 generally qualifies as QOZ business property.

Buildings

- For buildings in a QOZ, the original use of the building must commence with the QOF or QOZB, or the QOF or QOZB must substantially improve within 30 months to qualify as QOZ business property.
- The regulations suggest that <u>each</u> acquired building must be substantially improved
- Substantial improvement amount is equal to the fair value of the building at acquisition (not including land value)
- Leased buildings, subject to the same requirements as land, generally qualify as QOZ business property (with no substantial improvement required).

Requirements For QOZ Business

In order for a QOZ business to qualify:

- 70% of tangible property must be in the QOZ
- It must to have 50% gross income from within the QOZ. The safe harbors include: (i) 50% of services performed based upon hours are in QOZ (ii) 50% amounts paid to employees or independent contractors in the QOZ or (iii) both tangible property and management/operational functions for the business to generate 50% of its gross income are in the QOZ
- 40% of intangible property is used in a trade or business in the QOZ
- Not more that 5% of business property can be non-qualifying financial property
- And Not a “Sin Business”

QOZ Business Property as QOZ Property

QOZ Business Property

— Any tangible property used in a trade or business of the QOF and acquired by the QOF by purchase after 2017 from an unrelated party;*

— The original use of the property in the QOZ commenced with the QOF or the QOF substantially improves the property;

— Land acquired by the QOF by purchase after 2017 from an unrelated party; and,

— Tangible property acquired by the QOF under a lease entered into after 2017 under market rate terms (subject to some additional requirements for related party leases*).

❖ With respect to all of the above property, during substantially all (90%) of the QOF's holding period, substantially all (70%) of the use of the property was in a QOZ.

*Related party status is determined under sections 267(b) and 707(b), using a greater than 20 percent threshold.

Special rules regarding the acquisition of a QOF interest

- Taxpayers can acquire a qualifying investment in a QOF by purchasing QOF interests from existing QOF owners (“secondary purchase”).
  - That is, if the acquisition is made within the relevant 180 day period of an eligible gain, the QOF interest will be a qualifying investment in the hands of the secondary purchaser, even if it was not a qualifying investment in the hands of the seller.
- A QOF interest acquired in exchange for services is not a qualifying investment (e.g., QOF benefits are not available for carried interest).
- An investor can acquire a QOF interest in exchange for non-cash property.
  - If an investor contributes appreciated property to a QOF, the amount of the qualifying investment is equal to the investor’s adjusted basis in the property and the investor will have a non-qualifying investment equal to the amount of the unrealized appreciation in the property.
- An investor who acquires a QOF interest for both qualifying capital (i.e., rolled over eligible gains) and non-qualifying capital (e.g., services, appreciated property) is considered to own two separate interests in the QOF (this is called a “mixed-fund” investment).

Key Points on 2nd Set of Regulations

- Debt financed distributions are allowed if you have basis & it is not a disguised sale (2 year safe harbor)
- A building that has been vacant for 5 or more years would be considered original use
- Working capital safe harbor – ability to extend beyond 31 months if delay caused by waiting for government action
- Multi asset partnership can be accomplished
- Asset recycling can be accomplished
  - A QOF will have 12 month to reinvesting of sale or disposition proceeds
  - However gain is taxable, unless a like kind exchange completed
- Business income safe harbors expanded to include 50% of services performed in QOZ based on hours; 50% of pay to employees or independent contractors in QOZ; or, 50% gross income generated from tangible property and management within QOZ.
  - Gross income will not be based upon when customer is located
- Profits / Carried Interest for services is not eligible for benefits in a QOF

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