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Qualified Opportunity Zone Rules

Initial Guidance Issued by the IRS and Potential Opportunities | November 2, 2018

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Overview

What are the new rules all about?

- **The Qualified Opportunity Zone (QOZ) rules operate on two tracks:**
  - **First track is the deferred capital gain that generated the capital to put work in the OZ**
  - **Second track is the income, gain, loss and deduction from the OZ Investment**
- **Eligible taxpayers can defer capital gains recognized from virtually any investment by investing an amount equal to the gain into a Qualified Opportunity Fund (QOF)**
- **Current income from the Qualified Opportunity Zone Business is subject to tax**
- **Capital gain deferral from original transaction can be deferred under 2026**
- **Disposition gain from the OZ investment can be tax-exempt if the OZ investment is held for at least 10 years**

Overview

Taxpayers can get capital gains tax deferral (& more)

for making timely investments in

Qualified Opportunity Funds

which invest in

Qualified Opportunity Zone Property

Overview

YOU INVESTED
$2 MM
IN 2015 IN
ACME INC.

SOLD STOCK IN
2018
FOR $3 MM

THEN YOU INVEST THE
$1 MM GAIN
IN A QUALIFIED
OPPORTUNITY
ZONE FUND (“FUND”).

LEAVING YOU THE
REMAINING $2 MM
OF PROCEEDS
TO USE AS YOU LIKE

Overview

Tax Benefits for Deferred Gain

2018
defer paying $200,000 tax on gain (i.e., 20% tax on $1 MM gain)

2023
$20,000 of tax forgiven (5-yr holding period for 10% tax reduction)

2025
$10,000 of tax forgiven (7-yr holding for 5% more reduction)

2026
regardless of holding period: must pay $170,000 of tax (i.e., $200,000 less $30,000) so 17% tax rate on $1 MM gain from 2018

Tax Benefits for OZ Investment

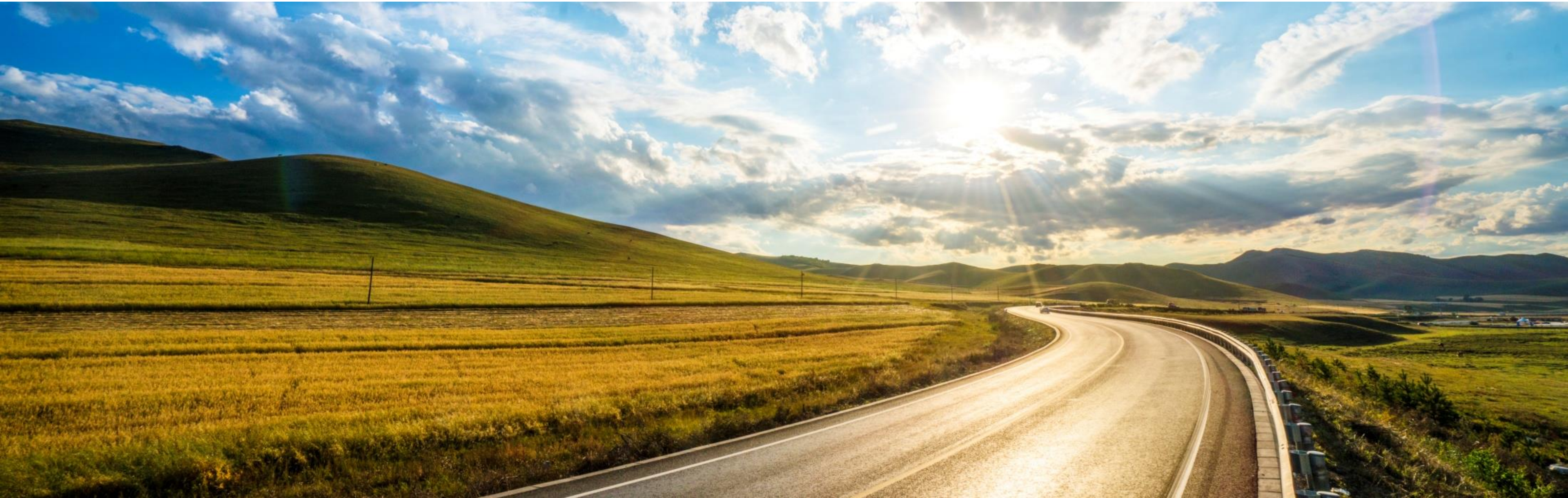
2018
$1 MM investment in QOF with zero outside tax basis

2023
$20,000 outside tax basis increase

2025
$10,000 outside tax basis increase

2028 to 2047
Outside tax basis in the Fund increases to fair market value of Fund interest (i.e., can sell Fund interest with no tax) at the time of sale of the interest; provided, met 10-yr holding period & before end of 2047

ELIGIBLE GAINS & ELIGIBLE TAXPAYERS



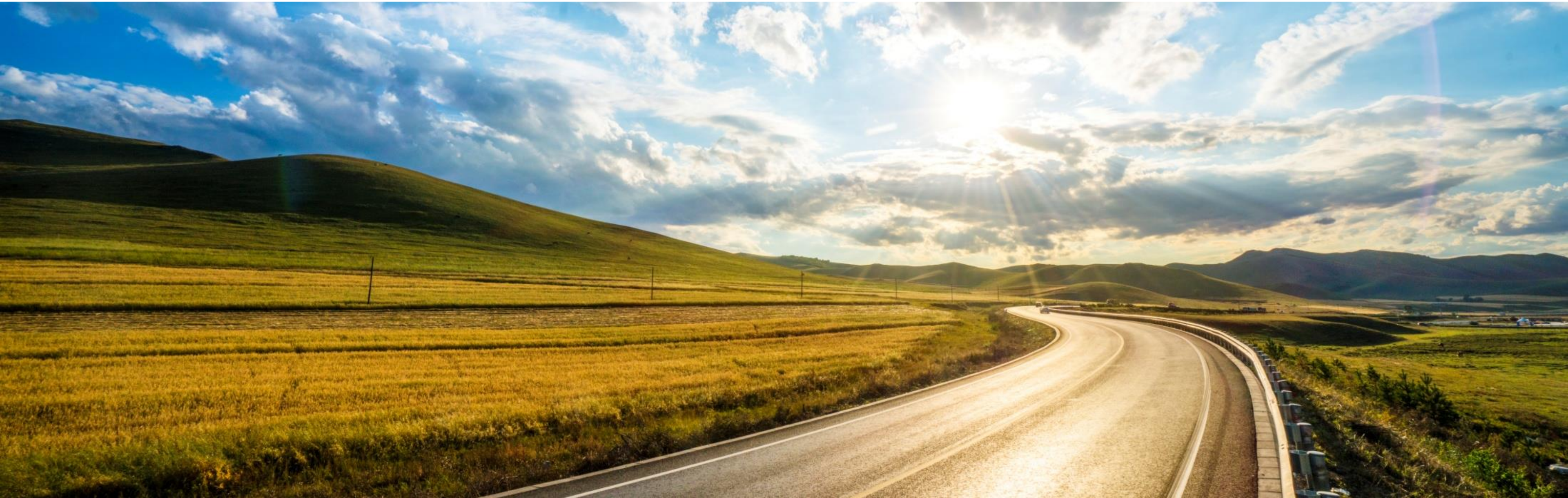
Eligible Gains & Eligible Taxpayers

- **Only <u>capital gains</u> from both actual and deemed sales or exchanges, including:**
  - **Section 1231 gain (from the sale of real estate used in a trade or business) and**
  - **Unrecaptured Section 1250 gain (“capital gain” taxed at a higher rate)**
  - **Depreciation recapture is <u>not</u> eligible for deferral**
- **Individuals, C corporations (including a regulated investment company (RIC) or real estate investment trust (REIT)), partnerships, S corporations, and trusts or estates are all eligible taxpayers**
- **Partnerships and other pass-through entities are eligible to defer gains by investing in a QOZ directly**
  - **Partnerships can elect to pass-thru gains to individual partners, who may elect to defer their allocable shares**

Special Rules for Section 1256 Contracts and Straddles

- Gain and loss are recognized on the mark-to-market method of accounting
- 60% long-term capital gain or loss and 40% short-term capital gain or loss
- Holders of Section 1256 contracts are required to net gains and losses and only treat the amount of any net gain as eligible for an investment in a QOF
- If a Section 1256 contract is held as part of a straddle transaction, any gain from the Section 1256 contract is not eligible gain that can be deferred through an investment in a QOF
- Proposed Regulations treat a transaction as a straddle for this purpose even if the offsetting position is not a position with respect to publicly traded property
- If any Section 1256 contract is part of an offsetting position transaction with a position that is not a Section 1256 contract, no Section 1256 net income may be deferred through an investment in a QOF

QUALIFIED OPPORTUNITY FUNDS



Qualified Opportunity Funds and Eligible Investments

- **A QOF must be a partnership or a corporation**
  - **Appears to permit S corporations, but the Proposed Regulations are silent**
- **Election to be to be treated as QOF as of a specified month in 2018 or later**
- **<u>90%</u> of its assets in eligible property or eligible partnership interests or stock at 2 semi-annual testing dates**
- **Investment must be in "equity" for income tax purposes**
  - **Preferred equity is ok**
  - **Partnership interests entitled to special allocations, such as cashflow or liquidation preferences, are ok**

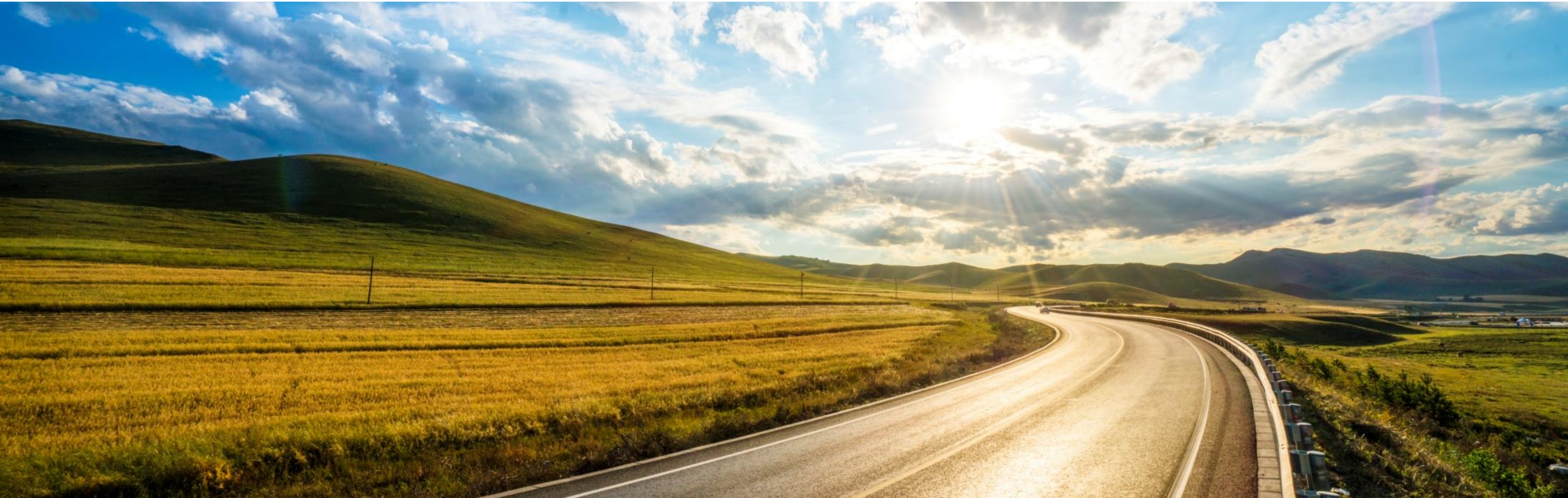
Pre-Existing Entities

- **A pre-existing entity can elect to be a QOF**
- **Regulations allow a QOF (i) to identify the taxable year in which the entity becomes a QOF and (ii) to choose the first month within that year to be treated as a QOF**
- **However, only assets acquired by a pre-existing entity after 2017 count towards the requirement that 90% of a QOF's assets constitute eligible property or investments**
  - **Pre-existing entities with material pre-2018 assets electing to be a QOF would be at a disadvantage in meeting the 90% requirement**

The 90 Percent Qualifying Assets Test

- **A QOF must hold 90% of its assets in "qualified opportunity zone property," which can be one of following three items:**
  1. **Newly issued stock of a corporation**
  2. **Newly issued partnership interests and**
  3. **Tangible business property in a QOZ**
- **In cases *#1* and *#2*, for stock or a partnership interest to constitute qualified opportunity zone business property, the corporation or partnership must conduct a "qualified opportunity business"**
- **Rules are much more lenient for investments into corporations and partnerships conducting qualified opportunity property directly**

QUALIFIED OPPORTUNITY ZONE BUSINESS REQUIREMENTS



Qualified Opportunity Zone Business Requirements

- **The QOF can opt for the qualified opportunity zone business route (i.e., investing in a subsidiary partnership or corporation), rather than directly investing in qualified opportunity zone property**
- **In this case, that business is subject to the following four requirements:**
  1. **50% “active” gross income**
  2. **Use of a substantial portion of the intangible assets in the “active” business**
  3. **5% limit on financial assets**
  4. **No “sin” business investments**
- **Those requirements care inapplicable if the QOF holds qualified opportunity zone business property directly**

50 Percent "Active" Gross Income & Asset Requirement

- **At least <u>50%</u> of the qualified opportunity zone business's gross income must be from the "active conduct" of a business in a QOZ**
- **A corporation or partnership can meet the qualified opportunity business requirement even if only <u>70%</u> of its tangible property is held for use in qualified opportunity zone business**
- **A substantial portion of the intangible assets must be used in the active business**
- **Proposed Regulations lack the definitions of:**
  - **"Active business" -- *Can net leasing qualify as "active?"***
  - ***Can an active business be conducted by independent contractors (rather than employees)?***
  - **"Substantial portion" (i.e., 90%, 70%, or other)**

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Generous Cash Rules for Start-Up Businesses

- **General rules for holding cash and securities:**
  - **Amount of "nonqualified financial property" that can be held in the business limited to <u>5%</u> of the average unadjusted bases of property held in such trade or business**
  - **"Nonqualified financial property" = debt, stock, partnership interests, options, futures, swaps and similar property**
  - **Working capital held in cash (or cash equivalents) is not treated as "nonqualified financial property"**
- **Working capital safe harbor (no limit as to amount):**
  - **QOF needs to prepare a written plan to invest its cash in tangible property (real or personal) in the QOZ within <u>31 months</u>**
  - **Cash will <u>not</u> be treated as nonqualified financial property during that period**
  - **Working capital must be expended substantially consistently with the plan**

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Comparison of Holding OZ Property vs Investing in a OZ Business

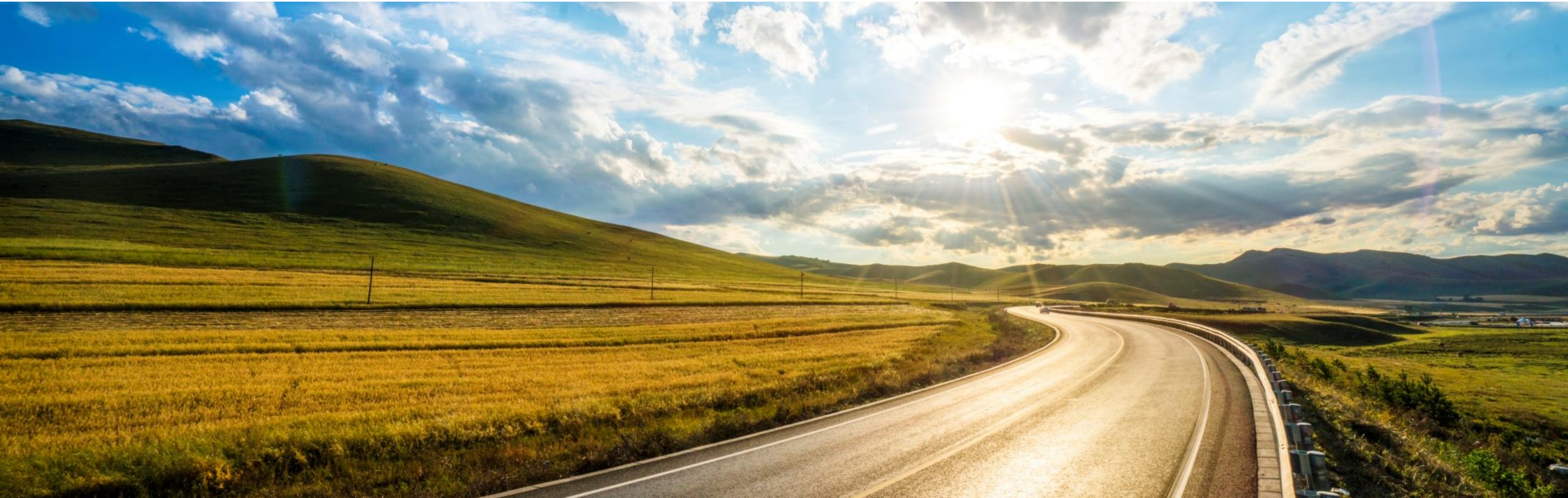
Practical Example:

- **If a QOF has $10 million in assets and wants to hold only $6.3 million in qualified opportunity zone business property, it can do so by investing $9 million in a partnership and having the partnership invest $6.3 million (i.e.,70% of its assets) in qualified opportunity zone business property**
- **The operating partnership could hold the remaining $2.7 million in cash of $450,000 (i.e., 5% of its assets) and $2.25 million in non-qualifying tangible assets.**
- **The QOF could hold its remaining $1 million (i.e., $10 million less the $9 million invested in the partnership subsidiary) in cash, bonds, the S&P 500, etc**
- **In contrast, if the QOF opted to purchase the qualified opportunity zone business property itself, it would have to buy $9 million of qualified opportunity zone business property, all of which would have to constitute tangible assets, and could then hold the remaining $1 million in cash, stocks, the S&P 500, nonqualifying real estate, etc.**

No Sin Business Investments

- A qualified opportunity business may not operate the following so-called “sin businesses:”
  - Golf course
  - Country club
  - Massage parlor
  - Hot tub facility
  - Suntan facility
  - Racetrack
  - Casino
  - Sale of alcohol to be consumed away from the premises
- *Prohibition on leasing real estate to such businesses?* Apparently not, so long as the qualified opportunity business is not operating the sin business itself

QUALIFIED OPPORTUNITY ZONE BUSINESS PROPERTY



Qualified Opportunity Zone Business Property

- **Tangible property (e.g., equipment, real estate) used in business in a QOZ that is acquired after December 31, 2017 and is:**

  i. **Land in a QOZ**

  ii. **Building in a QOZ that is first used by the QOF or the qualified opportunity business**

  iii. **Building in a QOZ that was previously used but is "substantially improved" by the QOF or the qualified opportunity business**

  iv. **Equipment that was never previously used in a QOZ or**

  v. **Equipment that was previously used in a QOZ but is "substantially improved" by the QOF or the qualified opportunity business**

The “Substantial Improvement” Requirement

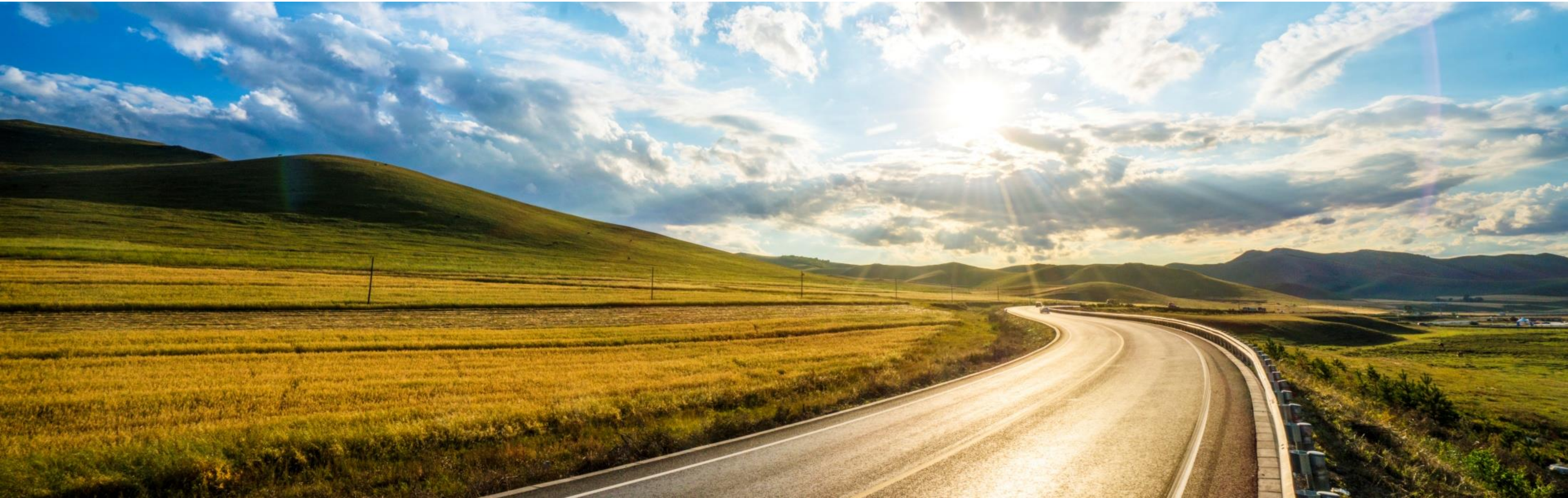
- **Applies to tangible property, other than land, that was used in a QOZ prior to its acquisition by the QOF (or the qualified opportunity business)**
- **“Substantial improvement” = the QOF (or qualified opportunity business) must invest more in the tangible property during any 30-month period than the adjusted basis in the property (excluding land) at the beginning of such period**
  - ***How does this rule interact with the bonus depreciation rules enacted as part of the TCJA?*** **The bonus depreciation rules allow a taxpayer to fully expense certain assets (but not real estate) upon acquisition, resulting in a zero basis in those assets**
    - **A literal application of the QOF rules in this context would mean that one cent of capital improvements could result in a substantial improvement to tangible property other than real property**

The "Substantial Improvement" Requirement (Rev. Rul. 2018-29)

<u>Practical Example</u>:

- A QOF buys an existing commercial building for $10 million on March 1, 2019
- Assume that $2 million is attributable to the land and and $8 million is attributable to the structure
- Under the rules, it appears that the building will satisfy the original use requirement if, at any time during the holding period of the building, the amount invested in rehabilitating the building over a 30-month period <u>exceeds the adjusted basis</u> of the building (no more than $8 million) at the beginning of that first 30-month period
- *How many 30-month periods can the taxpayer wait to apply the substantial improvement requirement?*

THE 180-DAY RULE FOR DEFERRING GAIN BY INVESTING IN A QOF



The 180-Day Rule for Deferring Gain by Investing in a QOF

- **Taxpayers must invest an amount equal to the gain to be deferred in a QOF within 180 days of the sale of the property**
- **The <u>180-day period</u> begins on the day on which the gain would be recognized if the taxpayer did not elect to defer recognition of that gain**
- **Proposed Regulations list the following examples illustrating the rule:**

Example	Beginning of the 180-day period
regular-way trades of stock	on the trade date
capital gain dividends received by RIC and REIT shareholders	on the day on which the dividend is paid
undistributed capital gains allocated to shareholders by RICs and REITs shareholders	on the last day of the RIC's or REIT's taxable year

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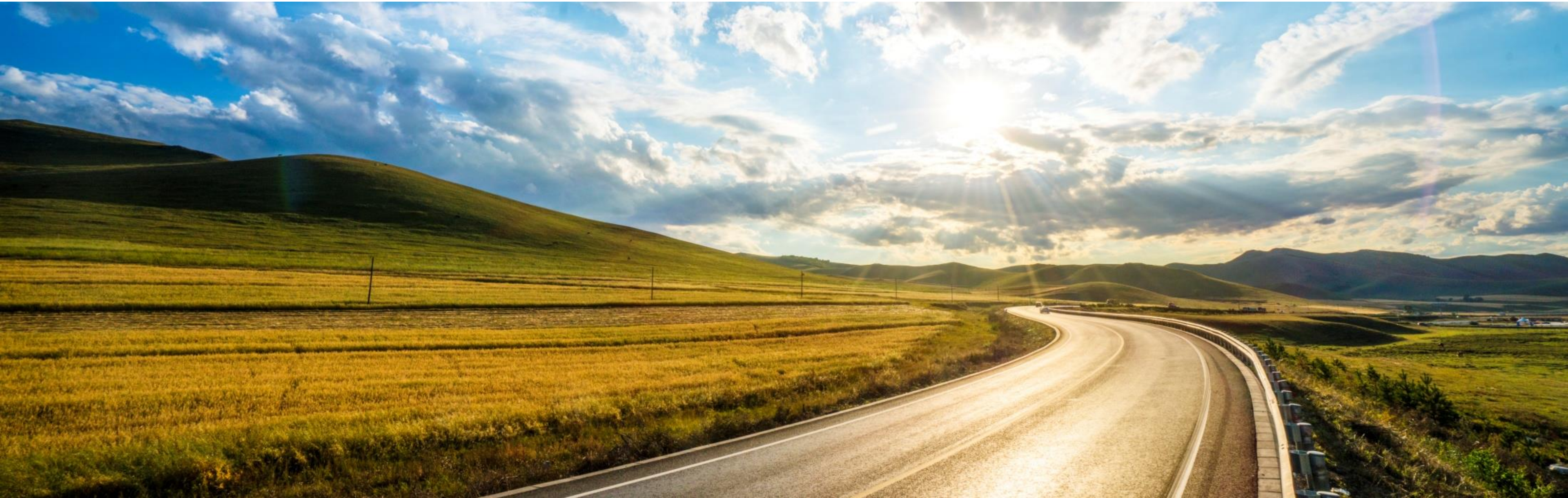
Special Partnership Rules for Deferring Gain by Investing in a QOF

- **Special rules for partnerships and other pass-through entities:**
  - **The Partnership's 180-day clock begins on the date that the partnership recognized the capital gain**
  - **If Partnership passes through the gain, the 180-day clock does not begin until the last day of the of the partnership's taxable year, because that is the day on which the partner would be required to recognize the gain if it was not deferred**
  - **Partners may elect to begin its own 180-day period on the same date as the start of the partnership's 180-day period**
  - **Section 1256 net income: the 180-day period begins on the last day of the taxpayer's taxable year (even if one or more Section 1256 contracts have been disposed of during the year)**

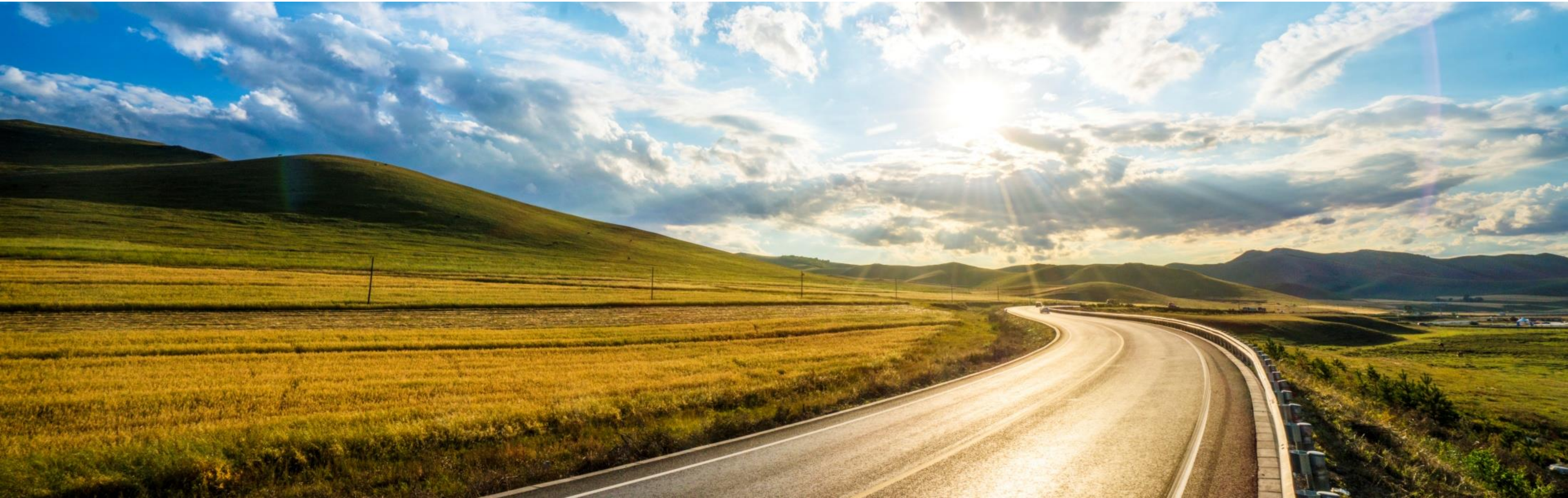
The 10-Year Rule



The 10-Year Rule

- A taxpayer is entitled to step up its basis in its investment in a QOF to fair market value if it has held that investment for at least 10 years
- Possibility to avoid any tax on the disposition of the QOF investment
  - Taxpayers who have not met the 10-year holding period by December 31, 2026, can merely continue to hold their investment until the 10-year holding period is achieved, despite their QOF technically ceasing to be one
  - Step-up to fair market value for any sale of an interest in a QOF allowed until December 31, 2047

DISPOSITION OF THE INVESTMENT



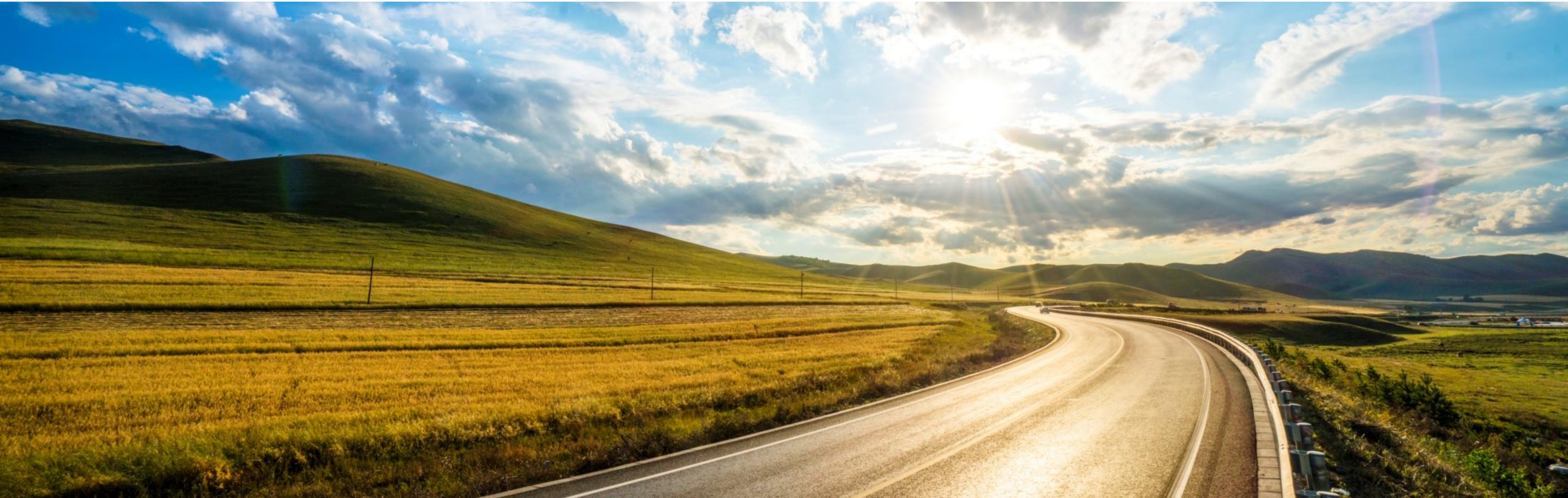
Disposition of the Investment

- **General rule: The original deferred gain from the sale of the capital asset must be recognized by the taxpayer at the earlier of 2026 and the date on which the taxpayer sells its interest in the QOF**
- **However, a taxpayer may use its QOF's interest as collateral for a loan, whether as part of a purchase-money borrowing or otherwise, without triggering the deferred gain**
- **Generous provisions for roll-overs:**
  - **If a QOF disposes of qualified opportunity zone business property, the taxpayer may make a qualifying investment in a new qualified opportunity business property and continue to defer the original gain**
  - **The gain must be triggered – and rolled over - by the end of the date at which all deferred gains must be recognized**
  - **Waiting for more regulations to address if the gain from QOZ property must be a "capital" to roll it over**

Attributes of Included Income When Gain Deferral Ends

- At the end of the deferral period, a taxpayer must include in income the excess of:
  - i. The lesser of (A) the eligible gain that the taxpayer rolled-over or (B) the fair market value of the taxpayer's QOF's investment as of the end of the deferral period over
  - ii. The taxpayer’s basis for the QOF investment
- The gain to be included has the same attributes in the taxable year of inclusion that it would have had if tax on the gain had not been deferred
- These attributes include those taken into account by Sections 1(h), 1222, 1256 and any other applicable provisions of the Code

SELF-CERTIFICATION FOR QOFS



Self-Certification for QOFs

- **Corporations and partnerships can self-certify that they meet the requirements to be treated as QOFs**
- **The IRS released draft Form 8996 with the proposed regulations**
- **Entities that desire to be treated as QOFs must include Form 8996 with their regular tax returns**

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**

DRAFT AS OF October 19, 2018 DO NOT FILE

Part I **General Information and Certification**

1 Type of taxpayer: ☐ Corporation ☐ Partnership

2 Is the taxpayer organized for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund)?
☐ **No. STOP.** Do not file this form with your tax return.
☐ **Yes.** Go to line 3.

3 Is this the first period the taxpayer is a Qualified Opportunity Fund?
☐ **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.
☐ **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.

Part II **Investment Standard Calculation**

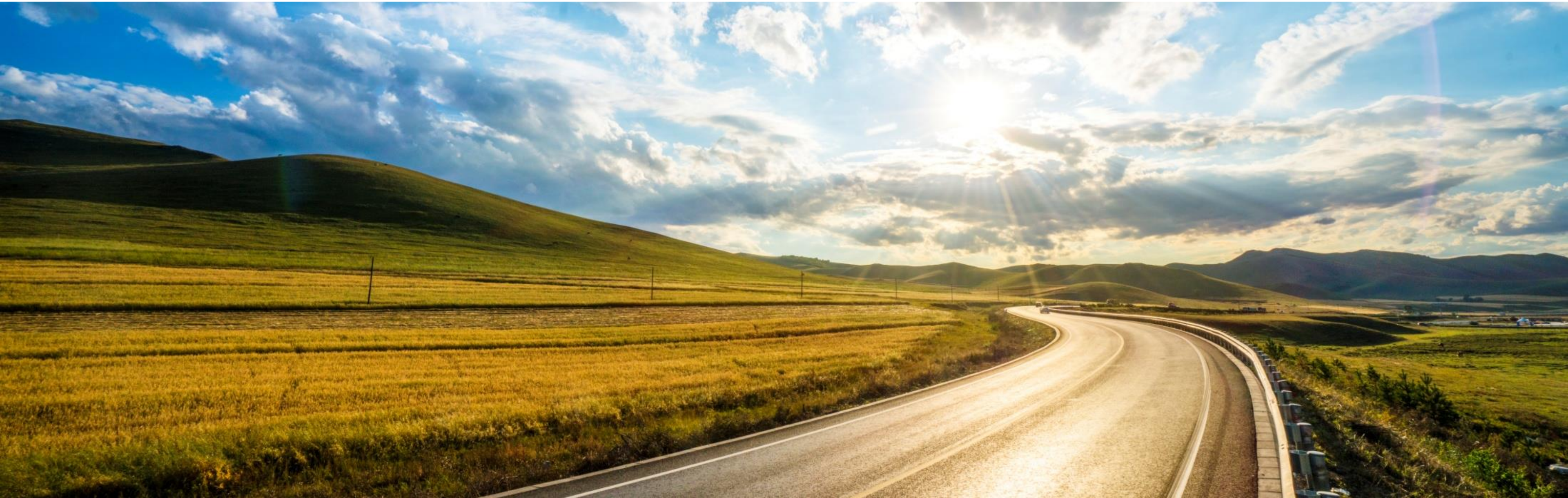
5	Total qualified opportunity zone property held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes"	5	
6	Total assets held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes"	6	
7	Divide line 5 by line 6	7	
8	Total qualified opportunity zone property held by the taxpayer on the last day of the taxpaye's tax year	8	
9	Total assets held by the taxpayer on the last day of the taxpayer's tax year	9	
10	Divide line 8 by line 9	10	

Part III **Qualified Opportunity Fund Average and Penalty**

11	Add lines 7 and 10	11	
12	Divide line 11 by 2.0. See instructions if Part I, line 3 is "Yes"	12	
13	Is line 12 equal to or more than .90? ☐ **Yes.** Enter -0- on this line and file this form with your tax return. ☐ **No.** The fund has failed to maintain the investment standard. Complete Part IV to figure the penalty. Enter the penalty from line 8 of Part IV on this line, and file this form with your tax return	13	

Cat. No. 37820G Form **8996** (12-2018)

STATE INCOME TAX EFFECTS

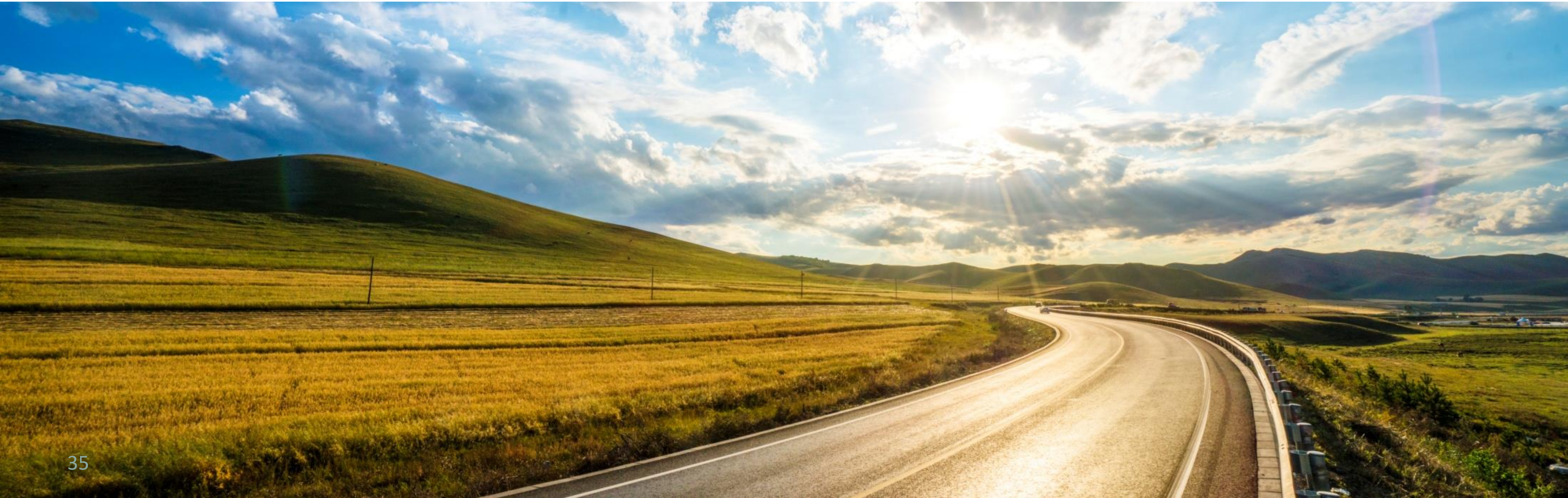


State Income Tax Effects

- **Most state income tax laws are structured so that deferral under Section 1400Z-2(a) will apply for state income tax purposes as well**
- **So far no state has specifically regulated Section 1400Z-2**
- **Corporations, partnerships, RICs, REITs individuals and other business entities that take advantage of deferral would automatically exclude their applicable gains from state taxable income and eventually include future gains under the terms of Section 1400Z-2(b)**
- **State benefits can be meaningful (the same tax rate is often applicable to capital and ordinary gains)**
- ***Example* – New York:**
  - **Corporations will be able to defer gain for purposes of the 6.5% NY State corporate tax and the 8.85 percent NY City corporate tax**
  - **Partnerships will be able to defer gain for purposes of the 4% NY City unincorporated business tax and the NY State and City taxes applicable to its partners.**

QUESTIONS?

For more information visit our **Legal Updates on QOZ** at https://www.mayerbrown.com/en-US/Gain-Deferral-Using-Qualified-Opportunity-Zone-Investment-Strategies-08-02-2018/ and https://www.mayerbrown.com/just-released-irs-qualified-opportunity-fund-guidance-10-23-2018/



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