

Qualified Opportunity Zone Investments

Robert D. Coon, Esq. *and* David A. Nix, Esq.



KUTAKROCK
kutakrock.com

Qualified Opportunity Zone Investments

Opportunity Zones Introduction¹

- Qualified Opportunity Zone Benefits
- What is a Qualified Opportunity Zone
- Qualified Opportunity Funds
- Types of Investment in Qualified Opportunity Zone Property
- Qualifying Investments in Qualified Opportunity Zone Property
- Qualified Opportunity Zone Business
- Qualified Opportunity Zone Business Property
- Potential Structures
- Proposed Regulations
- Revenue Ruling 2018-29
- Opportunity Zone Investment Example
- Where are Opportunity Zones

¹ Section 1400Z-2 of the Internal Revenue Code of 1986, as added pursuant to the Tax Cuts and Jobs Act of 2017 ("OZ Provisions"). Proposed Regulations (REG – 115420-18) and Reserve Ruling 2018-29 were issued on October 19, 2018 clarifying certain aspects of the OZ Provisions ("OZ Guidance").

Qualified Opportunity Zone Benefits

- Taxpayers, including taxpayers receiving allocated capital gains from Partnerships, get capital gains tax deferral & forgiveness of certain capital gains² for making timely investments in Qualified Opportunity Funds (QOFs) which subsequently invest in Qualified Opportunity Zone Property (QOZP)
 - Investor/Taxpayer must elect to apply provisions of Section 1400Z-2
 - Partnership or partners within a partnership may elect to apply provision at Partnership or Partner level
 - **Deferral** of 100% of Capital Gain ("Original Gain Forgiveness") on sale of property ("Original Property") until the earlier of:
 - sale of QOF investment, or
 - December 31, 2026
 - **Partial Forgiveness** of Original Gain depending on length of investment in QOF
 - 10% if investment in QOF held for at least 5 years
 - 15% if investment in QOF held for at least 7 years
 - **Basis increase** in QOF investment to shield additional gain on investment in QOZP
 - Increase in tax basis of QOF investment to FMV if investment in QOF held for at least 10 years
 - Ability to benefit from basis increase for all qualified investments made prior to June 30, 2027
 - Investors permitted to hold investment until December 31, 2047

² OZ Guidance clarified that only capital gains are eligible for tax deferral and forgiveness and that a QOF cannot utilize borrowed funds to make qualified investments

What Is a Qualified Opportunity Zone?

- A popular census tract in a low-income community
- Formally designated by the Treasury as nominated by U.S. State Governors
- More than 8,700 designated census tracts in the U.S.
- Variety of different investment opportunities
 - Funds can be used to finance commercial and industrial real estate, housing and existing or start-up businesses
- Potential real estate classes: affordable housing, medical facilities, student housing, data centers, warehouses, infrastructure, single and multifamily rentals and senior housing

Qualified Opportunity Fund (QOF)

- Statutory Requirements for QOF
 - Purpose – an investment vehicle organized as a corporation or partnership³ for the purpose of investing cash proceeds in QOZP
 - Certification
 - Certification Process has been determined by Treasury to be “Self-Certification” by the filing of Form 8996
 - QOF chooses the first month in which it will be treated as a QOF. If not chosen then first month will be first month of taxable year⁴
 - QOF must certify to its “purpose” on form 8996

³ OZ Guidance clarified eligible investment vehicles as including entities taxed as partnerships (e.g., LLCs) and also includes pre-existing entities. If not organized in 50 states or D.C., must be organized in territory where OZ is located.

⁴ This affects calculation of the Assets Test and Non-compliance Penalty discussed below

Qualified Opportunity Fund (QOF) (Cont'd.)

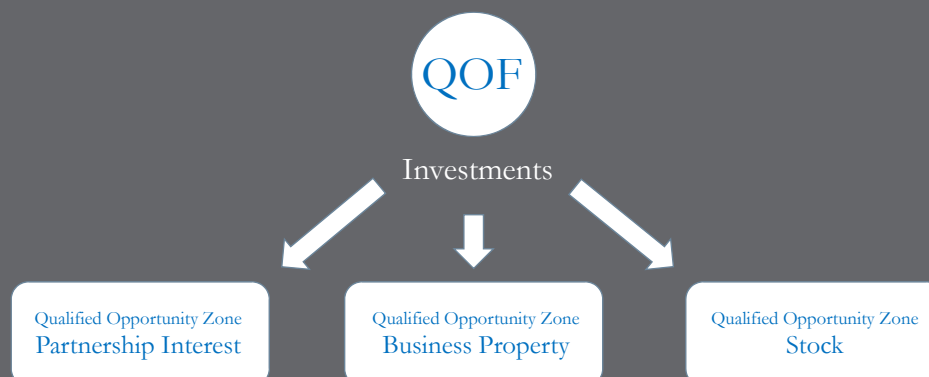
- Statutory Requirements for QOF
 - Assets Test – QOF must hold 90% of its assets in QOZP⁵
 - Noncompliance Penalty
 - The QOF can be penalized on a per month basis if it fails to meet the 90% test⁶
 - The penalty can be waived if the QOF can show the IRS that the reduction in investment was due to a reasonably unexpected cause⁷
 - The amount of the penalty is determined by the percentage shortfall below 90% multiplied by the federal short term under payment rate plus 3%

⁵ This is determined by the average of the QOZP held on (i) the last day of the first six-month period of the QOF's taxable year, and (ii) the last day of the QOF's taxable year. However, if less than 6 months remains in the taxable year, then test is only used at the last day of QOF's taxable year (no averaging).

⁶ OZ Guidance clarified that all QOFs have 6 months to meet the 90% test starting from the date such gains are contributed to the QOF and that if a QOF receives proceeds related to a QOZP back, that it must reinvest such proceeds in QOZP within 1 year and such funds must not violate NQFP in the meantime.

⁷ Similar to the "reasonable expectations" test in NMTC.

Types of Investment in Qualified Opportunity Zone Property (QOZP)



Qualifying Investments in Qualified Opportunity Zone Property (QOZP)

- The QOF's purchase of, or investment in, QOZP must occur after December 31, 2017 in exchange for cash;
- QOZP consisting of stock or partnership interest, must be in a qualified opportunity zone business, or a business which is being organized for the purpose of being a qualified opportunity zone business (collectively, a QOZB); and
- QOZB must qualify as a QOZB for substantially all of the QOF's holding period.

Qualified Opportunity Zone Business

- A trade or business in which substantially all (70% pursuant to OZ Guidance) of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property (QOZBP) and:
 - At least 50% of income of the QOZB must be derived from active conduct of a trade or business (Business Operations)⁸
 - Substantial portion (70% pursuant to OZ Guidance) of the QOZB's tangible property used in Business Operations
 - QOZB must maintain less than 5% of its unadjusted basis in property which is nonqualified financial property⁹

⁸ There are 4 different ways to satisfy whether this test is met (i.e., hours, amount paid, tangible property and facts and circumstances).

⁹ Same test as NMTC test.

Qualified Opportunity Zone Business (Cont'd.)

- A trade or business in which substantially all (70% pursuant to OZ Guidance) of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property (QOZBP) and:
 - Reasonable Working Capital does not count against the 5% limitation.
 - Construction and/or acquisition funds and funds for the development of a trade or business retained by a QOB will be deemed to be “reasonable amounts of working capital” for up to 31 months if:
 - such funds are actually used and designated for construction/acquisition
 - pursuant to a written schedule consistent with normal business practices
 - working capital use consistent with designated uses and schedule
 - Certain “sin businesses” do not qualify¹⁰

¹⁰ Same test as NMTC test (private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises).

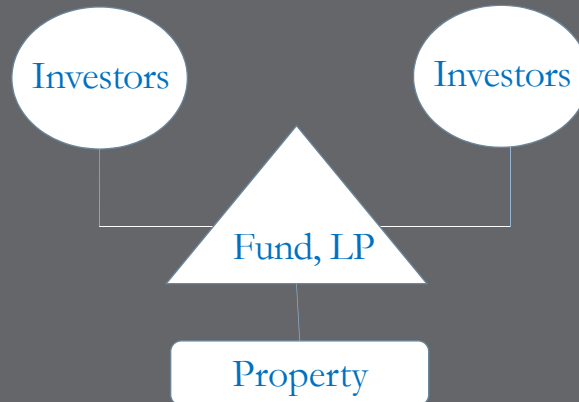
Qualified Opportunity Zone Business Property (QOZBP)

- Must be tangible property used in Business Operations
 - Acquired by purchase from unrelated party (the seller must not hold more than 20% of the interest in purchaser) after December 31, 2017
 - During substantially all of the holding period, substantially all of the use of the tangible property is within a QOZ
 - Original use of the property
 - Must be in a QOZ and must start with the taxpayer, or
 - Taxpayer substantially improves the property¹¹
 - Land not subject to original use requirement per OZ Guidance

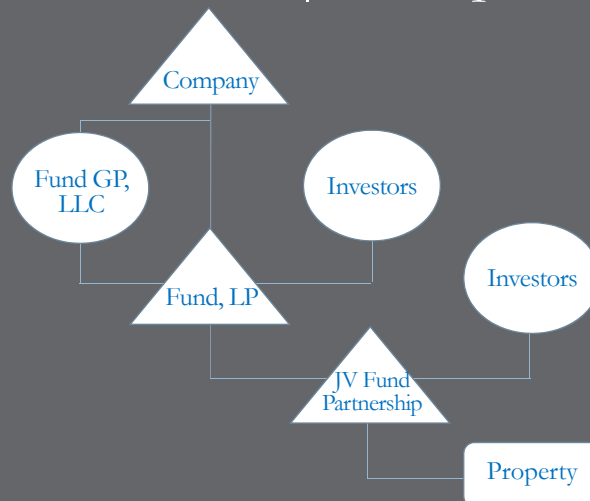
¹¹ During any 30-month period after acquisition, additions to basis (other than basis in land) exceed an amount equal to the adjusted basis of such property at the beginning of such period.

Potential Structure | *Single Tier*

Flexibility: Single-tier structure v. multiple-tier structure



Potential Structure | *Multiple Tier*



Proposed Regulations

- **Clarify:** only applies to capital gains and can't be from a sale/exchange with a related person
- **QOZB:** “substantially all” of the tangible property = 70% of tangible property
- Even though designations expire after 2028, investments made by the end of 2027 can take advantage of 10 year step-up if disposed of by the end of 2047
- **Partnerships:** entity level deferral v. partner level
- **Section 752(a):** deemed contributions, not an investment

Proposed Regulations, (Cont'd.)

- **Working Capital Safe Harbor**
 - Concern regarding requirement that investments in qualifying assets occur within time frame as developing/construction may take longer
 - Safe harbor – may delay 5% limitation on nonqualified financial property of working capital for up to 31 months if the following are met:
 - Written plan including schedule detailing use of working capital over 31 months;
 - Identification of the financial property as property held for the acquisition, construction or substantial improvement of tangible property in the Zone; and
 - Working capital must be expended in a manner that is substantially consistent with the plan

Proposed Regulations, (Cont'd.)

- Exits / Sales / Transfers
 - OZ Guidance clarified that Fund can sell its interest in QOZB rather than its interest in QOF and remain eligible for benefits
 - Allows for multi-asset QOFs since individual assets can be sold
 - OZ Guidance clarified that taxpayer can sell its interest in QOF to another investor as long as such purchaser has sufficient gains and meets all other tests
 - This creates a secondary market for QOFs
 - OZ Guidance clarified that upon taxpayers death, family steps into shoes of taxpayer
 - This does not apply to gifts or other transfers
 - Taxpayer cannot refinance its interest in a QOF within 2 years of acquiring its QOF interest
 - This does not apply to gifts or other transfers
 - Depreciation Recapture – NO; as long as 754 election is made on exit
 - LIHTC in 2026: OZ Guidance forced inclusion of debt into value at exit which resulted in a lower benefit for LIHTC investors

Proposed Regulations, (Cont'd.)

- Active Business Requirement / Master Lease
- Leasing activity is considered the active conduct of a trade or business; however:
 - Merely entering into a triple-net lease is not the active conduct of a trade or business
 - HTC transactions typically use triple-net leases and adjustments will need to be made (which will likely reduce amount of QREs available)
 - Further, “triple-net lease” is not defined in the Code and various interpretations exist

Proposed Regulations, (Cont'd.)

- Property Considerations
 - Original Use – Vacant buildings are considered “new” if vacant for at least 5 years
 - Leased Property – property can be purchased or leased as long as leased property is at market rates and no below market purchase options exist
 - Related Party Leases – these are ok; as long as no prepaid rent (in excess of 12 months) and QOZB must also *purchase* property equal to the value of the leased property within 30 months
 - Substantial Improvements – no requirement to *substantially improve* property acquired through lease from an unrelated party

Opportunity Zone Investment Example

- January 2, 2019
- Taxpayer enters into a sale of property that results in \$1M of capital gain
 - June 30, 2019 (which is within the 180 day requirement), the Taxpayer contributes cash equal to the entire \$1M of capital gain to obtain an interest in the Qualified Opportunity Fund
 - Qualified Opportunity Fund invests the \$1M in a Qualified Opportunity Zone Property (stock, partnership interest, business property)
 - **REMINDER:** Taxpayer is deemed to have a \$0 basis in its Qualified Opportunity Fund investment to retain taxability.
 - **NOTE:** The cash used to make Qualified Opportunity Fund investment does not need to be traceable to original gain transaction.

Opportunity Zone Investment Example (Cont'd.)

- June 30, 2024
 - After 5 years, the Taxpayer's basis in the Qualified Opportunity Fund investment is increased from \$0 to \$100k
- June 30, 2026
 - After 7 years, Taxpayer's basis in the Qualified Opportunity Fund investment is increased a further \$50,000 (from \$100k to \$150k)
- December 31, 2026 – NOTE: Statutory deadline for all gains to be triggered (required taxable event)
 - \$850k of the \$1M of deferred capital gains are taxed and the basis in Qualified Opportunity Fund investment increases to \$1M
 - It is hoped that this deadline will be amended to be a rolling 7 year deadline determined by the year of investment

Opportunity Zone Investment Example (Cont'd.)

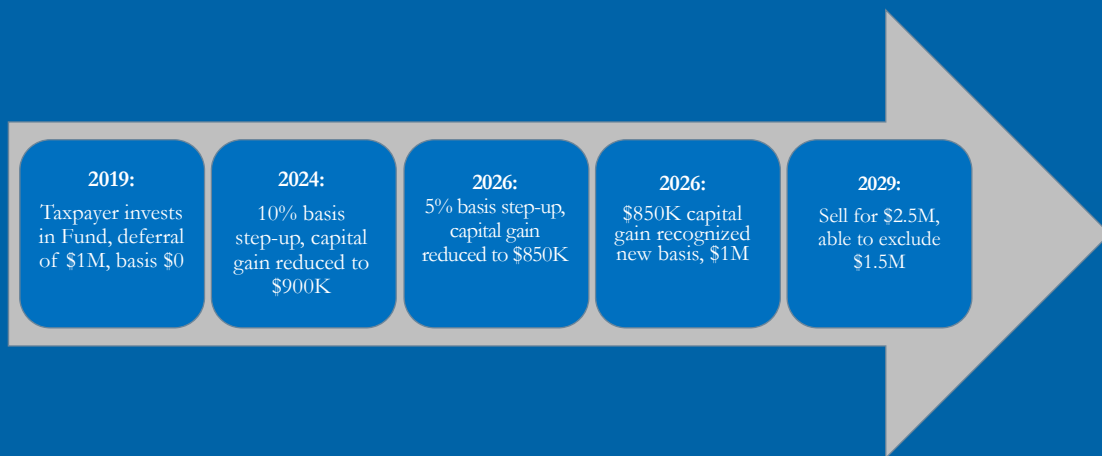
- June 30, 2024
 - After 5 years, the Taxpayer's basis in the Qualified Opportunity Fund investment is increased from \$0 to \$100k
- June 30, 2026
 - After 7 years, Taxpayer's basis in the Qualified Opportunity Fund investment is increased a further \$50,000 (from \$100k to \$150k)
- December 31, 2026 – NOTE: Statutory deadline for all gains to be triggered (required taxable event)
 - \$850k of the \$1M of deferred capital gains are taxed and the basis in Qualified Opportunity Fund investment increases to \$1M
 - It is hoped that this deadline will be amended to be a rolling 7 year deadline determined by the year of investment

Opportunity Zone Investment Example (Cont'd.)

- June 30, 2029
- After 10 years, Taxpayer sells its investment for \$2.5M
 - Taxpayer's basis in the Qualified Opportunity Fund investment is deemed by statute to be equal to current market value after 10 years
 - The effect is no tax on unrealized appreciation of the original investment in the Qualified Opportunity Fund (avoids gain on the new \$1,500,000 created by the unrealized appreciation of the original investment)
- After 25 years,¹² Taxpayer sells its investment for \$5M
 - Taxpayer's basis in the Qualified Opportunity Fund investment is deemed by statute to be equal to current market value at time of sale
 - The effect is no tax on unrealized appreciation of the original investment in the Qualified Opportunity Fund (avoids gain on the \$3,000,000 created by the unrealized appreciation of the original investment)

¹² The result is the same if the investment is sold on or before December 31, 2047

Opportunity Zone Investment Example (Cont'd.)



Where Are the Opportunity Zones

- Opportunity Zones can be located at:
 - <https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx>
 - https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml

Kutak Rock | Opportunity Zones

OMAHA



Robert D. Coon

402.231.8731
robert.coon@kutakrock.com

ATLANTA



David A. Nix

404.222.4610
david.nix@kutakrock.com