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ANALYSIS OF QUALIFIED OPPORTUNITY ZONES

This document provides a detailed analysis of the newly created tax incentives for investments in Qualified Opportunity Zones ("QOZs").[i] For a brief description of QOZs, please see our March 15, 2018 Client Alert located HERE. For an analysis of the opportunities to twin QOZ tax benefits with Low-Income Housing Tax Credit ("LIHTC"), the New Markets Tax Credit ("NMTC") and the Historic Tax Credit ("HTC"), see our March 15, 2018 article located HERE.

Qualified Opportunity Zones were created as part of the Tax Reform law that was enacted on December 22, 2017, Public Law No: 115-97. The QOZ provisions are contained in Internal Revenue Code Sections 1400Z-1 (Designation of Qualified Opportunity Zones) and 1400Z-2 (Special Rule for Capital Gains Invested in Opportunity Zones).

It is expected that guidance will be issued by the U.S. Department of Treasury ("Treasury") or by the Internal Revenue Service ("IRS"). There are many open issues for which guidance is needed. The conclusions in this analysis are our initial conclusions and are subject to change as guidance is released.

I. Qualified Opportunity Zones Are Designated NMTC Low-Income Communities

QOZs are census tracts designated by the Governor of each State or United States possession and must be low-income community census tracts for New Markets Tax Credits purposes. Based on the 2011-2015 American Communities Survey from the Census Bureau, there are 31,680 population census tracts that are eligible to be a QOZ and an additional 9,453 that can be designated as a QOZ by being adjacent to a QOZ, as further described below. QOZ designations last for 10 years.

Each Governor can designate up to 25% of low-income community census tracts as QOZs. States with less than 100 low-income communities can designate up to 25 tracts as QOZs. The Designation Period for Governors to notify the Secretary of the Treasury of the nominated tracts lasts until March 21, 2018, although a one-time 30-day extension is available. The Treasury will then have 30 days to certify and designate such tracts as QOZs. Under a special rule, all low-income communities in Puerto Rico are automatically considered to be QOZs.

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The statute also allows designation as a QOZ of census tracts that are contiguous with a designated QOZ and that have median family incomes not exceeding 125% of the contiguous QOZ. Such designated contiguous tracts cannot exceed more than 5% of all census tracts in the state.

TAKE-AWAY **QOZ nominations will be known by March 21, 2018 for most states and possessions or within 30 days for those that request an extension. Confirmation from the Treasury will then come within 30 days.**

Additional information on census tracts eligible to be QOZs is located at this link. https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

II. 1st Tax Benefit - Deferral of Gain - More Types of Deferrals than 1031 Exchanges

General Rule - If a taxpayer has a gain from a sale or exchange, it can avoid (defer) current taxation on that gain by investing the gain into a Qualified Opportunity Zone Fund ("QOZ Fund") within 180 days of the sale or exchange. Gain will be triggered at the earlier of the sale or exchange of the QOZ Fund or on December 31, 2026. The gain triggered is the lesser of the deferred gain or the fair market value of the investment in the QOZ Fund as of such date.

TAKE-AWAY The requirement to invest the gain within 180 days will create significant pressure to find an investment before the deadline. Investors that regularly generate gains would have an easier time finding investments and timing their investment with a normal LIHTC or HTC capital contribution schedule.

OPEN ISSUE There does not appear to be any actual tracing of the cash gain proceeds into a QOZ investment. This could lead to leveraging opportunities where the taxpayer puts in cash that equals a portion of the deferred gain and then borrows money that is invested for the balance of the deferred gain. This could be especially useful for NMTC transactions, but also other transactions.

Comparison to Section 1031 Like-Kind Exchange - There are two key benefit of investing in a QOZ Fund as opposed to entering into a 1031 Exchange:

a) QOZ Fund Investments Require Less Investment to Defer Tax – In order to defer tax on a gain, one need only invest the amount of gain into a QOZ Fund within 180 days. In contrast, Section 1031 Exchanges require that the entire value of the original property be reinvested in a new property in order to defer taxation. Section 1031 Exchanges have a 45-day identification period and a 180 day exchange period.
   i) Example 1 – QOZ Investment – Assume Jones has a building with a value of $10,000,000 and has a basis of $9,000,000. The sale of the building

would trigger $1,000,000 of taxable gain for Jones. In order for Jones to defer tax on the $1,000,000 gain, Jones **only needs to invest the $1,000,000 gain** into a QOZ Fund within 180 days. There are no restrictions on what the taxpayer does with the other $9,000,000.

ii) Example 2 - 1031 Investment – Assume the same facts as above. In order to defer tax on the entire $1,000,000 gain in a 1031 Exchange, Jones would need to **invest the entire $10,000,000** in a property that meets the 45-day and 180-day requirements.

b) No Restriction on Types of Eligible Gains Invested in QOZ Funds – The new QOZ law places almost no restriction on the type of gain eligible for deferment. It only requires that the gain stem from a sale or exchange to an unrelated person. Real estate, personal property, intangibles assets, vehicles and virtually any other asset can qualify. In contrast, under the new Tax Reform law, eligibility for 1031 treatment has been restricted to only gains from the sale of real estate.

III. 2nd Tax Benefit – Up to 15% Permanent Reduction in Taxable Gain

If the investment in the QOZ Fund is maintained for 5 years, then deferred gain from the original investment will be reduced by 10%. If the investment in maintained for 7 years, then the deferred gain will be reduced by another 5% for a total of 15% reduction. The deferred gain will become taxable at the earlier of the date the QOZ Fund investment is sold or December 31, 2026. Note, if the fair market value of the QOZ investment is less than the deferred gain, then gain is only triggered up to such fair market value.

Example 3 – 15% Reduction in Gain : Assume Invest Corp. has a stock with a basis of $6,000,000 that was sold for $10,000,000 on January 1, 2018. This creates taxable gain of $4,000,000 for Invest Corp. As a corporate taxpayer, $840,000 in tax would be due for the 2018 taxable year. However, if the $4,000,000 is invested by Invest Corp. in a QOZ Fund within 180 days and stays invested, then no tax is due in 2018. If Invest Corp. maintains the investment in the QOZ Fund for 5 years, then Invest Corp.'s deferred gain is reduced by 10% to $3,600,000. If the investment is maintained for 7 years, then the deferred gain is reduced by another 5% to net of $3,400,000. Assuming the QOZ Fund does not lose value, then no later than December 31, 2026, the remaining gain of $3,400,000 would become taxable. At a 21% corporate tax rate, Invest Corp. would owe $714,000. This is 15% less than would have been owed on the full $4,000,000. The permanent avoidance of tax results in a corporate tax savings for Invest Corp. of $126,000. The savings for individuals could be even higher, depending on their tax rate.

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IV. 3rd Tax Benefit – Avoidance of Gain on QOZ Fund Investment

The rules regarding the Investor's basis in the QOZ Fund are very specific and offer additional tax saving opportunities.

1) When the gain from a prior sale or exchange is invested by a taxpayer in a QOZ Fund, the taxpayer's basis in the QOZ Fund is initially set at zero. This is because the taxpayer has not yet paid tax on these funds due to the deferral described above.
2) When the QOZ Fund has been held for 5 years, the basis in the QOZ Fund goes up 10% of the deferred gain amount. This increase is linked to the reduction in gain on the Existing Gain that occurs after 5 years.
3) If held for 7 years, then the basis increases another 5% to a total of 15% of the original gain. This increase is linked to the reduction in gain on the Existing Gain that occurs after 7 years.
4) Any gain recognized on the deferred gain also increases the basis in the QOZ Fund by a like amount. Therefore, no later than December 31, 2026, the basis in the QOZ Fund will increase up to the lesser of the basis amount of the original deferred gain or the fair market value of the QOZ Fund investment.

   Example 4 – Increases in QOZ Basis Before Year 10: The same facts as in Example 3. After 5 years invested in a QOZ Fund, Invest Corp.'s basis in the QOZ Fund would increase from $0 to $400,000 (10% of the $4,000,000 deferred gain). After 7 years, Invest Corp's basis in the QOZ Fund would increase another 5%, to $600,000. Assuming the QOZ fund has maintained its value, on December 31, 2026, Invest Corp. would recognize $3,400,000 of gain that was previously deferred. But Invest Corp.'s basis in the QOZ Fund would also increase by $3,400,000 to a total of $4,000,000.

5) If the investment in the QOZ Fund is held 10 years, the taxpayer can elect to increase its basis in the QOZ Fund up to the fair market value of the investment on the date that is it sold or exchanged

   Example 5 – Stepping QOZ Fund Basis Up to Fair Market Value: Same facts as Example 3. After 10 years the fair market value of the QOZ Fund has increased to $5,000,000. Invest Corp. can elect to increase its basis up to $5,000,000. It could then sell the QOZ Fund investment for $5,000,000 and would owe no tax on the $1,000,000 gain it would otherwise have recognized

   Example 6 – QOZ Investments that Lose Value: Same facts as Example 3, except that the value of the QOZ Fund is only $3,000,000 after 10 years when the Fund investment is sold. In this case, Invest Corp. would not elect to have the basis equal the $3,000,000 fair market value because the QOZ Fund basis would already be $4,000,000. Invest Corp. could sell the stock and receive $3,000,000 and also take a loss of $1,000,000 on the sale. At a 21% tax rate, the $1,000,000 taxable loss would save Invest Corp. $210,000 in federal income tax, on top of the $3,000,000 of cash received from the sale.

V. What is a QOZ Fund?

Purpose Requirement - The requirements to qualify as a QOZ Fund appear very limited. The Fund must be a corporation or partnership with a purpose of investing in Qualified Opportunity Zone Property ("QOZP"). This purpose requirement can likely be satisfied by having fund organizational documents provide for such a purpose. While the Joint Explanation that accompanied the Tax Reform bill indicated that there would be a similar certification process as with New Markets Tax Credits, the actual statute does not indicate such a process is required. Informal discussions with Treasury personnel also indicate that the Treasury certification process will not be extensive.

Investment Requirement – **90% of the QOZ Fund's assets must be invested in QOZP** (excluding investments in another QOZ Fund)**.** The 90% requirement is tested by the average of the amount invested in QOZP on (i) the last day of the 6-month period of the QOZ Fund's tax year, and (2) the last day of the QOZ Fund's tax year.

TAKE-AWAY This provides a QOZ Fund with the ability to maintain 10% of its assets in non-QOZP assets. This could allow for fund level reserves which could be available if needed for the QOZP investment. Or it could be invested in other income producing investments that do not qualify as QOZP.

OPEN ISSUE Is the 90% test based on the original basis in the investment, the adjusted basis or the current value of the fund investments? A fair market value or adjusted basis answer could create a risk that the 10% of asset maintained in the QOZ Fund might be more than 10% of the current fair market value or adjusted basis of of all QOZ Fund assets.

OPEN ISSUE Can the IRS provide any flexibility on how quickly funds need to be invested in QOZP? A strict reading of the rules would seem to require a calendar year QOZ Fund to measure itself on June 30 and December 31st. But what if the QOZ Fund received cash from an Investor on June 29th. Would it really be penalized if that cash was not invested in QOZP by June 30th?

Penalty for Failure to Meet 90% Requirement – Failure to meet the 90% test results in a monthly penalty equal to amount of QOZP that the fund is short each month multiplied by the IRS Underpayment Rate—the Federal Short-Term rate + 3%.

Mixed Funds are Allowed – QOZ Funds may include both funds that qualify for gain deferral and other funds. Such investments are tracked separately and the non-gain investment does not receive any of the special tax benefits described above.

TAKE-AWAY – If a taxpayer wants to make an investment that exceeds any gain that it can defer, this is accomplished by having the fund track the gain investment separately from the non-gain investment. Alternatively, a fund which does not have enough QOZ investors with deferred gains can choose to get additional investments from non-gain investors.

VI. Qualified Opportunity Zone Property ("QOZP")

A QOZ Fund must invest 90% of its assets in QOZP. QOZP can be (i) **Qualified Opportunity Zone Stock**, (ii) **Qualified Opportunity Zone Partnership Interests**, or (iii) **Qualified Opportunity Zone Business Property ("QOZBP")**. The QOZ Fund investments must occur after December 31, 2017.

Requirements for Investments in Qualified Opportunity Zone Stock

1) Cash Purchase - The stock must be purchased by the QOZ Fund at the stock original issue (directly or through and underwriter) solely in exchange for cash.
2) Qualified Opportunity Zone Business ("QOZB") - The stock must be in a corporation that is a Qualified Opportunity Zone Business at the time of the stock purchase (or for newly formed corporations, have a purpose of being a QOZB). During "substantially all" of the QOZ Fund's holding period the corporation must qualify as a QOZB.

OPEN ISSUE How will "substantially all" be defined by the IRS.

Requirements for Qualified Opportunity Partnership Interests - the requirements are similar to investments in Qualified Opportunity Zone Stock. The QOZ Fund must purchase a partnership profits or capital interest for cash and the partnership has to meet the same QOZB requirements.

Requirements for Investments in Qualified Opportunity Zone Business Property – Must be tangible property used in a QOZ Fund's trade or business where the **Original Use of the property is in a QOZ**, or (b) there is a substantial improvement of the property and within 30 months the improvement exceed the original cost of the investment at the beginning of the 30-month period.

TAKE-AWAY **For investments twinned with LIHTC**, the QOZ substantial improvement requirement is substantially higher than the LIHTC requirement of the greater of 20% of the original basis of the Project or $6,000 plus an inflation factor. This means that QOZ investments twinned with LIHTC would likely not include light rehabilitations.

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Instead they would tend to be heavier rehabilitations such that the cost of the rehabilitation exceeds the cost of acquiring the building.

OPEN ISSUE Strangely, the statute does not require that a QOZ Fund acquiring Qualified Opportunity Zone Business Property qualify as a Qualified Opportunity Zone Business ("QOZB"). This could conceivably leave open the possibility that a QOZ Fund that chooses to invest in its own business would not have to meet the requirements of QOZBs (for example, the 50% gross income test listed described below or the requirement not to invest in certain "sin" businesses). It is unclear if the IRS can issue regulations that would require the QOZBP requirements to be met.

VII. Requirements for Qualified Opportunity Zone Businesses

QOZBs are trades or businesses that invest substantially all their assets in tangible property that is owned or leased. The original use and substantial improvement requirements for QOZBP must be met. In addition, the following rules apply:

a) 50% Gross Income Test – at least 50% of the gross income must be derived from the active conduct of a trade or business.

OPEN ISSUE Will the operation of real estate be considered an active conduct of a trade or business? Our best guess is that they will follow the NMTC approach and that the operation of real estate could qualify.

b) Active Conduct - A substantial portion of intangible property must be used in the active conduct of a trade or business
c) 5% Cap on Non-Qualified Financial Property - Less than 5% of the aggregate unadjusted basis of property owned by the QOZB can be Nonqualified Financial Property ("NQFP"). NQFP includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property.
    i) NQFP does not include reasonable amounts of working capital held as cash, cash equivalents, debt instruments with a term of 18 months or less or accounts receivable generated in the ordinary course of business.

OPEN ISSUE For NMTC transactions there is also an exception for funds that will be expended for construction of real property within 12 months. The QOZBP rules allow 30 months for a substantial improvement. Will the IRS allow an exception for funds that will be expended on a substantial improvement within 30 months?

d) No "Sin" Businesses – The QOZB cannot be a "sin business", which is defined as "a 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".

e) Above Requirements Do Not Apply to QOZBP – Curiously, QOZ Funds that choose to directly invest in QOZBP do not need to meet the 50% Gross Income Test, the Active Conduct of a Trade or Business Test, the 5% Cap on NQFP and the No Sin Business test.

OPEN ISSUE Will the IRS issue guidance requiring QOZBP to follow the same rules as QOZB?

For more information, please contact Glenn Graff, Ben Swartzendruber or any of your contacts at Applegate & Thorne-Thomsen.

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