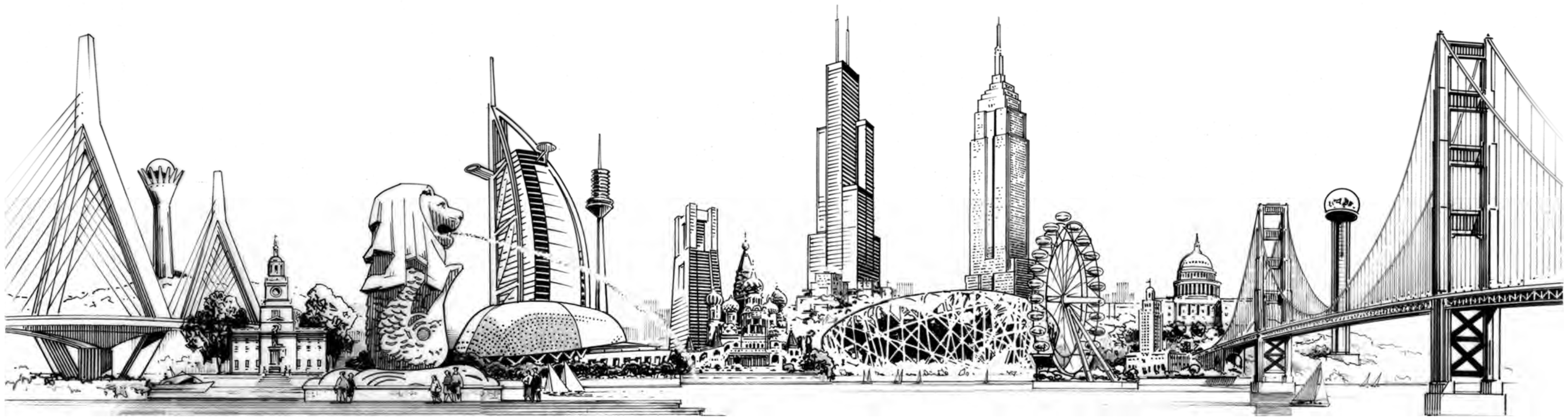
Morgan Lewis

QUALIFIED OPPORTUNITY ZONE FUNDS

November 14, 2018
Morgan Lewis Tax Webinar



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Qualified Opportunity Zone Fund Agenda

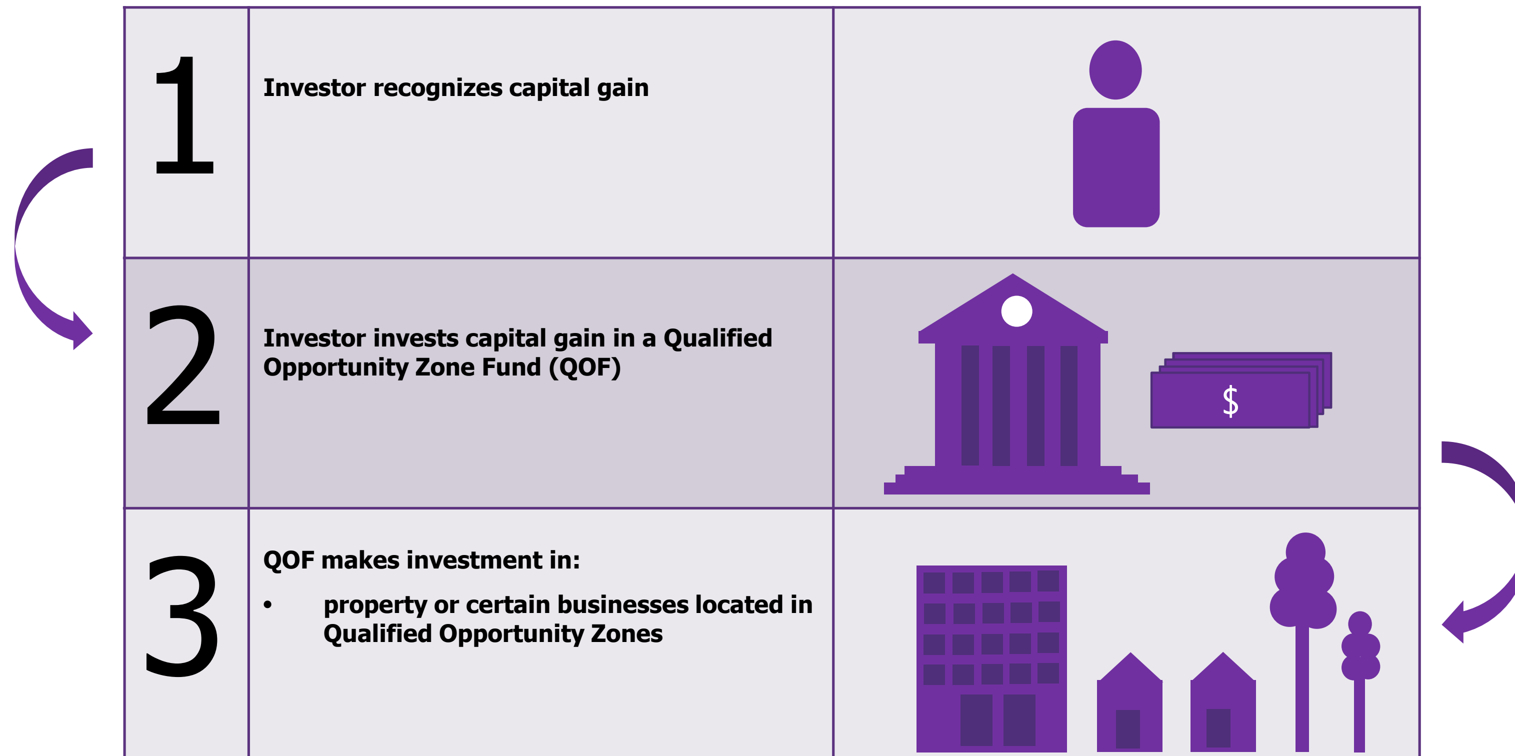
- Background on Qualified Opportunity Zones
- Tax Benefits from Investing in Qualified Opportunity Zone Funds
- Background on Qualified Opportunity Zone Funds
- The Ins and Outs of Qualified Opportunity Zone Businesses
- Additional Observations and Questions

BACKGROUND ON QUALIFIED OPPORTUNITY ZONES

What is a Qualified Opportunity Zone?

- A Qualified Opportunity Zone (QOZ) is a census tract selected by the Governors of individual states (and approved by the Treasury) that meets a definition of a "low-income community" for purposes of encouraging investment in such QOZs.
- Represents roughly 11% of the U.S.
- There are approximately 8,700 QOZs, which are located in every state, DC, Puerto Rico, and the Virgin Islands.
- The US Treasury's Community Development Financial Institutions (CDFI) Fund website maintains the full list of QOZ designations and accompanying map:
  - https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

Investing in Qualified Opportunity Zone Fund



TAX BENEFITS FROM INVESTING IN QUALIFIED OPPORTUNITY ZONE FUNDS

Overview of Tax Benefits of Investing In Qualified Opportunity Zone Funds

- Three new significant tax advantages to taxpayers that invest their capital gain in a Qualified Opportunity Fund (QOF):

  (1) For any capital gain recognized by a taxpayer that is invested within 180 days into a QOF (the "Deferred Gain"), such gain can be deferred until the earlier of December 31, 2026, or disposition of the taxpayer's interest in the QOF.

  (2) If an investor holds its interest in a QOF for at least 5/7 years, their basis in the QOF is increased by 10%/15%, such that they recognize 10/15% less of the Deferred Gain.

  (3) If an investor holds its interest in a QOF for at least 10 years, their interest in the QOF is stepped-up to FMV on disposition, such that any gain recognized by the investor attributable to its investment of Deferred Gain in the QOF is effectively eliminated.

Example (Pt. 1 of 3): Mechanics of Recognition of the Deferred Gain

- Facts:
  - Investor (X) holds a limited partnership interest in private equity fund (Y).
  - Y disposes of an asset during the year and X is deemed to received its distributive share of the $2 million of capital gain on December 31, 2018 (i.e., the last day of Y's calendar year).
  - X takes $3 million of cash on hand (or borrows such cash) and contributes such cash for an equity investment in a QOF **by June 29, 2019 (i.e., within 180 days of recognition of such gain**) and makes an election to roll such gain into the QOF.
  - X has a basis in the QOF equal to $1 million (not $3 million; the $2 million of Deferred Gain creates no basis).

Example (Pt. 2 of 3): Mechanics of Recognition of the Deferred Gain

- Note:
  - X can invest more or less than its gain in a QOF.
  - X can also spread its gain amongst multiple QOFs.
  - X does not need to roll the proceeds of a sale into QOF; it just needs gain.
  - Gain that was previously deferred via investment into a QOF could be rolled into another QOF within a reasonable time, provided the entire amount of such gain is rolled
  - In this example, Fund Y does not make an available election to roll the partnership's gain into a QOF; rather Fund Y permits its LPs to make the election with respect to their distributive share of capital gain.
    - Note: as an alternative, Fund Y could make the gain deferral election with respect to the entire partnership-level gain; however, this would create administrative burdens associated with entering and exiting partners.

Example (Pt. 3 of 3): Mechanics of Recognition of the Deferred Gain

- For illustration, assume there is no change in the value of the QOF:

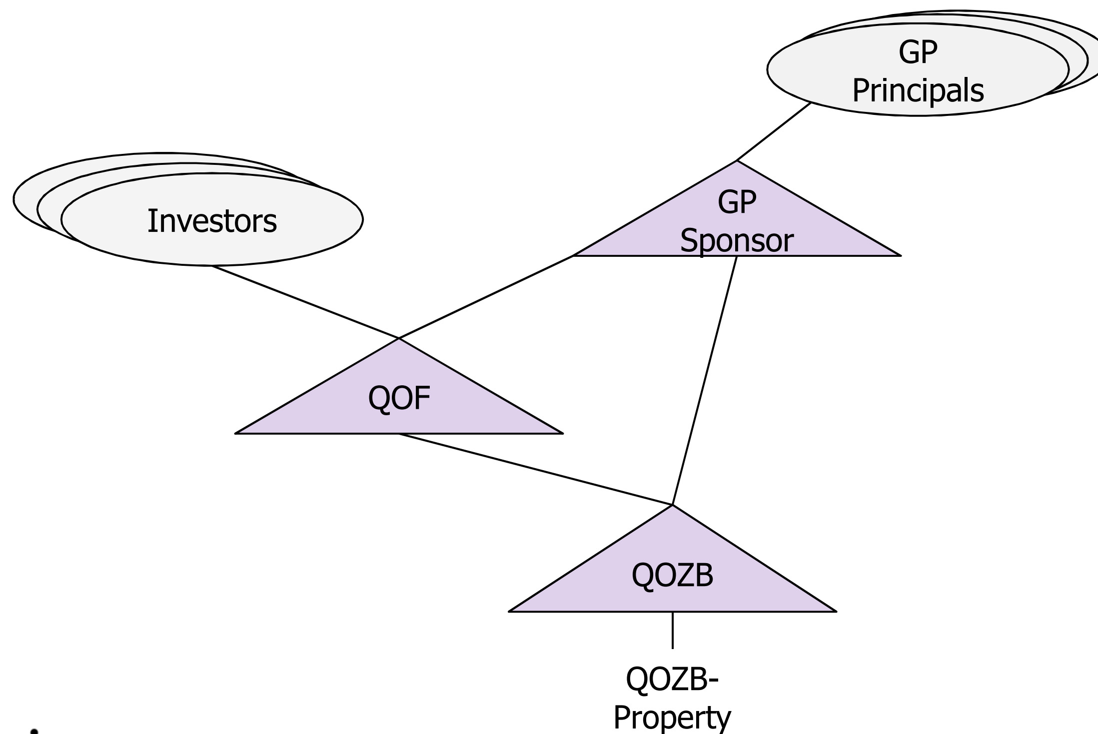
X sells its QOF interest after holding its investment for less than 5 years	X holds its QOF interest for more than 5 years but less than 7 years	X holds its QOF interest for more than 7 years
• **X recognizes the full amount of the Deferred Gain** (assuming the sales proceeds exceed the Deferred Gain) at the time of sale. • Same result if X allocated capital gain within 5 years.	• X receives a special 10% basis step-up on the $2 million Deferred Gain. • Thus, if X later sells its QOF interest (or is allocated capital gain within 5-7 years), **X recognizes only 90% of the Deferred Gain** (assuming the sales proceeds exceed the Deferred Gain) at the time of sale.	• X receives a special 15% basis step-up on the $2 million Deferred Gain. • Thus, if X later sells its QOF interest (or is allocated capital gain after 7 years), **X recognizes only 85% of the Deferred Gain** (assuming the sales proceeds exceed the Deferred Gain) at the time of sale.

- If X still holds its interest in QOF on December 31, 2026 (the end of the deferral period), X recognizes the Deferred Gain as adjusted by the applicable step-up in basis.

Mechanics of the Exclusion of Appreciation for a 10-year investment in a QOF

- Assuming X invested in a QOF on January 1, 2019 and holds its interest in the QOF until at least January 1, 2029 (min. 10-year holding period):
  - The portion of the appreciation attributable to the Deferred Gain is **tax-free upon disposition**.
  - This means that only the appreciation attributable to the $2 million of Deferred Gain is available for the exclusion.
  - Any appreciation attributable to the regular $1 million capital contribution is not eligible for the exclusion.
  - Gain allocated to an investor in a QOF is not eligible for the 10-year exclusion.

Mechanics of the Exclusion of Appreciation for a 10-year investment in a QOF



Additional Tax Considerations For Investing in a QOF

- Operating Income (e.g., rental income, dividends, etc.) from the underlying QOF's investments are subject to tax under traditional tax rules.
  - In the case of a QOF taxed as a partnership, such operating income flows through to the limited partners of the QOF on their Schedule K-1.
  - In the case of QOF taxed as a corporation, such income is taxed at the 21% tax rate, before being distributed to the QOF's shareholders as dividends.

- Basis Considerations: The investor in a QOF initially takes a $0 basis on the Deferred Gain rolled into a QOF. Such basis is increased at the time the investor recognizes the Deferred Gain.
  - A QOF organized as a partnership may limit an investors ability to utilize net losses of the QOF.

Additional Tax Considerations For Investing a QOF – cont'd.

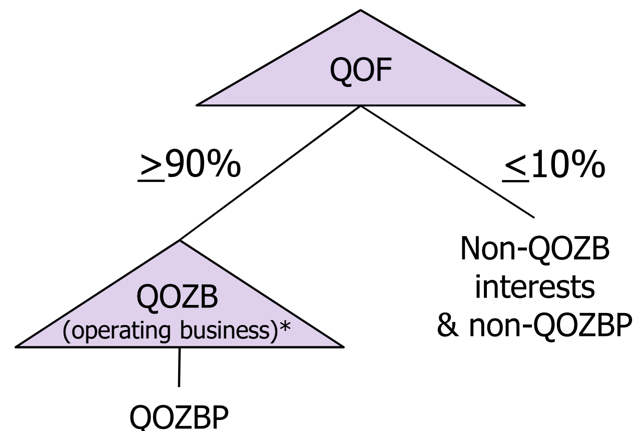
- QOF Sales of Assets:
  - In theory, prior to December 31, 2026, the QOF could elect to reinvest such assets in another QOZB or QOZBP to defer such gain.
  - Alternatively, the limited partners in the QOF could re-invest their distributive share of the capital gain allocated to them by the QOF prior to December 31, 2026.

- Exiting a QOF prior to December 31, 2026:
  - An investor that recognizes gain (i.e., holds its interest in a QOF less than 10 years) can reinvest such gains prior to December 31, 2026 into another QOF.

BACKGROUND ON QUALIFIED OPPORTUNITY ZONE FUNDS

What is Qualified Opportunity Fund?

- A Qualified Opportunity Fund (QOF) is:
  - An entity classified as a partnership or corporation for tax purposes.
  - $\geq$90% of the fund's assets must be QOZ business (QOZB) equity (capital or profits) interests or QOZ business property (QOZBP).



*while the QOF could hold QOZBP directly, we anticipate that most investors will use a two-tier structure (see slide 23)

How is the 90% Test Applied?

- With respect to QOZB equity interests:
  - QOZB equity must be acquired by the fund after December 31, 2017 in an original issuance solely in exchange for cash.
  - The business must have been a QOZB (or in the case of a new business, be organized for the purposes of being a QOZB) at the time the QOF acquired the QOZB stock.
  - Note: an investment in another QOF is not an eligible investment (i.e., it does not qualify as a QOZB equity interest).
- Generally tested twice a year, but can average results for the year.
- A QOF self-certifies satisfaction of the 90% Test on new IRS Form 8996.
- Failure to comply with the 90% Test (without reasonable cause) results in a penalty tax—it's unclear under the new rules whether failure could lead to disqualification; additional guidance is forthcoming.

THE INS AND OUTS OF QUALIFIED OPPORTUNITY ZONE BUSINESSES

Qualified Opportunity Zone Businesses

A QOZB is generally a <u>domestic</u> trade or business other than certain "sin" businesses (i.e., massage parlor; gambling; liquor store; golf course; sun-tanning, country club; race track; hot tub facility) with the following characteristics:

Income	Assets
• ≥50% of its gross income must be derived from the active conduct of the trade or business in the QOZ	• A substantial portion of the business' intangible property is used in active conduct of the trade or business • <5% of the average aggregate unadjusted bases of the business' property is attributable to nonqualified financial property (e.g., stocks, bonds, and certain other financial property other than certain amounts of working capital assets), but there is a working capital safe-harbor (discussed later). • Substantially all (>70%) of the property owned or leased by the business in a QOZ is tangible property that is QOZBP

What is Qualified Opportunity Zone Business Property?

If Property Not Yet Used/Located in QOZ	If Property Already Used/Located in QOZ
• Original use in QOZ commences with the business.	• The business substantially improves the property o Within a 30-month period after acquiring the property, improvements equaling at least the cost basis of the property at the beginning of the 30-month period are made ("doubling down"). o You get to exclude basis of land from such calculation and you do not have to improve land.

- Substantially all of its use is in a QOZ for substantially all of the time period held by the business.
  - "Substantially all" is undefined under the rules

- "Purchased" within the meaning of Section 179(d)(2) after December 31, 2017
  - Not acquired from certain related parties or between certain members of the same controlled group
  - The basis of the property isn't determined in whole or part by the adjusted basis in the hands of the transferor or under Section 1014(a) (FMV step-up in basis upon death of transferor)

- Must be tangible property used in the trade or business

Working Capital Safe Harbor

- An *exception* in the rules provides a safe harbor for a reasonable amount of cash, cash equivalents, or debt treated as "working capital", provided that certain requirements are met:
  - The amount is *designated in writing* for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ;
  - There is a *written schedule* that is consistent with the ordinary start-up of a trade or business for the expenditure of the working capital (and the working capital assets must be spent within 31 months); and
  - The working capital assets are *used in a manner substantially consistent* with the two requirements above.

Working Capital Safe Harbor (cont'd)

- If the working capital assets satisfy the Working Capital Safe Harbor:
  - The working capital assets are not treated as non-qualified financial property for purposes of the QOZB test;
  - Any gross income derived by the working capital assets is counted toward the requirement that 50% of the business' gross income is derived from the active conduct of a trade or business;
  - The substantial use of the intangible property requirement is satisfied during any period in which the business is proceeding in a manner substantially consistent with the Working Capital Safe Harbor; and
  - If the tangible property to be acquired, constructed, or substantially used under the written plan would satisfy the QOZBP test when completed, it will not be treated as failing such test, because the scheduled consumption of working capital is not yet complete.

QOF holding QOZBP Directly vs Utilizing First-Tier QOZB

- Assume QOF has $50 million in assets.

Direct investment in QOZBP	QOF invests through QOZB
• In order to satisfy the 90% test the QOF must purchase at least $45 million of QOZBP. • The remaining **$5 million** could be held in cash or other non-qualifying property. • Working capital safe-harbor does not apply to deployment of QOF assets directly.	• In order to satisfy the 90% test the QOF must invest at least $45 million in equity of a QOZB. • The QOF could hold the remaining **$5 million** in cash or other non-qualifying property. • The QOZB in turn must purchase at least $31.5 million of QOZBP (i.e., 70% of $45 million). • The QOZB could then hold **$2.25 million** in cash (i.e., 5% of $45 million) and **$11.25 million** in non-qualifying tangible assets. • QOZB may utilize the working capital safe-harbor to deploy its assets.

ADDITIONAL OBSERVATIONS AND QUESTIONS

Challenges for Certain Businesses

- It may be difficult for an *existing* operating business to satisfy the requirement that ≥70% of the property owned or leased by the business is QOZBP *at the time* of the fund's investment.
  - Any tangible property acquired prior to January 1, 2018 will not count toward the 70% QOZBP requirement.
  - compare the requirements for a new business, which merely needs to be organized for the purpose of being a QOZB at the time the QOF acquired the QOZB stock.

- Service businesses may face particular challenges, because the 70% test applies to all tangible property that is owned *or leased* by a purported QOZB, but leased property does not appear to qualify as QOZBP.

  - Example: Pizza Parlor, LLC rents space in a QOZ from Landlord. As the statute is structured, the leased real property would not count as QOZBP for Pizza Parlor, LLC, because it did not acquire the property by purchase and its original use in the QOZ was not with Pizza Parlor, LLC. However, the leased property would be considered tangible property factoring into the denominator for purposes of the 70% QOZBP test.

Resources & Contacts

Visit our Tax Reform Resource webpage for tax reform-related webinars, recordings, LawFlashes, articles, and more:

https://www.morganlewis.com/topics/navigating-us-tax-reform

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ML Tax Reform Resource Page

Past webinars and LawFlashes discuss tax reform implications for:

- Healthcare
- Energy industry
- Automotive industry
- Tax-exempt organizations
- Pass-through entities
- Hedge funds, investors, and managers
- M&A transactions
- International operations of US and non-US businesses
- State and local tax issues
- And much more…

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PAST EVENTS & RECORDINGS

Where possible, we have provided access to recordings and/or slides from our past tax reform programs covering the following issues and industries:

Navigating US Tax Reform: Prospects for Tax Reform 2.0 (09/27/2018)

Tax Reform – A Review of the Tax Cuts and Jobs Act and Recent Guidance (09/05/2018)

Implications for the Energy Industry – Domestic Issues (05/23/2018)

How Corporate Tax Reform Will Impact the Tech Industry – a Discussion in 'Plain English' (05/17/2018)

2017 Tax Act: Where Do Tax-Exempt Employers Go from Here? (04/10/2018)

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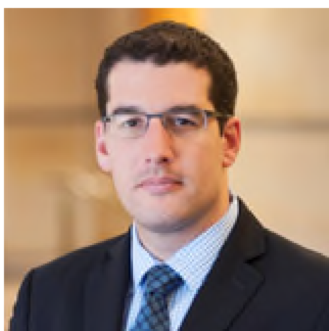
LAWFLASHES & ARTICLES

Opportunity Zone Fund Regulations – Long-Awaited Guidance Should Help Investors and Sponsors Get Off the Sidelines (10/23/2018)

The US Department of the Treasury and the Internal Revenue Service (IRS) released much-anticipated guidance on October 19 on investments in the new Opportunity Zone Funds. The release included proposed regulations (REG-

NAVIGATING US TAX REFORM

Biography



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Education

- The George Washington University Law School, 2005 J.D.
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Richard C. LaFalce counsels clients on the creation and taxation of private and pooled investment vehicles such as mutual funds, REITs, ETFs, hedge funds, Opportunity Zone Funds, and other investment-related entities. He frequently advises clients on the taxation of financial products, general corporate and international tax matters, and UBIT. Before joining Morgan Lewis, Rich was an assistant branch chief in the Internal Revenue Service Office of Chief Counsel, Financial Institutions and Products.

Rich advises clients on general corporate tax matters, the taxation of financial products, unrelated business taxable income (UBTI), information reporting, and international tax planning. He also counsels companies on international tax issues including compliance with the Foreign Account Tax Compliance Act (FATCA) and the Foreign Investment in Real Property Tax Act (FIRPTA).

Rich frequently assists clients in their interactions with the IRS including obtaining Private Letter Rulings and other guidance.

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Education

- Harvard Law School, 1969, J.D.
- Yale University, 1966, B.A.

Bill McKee's practice encompasses all areas of federal taxation, with special emphasis on partnership taxation. Bill served as tax legislative counsel at the US Treasury Department from 1981 to 1983. He is a member of the American Law Institute, the American College of Tax Counsel, and the National Institute for Tax Professionals.

In addition to authoring numerous articles, Bill co-authored the treatise *Federal Taxation of Partnerships and Partners* (Warren, Gorham & Lamont, 4th edition, 2007) as well as *Structuring and Drafting Partnership Agreements: Including LLC Agreements* (Warren, Gorham & Lamont, 3rd edition, 2003). He also frequently speaks on partnership taxation at seminars across the United States. Ranked in Band 1 by *Chambers USA*, Bill is described as "a pre-eminent expert in the tax field" and "simply unparalleled in partnership taxation." Clients praise Bill as a "clear thinker and an excellent communicator" who is client-focused and has "extraordinary technical tax expertise." He has been repeatedly named a leading lawyer in both *Chambers USA* and *Chambers Global*.

Bill has served as a law professor at the University of Virginia School of Law, and he has served as a visiting professor in the Graduate Tax Program at New York University School of Law. At Harvard Law School, Bill was an editor of the *Harvard Law Review*.

Biography

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Education

- New York University School of Law, 1997, J.D.
- Harvard University, 1994, A.B.

Daniel A. Nelson advises clients on the US and international tax and commercial considerations related to the efficient structuring of transactions and business relationships. He counsels global institutional investors—including investment managers for some of the world's largest pension funds, sovereign wealth funds, and insurance companies—in connection with investments in real estate, infrastructure projects, and other real assets. Dan also advises sponsors regarding the formation and operation of customized investment platforms, private investment funds, and joint ventures involving pension funds, sovereign wealth funds, insurance companies, and other institutional investors.

Much of Dan's work with institutional investors and sponsors is cross-border, involving both inbound investments into the Americas region as well as outbound investments. In addition to this work, Dan maintains a broad-based transactional tax practice.

In his tax practice, Dan advises clients on the tax issues that accompany merger and acquisition transactions and the formation of partnerships and joint ventures. He also counsels clients on transactions involving real estate, real estate investment trusts (REITs), the energy sector (including project finance transactions), and the formation and operation of private equity funds. Dan has experience with a wide range of capital markets transactions, business restructurings, and other transactional tax planning matters.
Dan also helps clients obtain administrative rulings from the US Internal Revenue Service (IRS).

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Education

- Columbia Law School, 1985, J.D.
- Amherst College, 1981, B.A.

Working with businesses in industries such as media, financial services, aviation, shipping, and education, Richard S. Zarin counsels clients on tax matters involving international and US transactions. He also advises clients on ongoing tax planning. Richard's experience includes mergers, acquisitions, the formation and operation of joint ventures, debt and equity restructurings, and securities offerings. In addition, he represents organizers of and investors in onshore and offshore investment funds and other alternative investment vehicles.

Richard's work with investment funds and alternative investment vehicles includes those with a range of investment objectives, including private equity, venture capital, and hedge funds.

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Education

- New York University School of Law, 1990, LL.M.
- University of Pennsylvania Law School, 1989, J.D.
- Dickinson College, 1986, B.A.

William P. Zimmerman guides clients on the creation and operation of private and pooled investment vehicles, such as mutual funds, hedge funds, real estate investment trusts, and other investment-related vehicles. He also advises clients on general corporate and individual tax planning matters, including reorganizations, mergers, acquisitions, spinoffs, recapitalizations, and workouts. Additionally, Bill provides partnerships and limited liability companies with planning and operational guidance on tax-related issues.

Bill is the most recent past chair of the investment management committee of the tax section of the American Bar Association. He is a frequent speaker on tax-related topics, and also annually presents at Morgan Lewis's Private Fund Investor Roundtable. In addition, Bill is a fellow of the American College of Tax Counsel.

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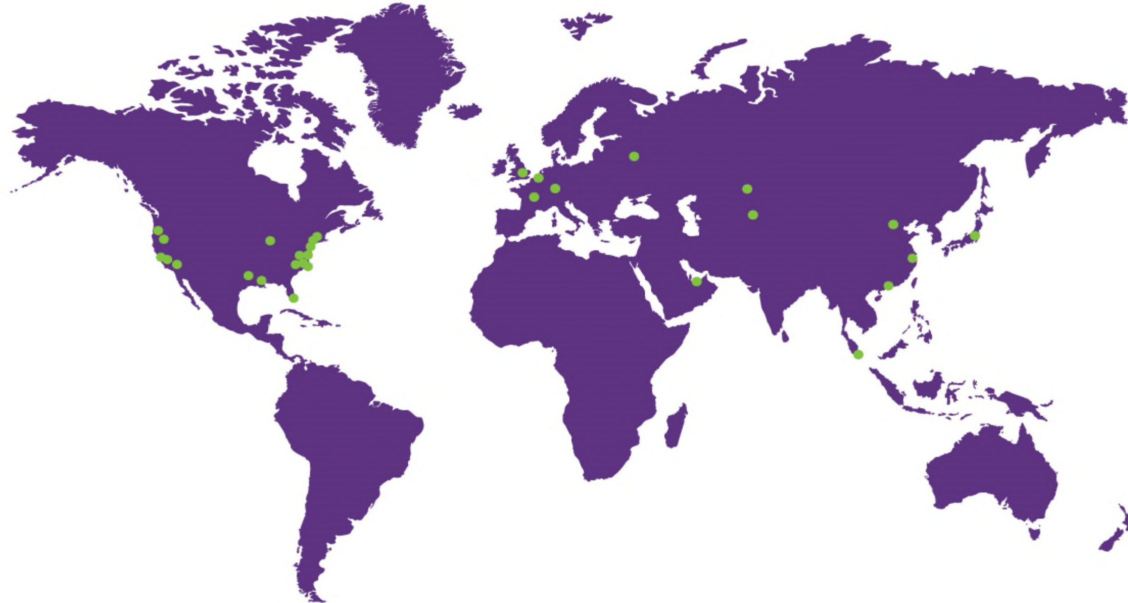

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