



**OPPORTUNITYZONEEXPO**



# ■ What is a Qualified Opportunity Fund and Qualified Business, Who is investing? Fund Formation and regulation, Securities Implications

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# OPPORTUNITY



- DRE = Deferral, Reduction and Elimination
- A taxpayer can invest “capital gain” in a Qualified Opportunity Fund
  - It is only the capital gain and not the underlying investment
- The taxpayer is not required to recognize the gain until the earlier of
  - the date on which the investment is sold or exchanged, or
  - December 31, 2026 (the “Trigger Date”)
- The tax basis in the investment is increased by 10% if the investment is held for at least 5 years
- The tax basis in the investment is increased by 15% if the investment is held for at least 7 years
- If the taxpayer holds the investment for at least 10 years the taxpayer does not have to pay ANY tax when the investment is sold
  - It appears that a taxpayer can depreciate the project for 10 years and use the losses against other income and then avoid all gain on the sale of the investment



# BACKGROUND



- Enacted as part of the Tax Cuts and Jobs Act
- Proposed Treasury Regulations were issued on September 19, 2018
- Additional guidance is still needed from the IRS
- The program is directed towards designated, low-income census tracts, referred to as “Qualified Opportunity Zones”
- All of the Qualified Opportunity Zones have been designated by the Governors of the states
- The program has been designed to create an urgency
  - The right to participate ends on December 31, 2026
  - The 15% reduction requires an investment by December 31, 2019
  - The 10% reduction requires an investment by December 31, 2021
  - To avoid the tax on sale of the investment the taxpayer must make an investment by December 31, 2026



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# QUALIFIED OPPORTUNITY ZONES



- The program is designed to incentivize capital investment into Qualified Opportunity Zones
- The list of the Qualified Opportunity Zones is available online
  - <https://www.cdfifund.gov/pages/opportunity-zones.aspx>
- FFIEC Geocoding System (the system that permits street address information to be translated into census tract number) is available online
  - <https://www.ffiec.gov/geocode/>
- A Qualified Opportunity Fund can self-certify on its federal income tax return.
- Some states that do not match federal income tax law will have to enact new legislation or their residents will not be able to participate from a state income tax standpoint

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# DETAILS



- The Taxpayer must make an election to invest “capital gains”
  - from the sale or exchange of any property held by the taxpayer to an unrelated person (generally 20% cross ownership)
  - within 180 days of the sale or exchange
  - into a Qualified Opportunity Fund
- You cannot invest the same gain twice
- Only applies to gain recognized on or before December 31, 2026
- The amount of the gain recognized in 2026 (or earlier sale or exchange of the investment) is the lesser of
  - the excluded gain or
  - the fair market value of the investment on the Trigger Date over the taxpayer’s basis in the investment

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# DETAILS (cont'd)



- The gain retains the same characteristics as it would have had if the Qualified Opportunity Fund provisions did not apply
- Taxpayers include individuals, C corporations, regulated investment companies, real estate investment trusts, partnerships, S corporations and trust and estates
- A partnership can elect to defer its own gain or can pass through the capital gain to its partners
- 180 day period
  - Usually 12/31
  - The partnership can adopt the partnership's sale date

# QUALIFIED OPPORTUNITY FUND



- The taxpayer must invest in a “Qualified Opportunity Fund”
- A Qualified Opportunity Fund is any investment vehicle that is a corporation or partnership organized for the purpose of investing in Qualified Opportunity Zone Property (other than another Qualified Opportunity Fund).
- The Qualified Opportunity Fund must hold at least 90% of its assets in Qualified Opportunity Zone Property
- The 90% test is the average of the percentages of the Qualified Opportunity Zone Property determined:
  - At the end of first 6 months of the Fund’s taxable year
  - At the end of the Fund’s taxable year

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# QUALIFIED OPPORTUNITY ZONE PROPERTY



- Qualified Opportunity Zone Property means
  - Qualified Opportunity Zone Stock
  - Qualified Opportunity Zone Partnership Interest
  - Qualified Opportunity Zone Business Property

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# QUALIFIED OPPORTUNITY ZONE STOCK



- Qualified Opportunity Zone Stock means stock in a domestic corporation if
  - the stock is acquired by the Qualified Opportunity Fund after December 31, 2017 from the corporation in exchange for cash
  - at the time the stock is issued the corporation was either a Qualified Opportunity Zone Business or in the case of a new corporation the corporation was organized for the purpose of being in a Qualified Opportunity Zone Business
  - during substantially all of the Qualified Opportunity Fund's holding period for the stock the corporation qualified as a Qualified Opportunity Zone Business
  - Special rules for redemptions are applicable to avoid abuse

# QUALIFIED OPPORTUNITY ZONE PARTNERSHIP INTEREST



- A Qualified Opportunity Zone Partnership Interest is a capital or profits interest in a domestic partnership if
  - the interest is acquired by the Qualified Opportunity Fund after December 31, 2017 from the partnership in exchange for cash
  - at the time the interest is acquired the partnership was either a Qualified Opportunity Zone Business or in the case of a new partnership the partnership was organized for the purpose of being a Qualified Opportunity Zone Business
  - during substantially all the Qualified Opportunity Fund's holding period the partnership qualify as a Qualified Opportunity Zone Business

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# QUALIFIED OPPORTUNITY ZONE BUSINESS PROPERTY



- Qualified Opportunity Zone Business Property means any tangible property used in a trade or business of the Qualified Opportunity Fund if
  - the property was acquired by purchase (not from a related party) after December 31, 2017
  - the original use of such property in the Qualified Opportunity Zone commences with the Qualified Opportunity Fund or the Qualified Opportunity Fund substantially improves the property
  - during substantially all the Qualified Opportunity Fund's holding period for such property substantially all of the use of such property was in a Qualified Opportunity Zone
- A Substantial Improvement means additions to the basis of the property during a 30 month period that is greater than the basis at the beginning of the 30 month period (Improvements must equal cost plus \$1)
- The cost of the land is excluded in the determination
- Related Party Rules – Substitutes 20% for 50%



# QUALIFIED OPPORTUNITY ZONE BUSINESS



- A Qualified Opportunity Zone Business means a trade or business
  - which substantially all of tangible property owned or leased by the taxpayer is Qualified Opportunity Zone Business Property
  - which satisfies the following requirements
    - at least 50% of the gross income is derived from the active conduct of the business
    - a substantial portion of its intellectual property is used in the active conduct of the business
    - less than 5% of the basis of property is invested in certain financial products but excluding reasonable working capital held in cash or short term notes – no subsidiaries
    - reasonable working capital includes cash for development as long as
      - The amounts are designated in writing
      - There is a written schedule for the expenditure of the working capital
      - The working capital is actually used in a substantially consistent manner



# QUALIFIED OPPORTUNITY ZONE BUSINESS (cont'd)



- Tangible Property that ceases to be Qualified Opportunity Zone Business Property will continue to be treated as such for the lessor of:
  - 5 years or
  - the date the property is no longer held by the Qualified Opportunity Zone Business

# MIXED FUNDS



- If you create a fund that has qualified money and nonqualified money, the investments will be treated as two separate investments

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# FAILURE TO QUALIFY



- If a Qualified Opportunity Fund fails to meet the 90% test the Fund is required to pay a penalty equal to
  - the shortfall (90% - actual percentage) X the underpayment rate
  - If the Qualified Opportunity Fund is a partnership the penalty must be allocated to the partners



# SECURITIES ISSUES



- If these Funds are syndicated they will be securities
- Investment Company Issues
  - Need to structure around the Investment Company Act or the Funds will be limited to 100 investors
  - Congress did not think about the Investment Company Act Issues
    - The law assumes that the Qualified Opportunity Funds will invest in other securities
- Investment Advisor Issues
  - Sponsors may now have to comply with the investment advisor rules
- General Solicitation

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# ANTICIPATED USE



- Qualified Opportunity Zone Funds are a good fit for development/redevelopment projects
  - This results from the requirement that the property must be either (i) purchased in and original use commenced in the Qualified Opportunity Zone or (ii) located in the Qualified Opportunity Zone and substantially improved
- Syndicator organizes a Qualified Opportunity Zone Fund to sell interests to investors looking to shelter gains
  - Similar to existing markets for syndicating Delaware statutory trusts for 1031 exchanges

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# QUALIFIED OPPORTUNITY ZONES FOR A FAILED 1031 EXCHANGE



- If an investor fails a Section 1031 exchange, this could be the perfect fix
  - Can you use it to eliminate boot?

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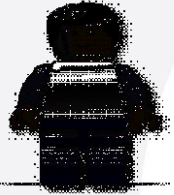
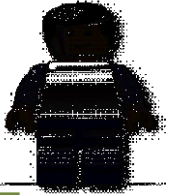






# ISSUES



- How do you meet the 90% test if you are a blind pool?
- How do you pay your taxes in 2026?
  - The Fund cannot reserve cash
- How do you determine the value in 2026?
- The law seems to imply that you have to sell your partnership interest as opposed to a sale of the property
- What is substantially all?
- Is real estate a trade or business?

# ILLUSTRATIVE LIFE CYCLE\*



Stock Sale	Makes Investment	10% Basis Step Up	5% Basis Step Up	Gain Recognized	Sells Investment
August 1, 2018	January 28, 2019	January 28, 2024	January 27, 2026	December 31, 2026	January 27, 2029
Investor sells \$2M of Apple stock, with \$1M of capital gain	Investor invests \$1M in Fund for 10% ownership	5-year anniversary of Investment	7-year anniversary of Investment	Statutory Gain Trigger Date	10-year anniversary of Investment
	 ↓ <b>\$1M</b> 10 shares \$0 basis <b>O-ZONE FUND</b>	10 shares \$100K basis <b>O-ZONE FUND</b>	10 shares \$150K basis <b>O-ZONE FUND</b>	 <b>\$850,000 gain</b> <b>Pays \$170,000 in Federal taxes</b>	 ↑ <b>Sells shares back for \$4.5M</b> <b>Pays \$0 taxes</b> <b>O-ZONE FUND</b>
	↓ <b>\$10M</b> <b>\$20M Debt</b> Fund constructs Apartment Building in Opportunity Zone for \$30M 	Value of Apartment Building appreciates to \$36M 	Value of Apartment Building appreciates to \$40M 		<b>Total Gain \$3.5M</b> <b>Total tax \$170,000</b> Value of Apartment Building appreciates to \$65M 



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