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# Qualified Opportunity Zones

**Megan Jones**

Withers Bergman LLP

[Megan.jones@withersworldwide.com](mailto:Megan.jones@withersworldwide.com)

310-228-5742

**Brad Cohen**

Jeffer Mangels Butler & Mitchell LLP

[BCohen@jmbm.com](mailto:BCohen@jmbm.com)

310.201.3575

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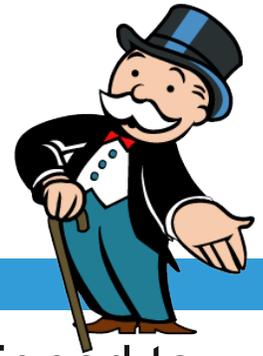
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# Tax Reform

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- The Tax Cuts and Jobs Act created a new Internal Revenue Code section, IRC § 1400Z, which provides a new tax deferral program to encourage investments in distressed communities, known as Qualified Opportunity Zones.
- The IRS released proposed regulations, Revenue Ruling 2018-29 draft Form 8996 and corresponding instructions on October 19, 2018; and on April 17, 2019 new proposed regulations were released.
- This income tax incentive program is different than other programs, such as the New Market Tax Credit, because it allows a taxpayer to defer tax, reduce the amount of gain realized through a basis adjustment, and exclude gain on the appreciation of an interest in a Qualified Opportunity Fund permanently.

# Qualified Opportunity Zones – Intro



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- The Qualified Opportunity Zone (“QOZ”) provisions are designed to **spur long-term private sector investments** in low-income communities nationwide.
- This new economic development program offers an easy way for equity investments to **reinvest realized capital gains** into distressed communities through Opportunity Funds, in exchange for a graduated series of incentives tied to long-term holdings.
- The deferral is available only if the **gain** is reinvested into a Qualified Opportunity Fund in a **timely manner**.
- **California has not conformed.**
- Governors of each state (and Mayor of Washington, D.C.) can designate up to 25% of the number of low-income communities within the state as Qualified Opportunity Zones.

# Qualified Opportunity Zones – Intro



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- A Qualified Opportunity Fund (QOF) is a newly created investment vehicle established by Congress that is set up as either a **tax partnership or corporation** for equity investment in **eligible property** located in a Qualified Opportunity Zone, and that utilizes the **investor's realized gains** from a prior investment for funding the Opportunity Fund.
- A taxpayer may elect to exclude from gross income part or all of the **capital gain** (long-term or short-term, actual or deemed) on the sale or exchange of **any** property to an **unrelated party** to the extent that the **gain** is reinvested in a Qualified Opportunity Zone generally **within 180 days** of the gain recognition.
- The maximum amount of capital gain that can be excluded is equal to the amount of capital gain invested in the Qualified Opportunity Fund.
- Most or all of the **deferred gain is recognized** on the **earlier of** the date on which the Qualified Opportunity Zone **investment is disposed of or December 31, 2026**.
- **Permanent exclusion of post- QOZ acquisition gains** (reinvestment gains) from sale or exchange of an interest in a Qualified Opportunity Zone investment **held for at least 10 years**. No additional gain exclusion on gains realized after December 31, 2047.

# Qualified Opportunity Zones – Taxation

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- The statute allows deferral of any “capital gain” (long-term or short-term, actual or deemed).
- The gain being deferred must come from the actual or deemed sale or exchange of any property, including stock.
- Depreciation recapture that is subject to ordinary income treatment will not qualify for deferral or exclusion.
- The sale/exchange causing the recognition of a gain must be generated by the sale or exchange to an “unrelated person” (20% related party test, plus most family members).
- The investment in the Qualified Opportunity Fund must occur within the 180-day period **generally** beginning on the date on which the capital gain would have been recognized for Federal income tax purposes.
  - For partners, members of LLCs or S corporation shareholder investments in QOFs, the 180-day period begins to run at the end of the entity’s tax year including the date of sale.
  - For 1231 gains, the 180-day period begins to run at the end of the entity’s tax year including the date of the sale.
- Investor must elect to have this provision apply. IRS Form 8949.

# Qualified Opportunity Zones – Taxation

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- If an investor **sells** an existing investment that generates capital gain **before December 31, 2026**, the proceeds must be invested within 180 days from the initial sale or exchange in the amount equal to the gain.
  - ▢ Unlike 1031 exchanges, only the “gains” have to be rolled over. Can rollover all or part of the gains.
- Benefits can include:
  - ▢ Ability to elect to defer that gain, **potentially** until the end of 2026.
  - ▢ 10% exclusion if in the QOZ program for at least 5 years on December 31, 2026.
  - ▢ Additional 5% exclusion if in the QOZ program for at least 7 years on December 31, 2026.
  - ▢ Investor must complete investment into the fund before the end of 2019 for a 7-year holding period to be achieved and full 15% gain exclusion to be realized.
  - ▢ Investor must complete investment into the fund before the end of 2021 for a 5-year holding period to be achieved and full 10% gain exclusion to be realized.
  - ▢ **All further gains from sale of fund interest will be tax free, if the fund investment is held for more than 10 years.**
  - ▢ Only cash from deferred gain qualifies for the Qualified Opportunity tax benefits. No tracing is required.
- If the sale or exchange of the QOF investment occurs after December 31, 2047, the basis in the QOF investment is adjusted on the date of the sale. However, the amount of the basis adjustment is the lesser of the fair market value on the date of the sale or the fair market value on December 31, 2047.

# Period of Deferral

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- The period of capital gain tax deferral ends upon the **earlier of the disposition of the fund investment OR:**



# Elections for Investments Held at Least 10 years

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- Eligible taxpayers who hold investments in a QOF for at least 10 years may elect to increase the basis of the investment to fair market value of the investment on the date that the investment is sold or exchanged. This results in no **federal** tax on the sale of the QOF interest.
  - ▣ QOF may be able to reinvest within a reasonable time (one-year) to bring it back in compliance.
  - ▣ During the interim period, the proceeds must continually be held in cash, cash equivalents or debt (with a term less than 18 months).
  - ▣ The one-year period may be extended if failure to meet the 12-month deadline is “attributable” to delay in government action, the application for which is “complete.”

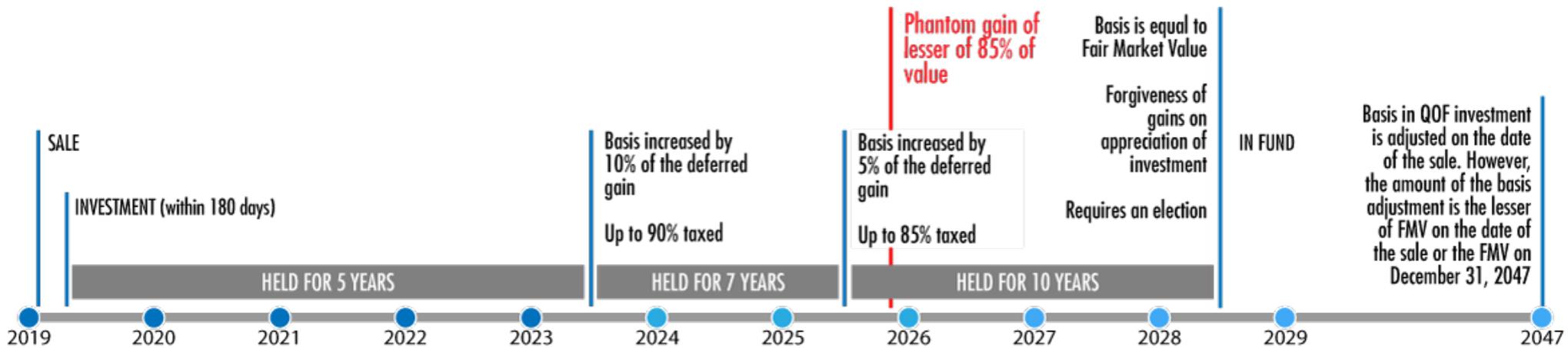
# Elections for Investments Held at Least 10 years

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- The step-up in basis election is available only for gains realized upon investments made in connection with a proper deferral election.
- To the extent the taxpayer also makes an investment in the QOF and it is not subject to a proper deferral election, the investments will be bifurcated and treated separately.
- **Eligible taxpayers are permitted to make an otherwise qualified basis step-up election even after a qualified opportunity zone designation expires.**

# Partial Forgiveness and Forgiveness of Additional Gains

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The “ten-year” exclusion would provide the most tax benefit for an investment in a low-income community in which significant appreciation in value can be anticipated. For example, investment in a newly constructed commercial office or retail project in an up-and-coming low-income community may offer the potential for significant appreciation in value over a 10-year holding period. Making that investment via a Qualified Opportunity Fund offers the investor the potential to exit the Qualified Opportunity Zone program after 10 years without any income tax on the fund’s resulting gain.

# Example

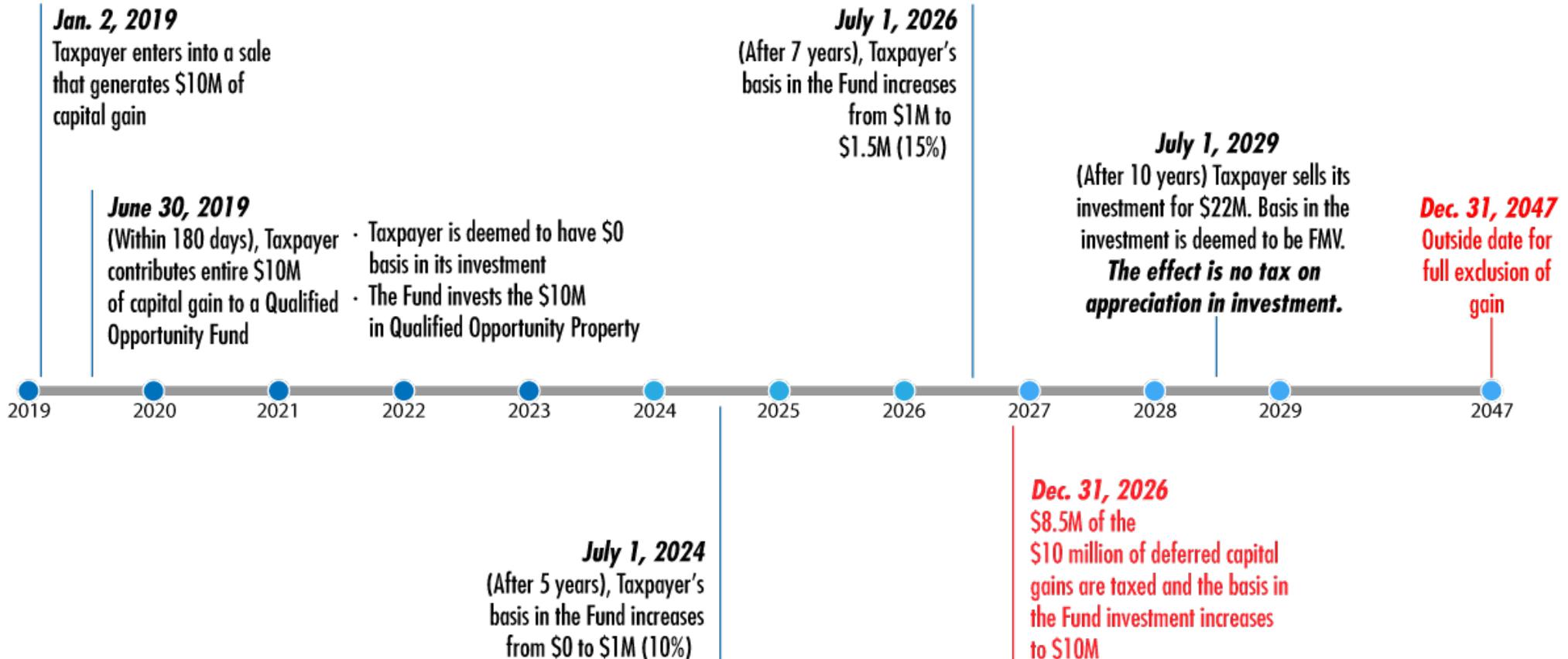
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- Investor sells stock for \$20M (\$10M of long-term capital gain on January 2, 2019).
- Investor invests \$10M in an interest in a QOZ Fund on June 30, 2019.
  - ▢ Does not need to invest the entire \$20M (sale proceeds).
  - ▢ Does not need to invest the entire gain \$10M (gain).
- December 31, 2026:
  - ▢ Investor's tax basis in the QOZ plus \$500K Fund was increased by \$1.5M (15% of \$10M).
    - \$1M on July 1, 2024 plus \$500K on July 1, 2026.
  - ▢ Investor has to pay tax on \$8,500,000 long-term capital gain.
- July 1, 2029:
  - ▢ Investment in the QOZ Fund has appreciated from \$10M to \$22M (\$12M in potential gain).

*\*Results/outcomes may vary*

# Example

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Note: to receive the full 15% income tax basis increase, the initial fund investment has to be made on or before December 31, 2019.

# Basis Adjustments

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- A taxpayer's outside basis in a QOF investment is generally zero BUT:
- If the taxpayer keeps their interest in the QOF for 5 years then the taxpayer will receive an increase in their basis equal to 10% of the original gain, thus eliminating 10% of the original gain.
- If the taxpayer keeps their interest in the QOF for a total of 7 years then the taxpayer will receive an additional 5% increase in her basis of the original gain, thus eliminating 15% of the original gain.
- The taxpayer will recognize the gain on either the date the investment in the QOF is disposed of or December 31, 2026, which is earlier.
- Therefore, in order to receive a 15% basis adjustment the investment needs to be made by 2019 and in order to receive a 10% basis adjustment, the investment needs to be made by 2021.
- While the designations of all QOZs will expire on December 31, 2028, taxpayers are now permitted to elect to defer gain on appreciation until December 31, 2047.

# Inclusion Events

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## EVENTS THAT CAUSE INCLUSION OF DEFERRED GAIN.

- In general, the earlier of the date of the disposition of the qualifying investment or December 31, 2026.
  - ▣ **Reduction of taxpayer's equity interest, or**
  - ▣ **Receipt of property including money, securities or other property (other than equity in a QOF) by the taxpayer.**
- Non-exclusive list:
  - 1) Taxable disposition of qualifying investment.
  - 2) Taxable disposition of S corporation stock or partnership interest where ownership has changed more than 25 percent.
  - 3) Transfer by partner of interest in a partnership that itself directly or indirectly holds a qualifying investment.
  - 4) Transfer by gift (except to grantor trusts) of a qualifying investment.

# Inclusion Events

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- 5) Distribution to a partner of a QOF partnership property that has a value in excess of basis of the partners qualifying partnership interest.
  - 6) Section 301(c)(3) stock distribution.
  - 7) Section 1368(b)(2) and (c) distribution of property to the extent it is treated as a gain from a sale or exchange.
  - 8) Section 302 redemption of qualifying QOF stock.
  - 9) Section 304 disposition of qualifying QOF stock.
  - 10) Section 331 liquidation of qualifying QOF corporation.
  - 11) Certain other non recognition transactions, including various stock for stock exchanges and reorganizations.
- Death is not an inclusion event.
    - ▣ **Beneficiary gets tacking of the holding period**
  - Transfer to a disregarded entity is not an inclusion event.
    - ▣ **Including a single member LLC or grantor trust.**

# 3 Major Tax Incentive Benefits

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- Capital gain deferral until December 31, 2026 in an unlimited amount.
- Partial elimination of deferred capital gain.
- Unlimited forgiveness of post investment capital gains through December 31, 2047.
- Other tax benefits in the 2017 Tax Act can be combined with Qualified Opportunity Zone benefits;
  - ▣ 100% bonus depreciation.
  - ▣ Increased 179 deduction.
  - ▣ Accelerated depreciation.
  - ▣ Housing credits.
  - ▣ Carried interests/special allocations.
  - ▣ Etc.

# Qualified Opportunity Zone Property

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	No Sale		Sale + Reinvestment within 1 year		Sale + No Reinvestment within 1 year	
	Original Gain	QOZ Property Gain	Original Gain	QOZ Property Gain	Original Gain	QOZ Property Gain
No Sale at December 31, 2026 if before 5 years	100% deferred gain recognized	No gain recognized, full exclusion.				
At December 31, 2026 at 5 years or after but before 7 years	90% of deferred gain recognized	No gain recognized, full exclusion.				
Sale at December 31, 2026 at or after 7 years	85% of deferred gain recognized	No gain recognized, full exclusion.				
Sale before 5 years before December 31, 2026			Original gain still deferred, no tax	Fully taxable basis increase for gain recognized	100% of the lesser of the actual gain or deferred gain recognized – no longer in QOZ program	Fully taxable no longer in the QOZ program
Sale at 5 years before December 31, 2026			Original gain still deferred, no tax	Fully taxable basis increase for gain recognized	90% of the lesser of the actual gain or deferred gain recognized – no longer in QOZ program	Fully taxable no longer in the QOZ program
Sale at or after 7 years before December 31, 2026			Original gain still deferred, no tax	Fully taxable basis increase for gain recognized	85% of the lesser of the actual gain or deferred gain recognized – no longer in QOZ program	Fully taxable no longer in the QOZ program
Sale after 10 years on or before December 31, 2047			Gain previously recognized	No gain recognized	Gain previously recognized	No gain recognized
Sale after 10 years after December 31, 2047			Gain previously recognized	Excess of realized gain over Dec. 31, 2047 gain is recognized	Gain previously recognized	Excess of realized gain over Dec. 31, 2047 gain is recognized

# What is a Qualified Opportunity “Zone”?

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- Low-income community census tracts.
- 8,761 certified tracts (IRS Notice 2018-48).
- Need Congressional approval for additional tracts.
- There are many commercial and industrial areas throughout the country that were designated as Qualified Opportunity Zones.
- Qualified Opportunity Zones **remain in effect for 10 years** following designation.
  - ▣ Eligible taxpayers are permitted to make basis step-up election even after a Qualified Opportunity Zone designation expires.
- Some tracts are contiguous with low-income community tracts.
- <https://www.cdfifund.gov/Documents/Copy%20of%20Designated%20QOZs.6.14.18.xlsx>

# IRS Notice 2018-48: Designated Qualified Opportunity Zones Under Internal Revenue Code § 1400Z-2

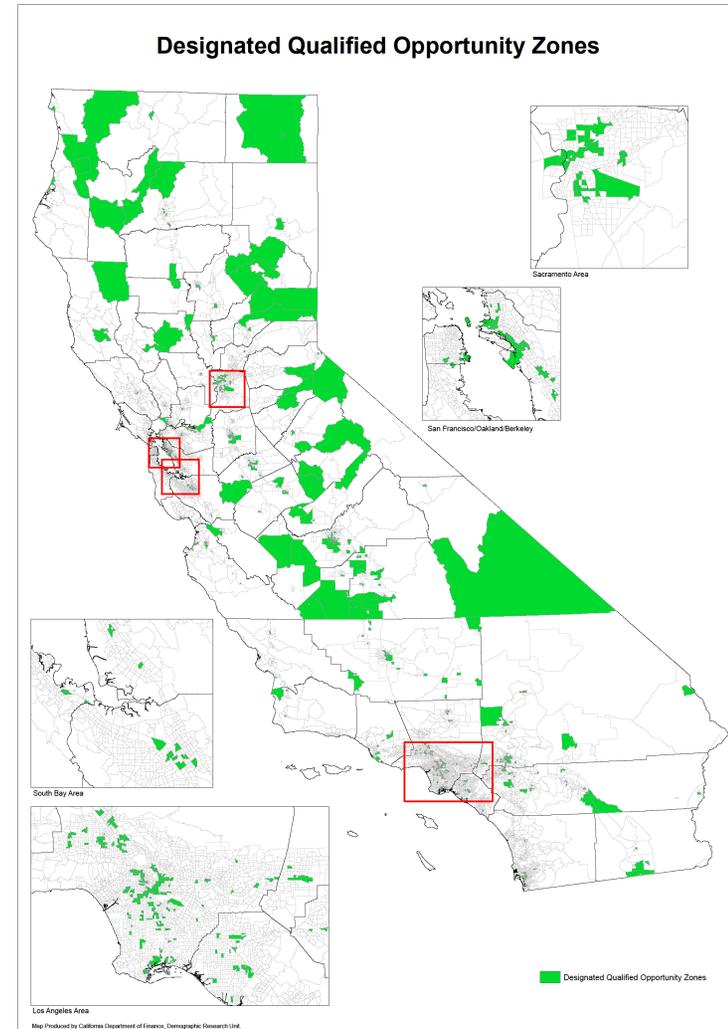
State	# Census Tract	State	# Census Tract
Alabama	158	Montana	25
Alaska	25	Nebraska	44
American Samoa	16	Nevada	61
Arizona	168	New Hampshire	27
Arkansas	85	New Jersey	169
California	879	New Mexico	63
Colorado	126	New York	514
Connecticut	72	North Carolina	252
Delaware	25	North Dakota	25
District of Columbia	25	Northern Mariana Islands	20
Florida	427	Ohio	320
Georgia	260	Oklahoma	117
Guam	25	Oregon	86
Hawaii	25	Pennsylvania	300
Idaho	28	Puerto Rico	861
Illinois	327	Rhode Island	25
Indiana	156	South Carolina	135
Iowa	62	South Dakota	25
Kansas	74	Tennessee	176
Kentucky	144	Texas	628
Louisiana	150	Utah	46
Maine	32	Vermont	25
Maryland	149	Virgin Islands	14
Massachusetts	138	Virginia	212
Michigan	288	Washington	139
Minnesota	128	West Virginia	55
Mississippi	100	Wisconsin	120
Missouri	161	Wyoming	25
		<b>Total</b>	<b>8762</b>

<https://www.irs.gov/pub/irs-drop/n-18-48.pdf>

# Qualified Opportunity Zones - California

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- 879 nominated tracts in CA.
- For more specific information go to:
  - [http://dof.ca.gov/Forecasting/Demographics/opportunity\\_zones/](http://dof.ca.gov/Forecasting/Demographics/opportunity_zones/)
- CA will not conform to deferral law and extend the same tax benefit for investments in Opportunity Zones.
  - [https://www.ftb.ca.gov/forms/2018/18\\_100sdins.pdf](https://www.ftb.ca.gov/forms/2018/18_100sdins.pdf).



# Qualified Opportunity Zones – State Conformity

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<b>Conforming - Rolling:</b>	<b>Conforming - Fixed Date:</b>	<b>Conforming</b>	<b>Partially Conforming:</b>	<b>No Capital Gains Tax:</b>	<b>Nonconforming:</b>
<i>The state automatically conforms to the current IRC as it is amended.</i>	<i>The state conforms to the IRC as of a specific date that is after the enactment of the Opportunity Zones legislation.</i>		<i>The state specifically conforms with Section 1400Z-2 of the IRC.</i>	<i>No state income tax or generally does not tax capital gains.</i>	<i>The state conforms to the IRC as of specific date prior to the enactment of the Opportunity Zones legislation or the state has specifically decoupled from the Opportunity Zones provision of the IRC.</i>
Alabama	Georgia	New Jersey	Arkansas	Alaska	Arizona
Colorado	Idaho			Florida	California
Connecticut	Indiana			Nevada	Hawaii
Delaware	Iowa			New Hampshire	Massachusetts
District of Columbia	Kentucky			South Dakota	Minnesota
Illinois	Maine			Tennessee	Mississippi
Kansas	Michigan			Texas	North Carolina
Louisiana	Ohio			Washington	Pennsylvania
Maryland	Oregon			Wyoming	
Missouri	South Carolina				
Montana	Vermont				
Nebraska	Virginia				
New Mexico	West Virginia				
New York	Wisconsin				
North Dakota					
Oklahoma					
Rhode Island					
Utah					



# Qualified Opportunity Funds

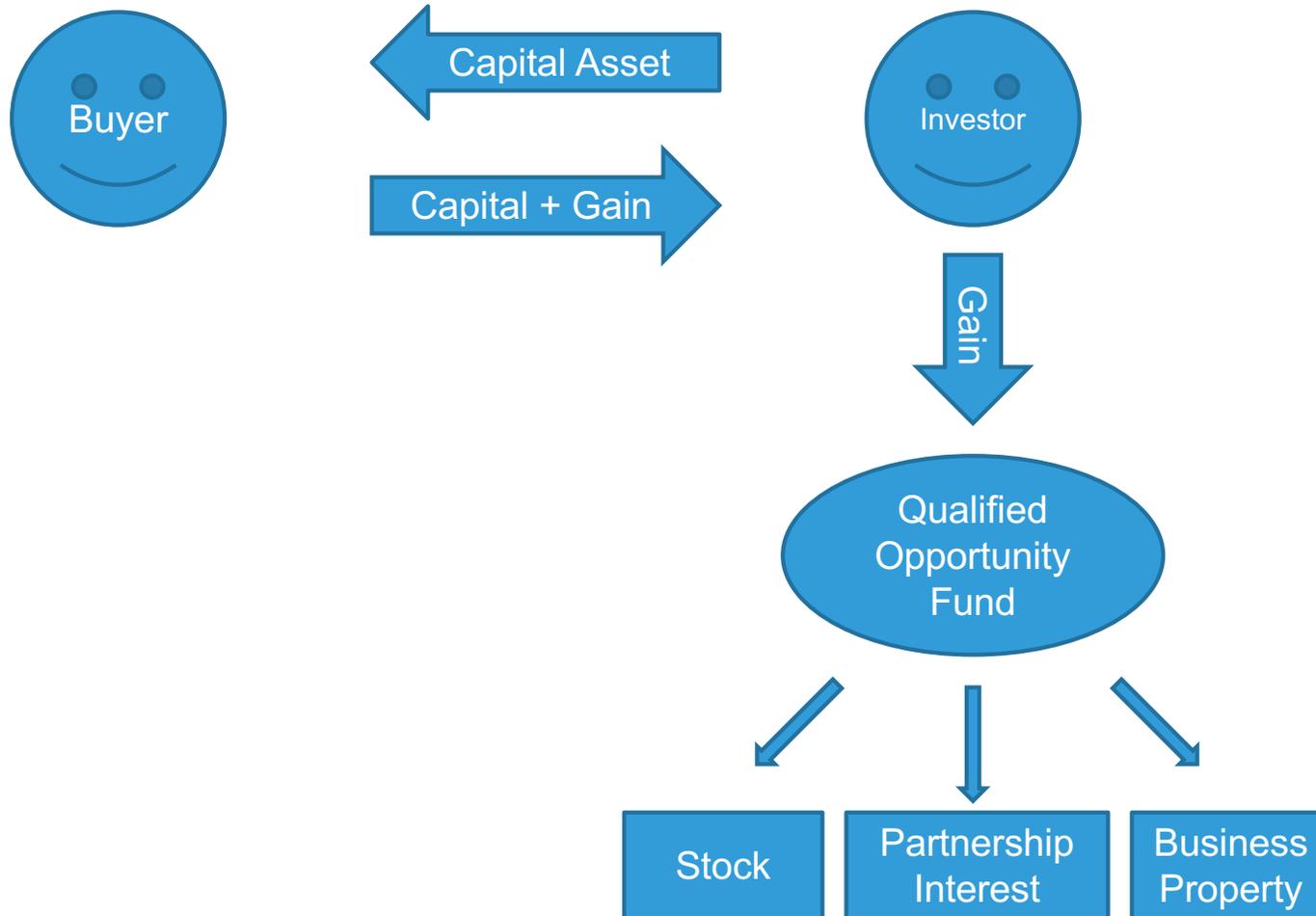
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- There are 2 key components of a Qualified Opportunity Fund:
  - ▣ Must be organized as a domestic tax **partnership** or domestic corporation.
  - ▣ Hold at least **90% of its gross assets in Qualified Opportunity Zone Property**.
    - through special purpose entities, or
    - Direct ownership of Qualified Opportunity **Business Property**.

# Qualified Opportunity Zone Property

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- The Qualified Opportunity Fund must hold **90%** of its gross assets in Qualified Opportunity Zone Property.
  - ▣ May be able to exclude capital received within six-months of each semi-annual testing period.
- Qualified Opportunity Zone **Property** refers to asset types that are eligible for investment under the Qualified Opportunity Zone Program.
- Qualified Opportunity Zone Property is:
  - ▣ Qualified Opportunity Zone stock (special purpose entity owned by the QOF), **or**
  - ▣ Qualified Opportunity Zone partnership interest (special purpose entity owned by the QOF), **or**
  - ▣ Qualified Opportunity Zone business property – direct ownership by the QOF.



# Failure to Meet Maximum Investment Standard

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- If an Opportunity Fund fails to meet the requirement that 90% of its assets be invested in Qualified Opportunity Zone Property, the Opportunity Fund must pay a monthly penalty for each month in which it fails to meet this requirement.
- The penalty is calculated by multiplying the Federal short-term interest rate for the applicable month plus 3%, by an amount equal to the excess of 90% of the Opportunity Zone Property held. IRC Section 6621(a)(2).
- However, no penalty is to be imposed with respect to any failure where it is shown that the failure is due to reasonable cause. Congress failed to provide a definition of “reasonable cause” and the Treasury will presumably address this issue in forthcoming guidance.
- If however, tangible property ceases to be deemed a Qualified Opportunity Business Property, it shall continue to be treated as a Qualified Opportunity Zone Business Property for the lesser of (1) five years after the date on which such tangible property ceases to be so qualified, or (2) the date on which such tangible property is no longer held by the Qualified Opportunity Business.

# Possible Structures

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- **Investment Through Special Purpose Entity.** The Qualified Opportunity Fund acquires stock or partnership interest in a Qualified Opportunity **Business** special purpose investment entity and the special purpose investment entity uses the invested cash to acquire and/or improve the project.
- **Direct Investment.** The Qualified Opportunity Fund invests directly in Qualified Opportunity Zone **Business Property**, which means original use property **or** the fund substantially improves such property within any 30 month period beginning after the date of acquisition.

# Zone “Business Property”– Direct Ownership of Operating Assets by Special Purpose Entity or the Fund Itself

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- **Tangible property used (owned or leased) in a trade or business of the Qualified Opportunity Fund.**
- **If owned, it must be acquired by purchase from an unrelated party (20% related party test, plus most family members) after December 31, 2017.**
- **IF OWNED the Original use of the Qualified Opportunity Zone Property commences with the fund, OR Fund must “substantially” improve the property.**
  - ▣ **During any 30-month period after acquisition of such property, additions to basis **exceed an amount equal to 100% of the adjusted basis** of such property at the beginning of such period.**
  - ▣ **Substantially improved means an expenditure of over 100% of the income tax basis of any pre-existing tangible property in a Qualified Opportunity Zone Fund.**

**Question:** Can the 30<sup>th</sup> month substantial improvement be extended if the inability to comply is attributable to government inaction? Can you stagger the 30 months for various phases?

# “Owned Property”; Original Use or Substantial Improvement

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- Original Use:
  1. Land – used in a trade or business.
    - ▣ Due to the permanence of land, land can never have its original use in a QOZ commence with a QOF.
  2. Building:
    - ▣ The original use of an existing building is not considered to have a commenced with the QOF.
  3. The “Original Use” of a tangible property acquired by purchase commences on the date when that person or prior person first places the property in service in a QOZ for purposes of depreciation or amortization.
    - ▣ Therefore, if not previously depreciated or amortized, it will satisfy the original use requirement.
    - ▣ If previously placed in service, it would have to be substantially improved to qualify.
  4. To the extent that vacant structures or other tangible property (other than land) purchased after 2017 but previously placed in services may be disregarded for purposes of the Original Use requirement -- if the structure or other property has not been utilized or has been abandoned for at least 5 years prior to being purchased by the QOF or Qualified Opportunity Zone Business.
  5. Land can be counted as Qualified Opportunity Zone Property only if it is used in a trade or business of a QOF or Qualified Opportunity Zone Business.
    - ▣ Holding of land for investment does not qualify.

# “Owned Property”; Original Use or Substantial Improvement *cont’d*

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## Substantial Improvement:

- Substantial improved or purchased tangible property is made on an asset-by-asset basis.
  - Treasury is seeking comments about asset by asset vs aggregate test as well as how to treat property not capable of being substantially improved.
  - “Excluding the basis of land from the amount that needs to be doubled for a building to be a substantially improved facilitates repurposing vacant buildings in QOZs.”
  - Within any 30-month period beginning after the date of acquisition, additions to basis with respect to the non-land property need to exceed an amount equal to the adjusted basis of such property at the beginning of the 30-month period.
1. Land:
    - The cost of the land within the QOZ upon which the building is located is not included in the taxpayer’s adjusted basis in the building.
    - The QOF is not required to separately substantially improve the land upon which the building is located.
  2. Building:
    - Substantial improvement is measured by the QOFs additions to the adjusted basis of the building.
    - Tenant improvements, to the extent of the costs basis of the improvements on leased property, are counted as substantial improvements.

# Leased Tangible Property; Original Use or Substantial Improvement

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- Same basic criteria for owned or leases property to qualify as Qualified Opportunity Business Property except:
  - Lease has to be entered into after December 31, 2017.
  - Substantially all of the “use” of the leased property (70%) has to be in the Qualified Opportunity Zone during substantially all of the lease term (90%).
  - NO ORIGINAL USE OR SUBSTANTIAL IMPROVEMENTS REQUIREMENT FOR LEASED PROPERTY. DOES NOT HAVE TO BE LEASED FROM AN UNRELATED PARTY.
  - In all cases the Leased Tangible Property must be a “market rate lease” DOES NOT HAVE TO BE LEASED FROM UNRELATED PARTY – BUT
- If leased from related party:
  - Can not make more than a one-year prepayment .
  - Then the related lessee becomes the owner of other tangible qualified business property with a value equal to or greater than the leased tangible property.
  - Acquisition of the tangible property must occur during a period that begins on the date that the lessee takes possession of the leased property and ends on the earlier of:
    - Last day of the lease, (or)
    - The end of the 30<sup>th</sup> month period beginning on the date that the lessee takes possession of the tangible leased property.
- In the case of leased “real property” (other than vacant land) where there is a plan to purchase the leased real property, in order to qualify as Qualified Opportunity Zone Business Property, it cannot be purchased at other than fair market value.
- Improvements to leased property made by the lessee satisfy original use requirement and are considered purchased property for the amount of unadjusted cost basis.

# Related Parties – § 267(b) & § 707(b)(1)

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- Members of a family (“family is defined as brothers, sisters, spouse, ancestors and lineal descendants).
- An individual and a corporation more than 20% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
- Two corporations which are members of the same controlled group;
- A grantor and a fiduciary of any trust;
- A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a beneficiary of such trust;
- A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a corporation more than 20% in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- A person and an organization to which section 501 applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
- A corporation and a partnership if the same persons own—more than 20% in value of the outstanding stock of the corporation, and more than 20% of the capital interest, or the profits interest, in the partnership;
- An S corporation and another S corporation if the same persons own more than 20% in value of the outstanding stock of each corporation;
- An S corporation and a C corporation, if the same persons own more than 20% in value of the outstanding stock of each corporation; or
- An executor of an estate and a beneficiary of such estate.

# Qualified Opportunity Zone “Business Property” – Direct Ownership of Operating Assets by Special Purpose Entity or the Fund Itself

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- Trademarks and other intangibles must be used in connection with the trade or business of the Qualified Opportunity Fund (40%).
- Reasonable amounts of working capital.
- During “**substantially all**” of holding period (90%), “**substantially all**” the use (70%) is in a Qualified Opportunity Zone.
- Property already held by the QOF prior to 12/31/17 or contributed to the QOF does not qualify as qualified opportunity zone business property.

# Qualified Opportunity Zone “Business” – Special Purpose Entity Requirements

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- The Special Purpose Entity must be **acquired after December 31, 2017** in exchange for **cash**.
- The special purpose entity must be a Qualified Opportunity Zone **Business**, or is being organized for the purpose of being a Qualified Opportunity Zone Business.
- Must remain a Qualified Opportunity Zone Business for “**substantially all**” of the Qualified Opportunity Fund’s holding period.
- 50% of total gross income must be derived from the active conduct of the Opportunity Zone Business.
- Three safe harbors (only have to meet one):
  - ▣ Hours = employees + independent contractors ex: 50% hours performed within the zone  
or
  - ▣ Cost = employee + independent contractors ex: 50% cost of services within the zone  
or
  - ▣ Tangible property and management ex: tangible property and management property must be within the zone and are each necessary to generate 50% of the gross income of the trades or business.
- Facts and circumstances that at least 50% of the gross income of a trade or business is derived from the active conduct of a trade or business in the QOZ.
- Substantial portion of “intangible property” must be used in the active conduct of a trade or business within the QOZ (40%).
- “**Substantially all**” of the tangible property **owned or leased** by the taxpayer is **Qualified Opportunity Zone Business Property**.
  - ▣ “**Substantially all**” for this purpose is defined as 70%.

# Qualified Opportunity Zone Excluded Businesses

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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.



# Qualified Opportunity Zone Property – “Stock”

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- Qualified Opportunity Zone **stock** is:
  - ▣ **Original issue.**
  - ▣ Domestic corporation.
  - ▣ S Corporation or C Corporation.
  - ▣ Acquired after December 31, 2017.
  - ▣ At time of issuance and for “**substantially all**” the fund’s holding period, must be a Qualified Opportunity Zone **Business.**

# Qualified Opportunity Zone Property – “Partnership”

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- Qualified Opportunity Zone **partnership interest** is:
  - Any capital or profits interest.
    - **Does it have to be original issue?**
  - Domestic partnership.
  - Acquired after December 31, 2017.
  - At time of issuance and for “**substantially all**” the fund’s holding period, must be a Qualified Opportunity Zone **Business.**

# Satisfying the 70% Substantially All Requirement for Special Purpose Entities

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The proposed regulations specify that if at least 70% of the tangible property owned (or leased) by a trade or business, is qualified opportunity zone property, then the trade or business is treated as satisfying the substantially all requirement.

- ❑ The 70% requirement for a trade or business gives a Fund an incentive to invest in a special purpose entity rather than owning the qualified opportunity zone property directly. (See example).
- ❑ However, if you fail the 70% substantiality Qualified Opportunity Zone Business Property requirement, it's an all or nothing test. Unlike the 90% Qualified Opportunity Zone Property requirement, wherein there is imposed a monthly penalty for failure to comply.
- ❑ The Qualified Opportunity Zone Business Property remains Qualified Opportunity Zone Business Property for five years even if it is moved out of the Qualified Opportunity Zone as long as the entity still owns it.
  - There is no five-year grace period for failure to meet the 90% Qualified Opportunity Zone Property test.

# Satisfying the 70% Substantially All Requirement for Special Purpose Entities *cont'd*

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For example, consider a QOF with \$10 million in assets that plans to invest 100% of its assets in real property. If it held the real property directly, then at least \$9 million (90%) of the property must be located within an opportunity zone to satisfy the 90% asset test for the QOF.

If instead, it invests in a subsidiary that holds real property, then only \$7 million (70%) of the property must be located within an opportunity zone.

In addition, if the QOF only invested \$9 million into the subsidiary, which then held 70% of its property within an opportunity zone, the investors in the QOF could receive the statutory tax benefits while investing only \$6.3 million (63%) of its assets within a qualified opportunity zone.

# Working Capital Safe Harbor from Non-Qualified Financial Property – Special Purpose Entity Requirement

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- Working capital will be considered to be a “reasonable amount” if:
  - ▣ Amounts are **designated in writing** for the acquisition, construction and/or substantial improvement of tangible property in a qualified opportunity zone.
  - ▣ There is a **“reasonable” written schedule** for the expenditure of the working capital assets consistent with the ordinary start-up of a trade or business (and must be within 31 months of receipt of the working capital by the business).
  - ▣ Working capital asset **consumption is substantially consistent** with the first two requirements.
- A taxpayer will not fail the test if the consumption of the working capital is not complete at the scheduled time.
- Exceeding the 31-months period does not violate the safe harbor if the delay is “attributable” to waiting for government action, the application for which is “completed” during the 31-month period.

# Comparisons to Like-Kind Exchanges

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## ■ Section 1031 Program:

- Only real property can be exchanged under the like-kind exchange program.
- Like-kind exchange rules require all sale proceeds to be rolled over into a like-kind investment to obtain deferral from tax for the gain component of those sale proceeds. Only the gain must roll over in a Qualified Opportunity Zone.
- Income Tax can be delayed indefinitely under the like-kind exchange program; with a permanent deferral at death.
- Under Qualified Opportunity Zone program, rolled over capital gains can be deferred only until December 31, 2026.
- If attempting 1031, but fail to identify replacement property within 45 days **or** the identified property is no longer viable as a replacement property, taxpayer may be able to use the qualified opportunity zone program to defer the original gain.

# Comparisons of Section 1031 to Like-kind Exchange

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	Pre-Tax Reform	Post-Tax Reform
Assets Eligible for Sec. 1031 Exchange:	<b>Broad</b> – Personal Property and Real Property	<b>Limited</b> – Real Property ONLY
<b>Key Information</b>	<b>1031</b>	<b>Opportunity Zone</b>
<b>Investment Options</b>	Once invested in real estate, only real estate is of like-kind	Investment must be 90% within designated zones
<b>Qualifying Corporate Stock</b>	No	Yes
<b>Qualifying Partnership Interest</b>	No	Yes
<b>Real Estate</b>	Yes	Yes
<b>Pooled Investing</b>	Difficult	Easy
<b>Geographic Limitations</b>	Within the United States	Within Opportunity Zones
<b>Capital Gains</b>		
<b>Reduction</b>	None, except through a step-up at death	Yes, 10% after 5 years, max 15% if invested by 12/31/2019
<b>Inclusion During Deferral Period</b>	None, unless incomplete rollover depreciation recapture, boot	Yes, 2026 inclusion (less reduction)
<b>Deferral</b>	Yes	Yes
<b>Inclusion on Final Sale</b>	Yes	No, if hold is > 10 years
<b>Inclusion at Death</b>	No (step-up at death)	Yes, likely IRD item
<b>Rollover Mechanics</b>	All rollovers must be of principal and capital gains	Only gain portion must be rolled over
<b>Intermediary</b>	Almost always necessary	Fund invests directly
<b>Timeline</b>	180 days	180 days
<b>Failure to Timely Reinvest Penalty</b>	Total gain inclusion - rollover fails if not met	Monthly penalty until corrected, reasonable cause abatement
<b>Most suitable for:</b>		
<b>Purchase Time Horizon</b>	Open-ended	Best before 12/3/2019
<b>Access to Principal Capital</b>	Not needed	Needed, or desirable
<b>Hold Time Horizon</b>	Very long-term or if death is expected in short-term	> 10 year horizon - no one needs to die to get the step-up
<b>Willing to be "Locked In" Real Estate Until Death</b>	Yes	No
<b>Diversification Opportunities</b>	Minimal, difficult to accomplish	Yes
<b>Gain Stemming From:</b>	Real Estate	Any capital transaction

# Rules for Heirs Inheriting an Opportunity Zone Interest

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- The beneficiary of the inherited interest receives only the basis that the decedent would have. There would be no step up to fair market value. The beneficiary would receive the additional basis step ups as though the beneficiary acquired the interest on the same date as the decedent.
- Beneficiary gets tacking of holding period.
- Planning Ideas.

# Where do we see greatest opportunity?

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- Candidates: (Buyers) Taxpayers who have just had or will have a major liquidity event from a sale of securities or business.
  - ▣ (Sellers) Present owners needing to package assets for sale.
  - ▣ (1031 Exchangers) If 45 or if 180 days approaches without a suitable up-leg, consider collapsing the exchange and using a QOZ approach instead; there are multiple advantages.
- Target investments:
  - ▣ Adaptive re-use or substantial rehabilitation of real estate in transitional markets.
  - ▣ Acquiring or investing in promising business opportunities located in or moveable to QOZs for the long term.

# Big Takeaways from Qualified Opportunity Zone Regulations 2.0

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## 1. QOFs Can Hold Cash Longer

- So don't fail 90% test; tested 2x per year
  - a) Ignore contribution received within 6 months of testing period.
  - b) If QOF sells an asset, the QOF has 12 months to reinvest the cash before it becomes a non-qualified opportunity business property.

Q: How does reinvestment impact holding period in QOF?

The sale/reinvestment should not affect investor's original deferral of gain –

However, a gain on the sale of the asset is allocated to investors and investors will have to pay tax on that gain.

## 2. Real Estate – Original Use is Made Easier

- a) Development projects considered original use – when placed in service for depreciation purpose.
- b) Previously used in building satisfies original use so long as the building was vacant or unused for at least 5 consecutive years before QOF or QQFB places the property in service.

# Big Takeaways from Qualified Opportunity Zone Regulations 2.0

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3. Land Used in a Trade or Business
  - a) Vacant land can qualify as qualified opportunity business property if used in a trade or business of the QOF or QOF business.
  - b) Land banking doesn't qualify as QOF business property unless
    - 1) Have written plan with expectation or intention to improve the land by more than an insubstantial amount within 30 months of acquisition.
    - 2) Ex: land for parking lots, playground or park around building is OK but empty overgrown is not OK unless there is a 30-month plan to improve.
4. Extension of 31-month Working Capital Safe Harbor General Rule – 5% limit on cash and other financial assets. Original regulations had, however, safe harbor for real estate would be met if written plan to spend within 31 months and actually spending the cash consistently with plan.
  - a) New regulations extend safe harbor to developing a trade or business.
  - b) If delay in spending is attributable to approval proceeds or governmental inaction on a filed application (within 31 months), then delay will not cause failure of safe harbor.
  - c) You can have multiple overlapping 31-month safe harbors. Therefore, try to lump staggered contributions to discreet phases.

# Big Takeaways from Qualified Opportunity Zone Regulations 2.0

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- Example for multiple phases:
  1. Acquisition
  2. Predevelopment
  3. Development Phase I, etc.

## 5. Distribution of Refinanced Proceeds

General Rule – investor must stay invested for 10 years. However, a distribution by a QOF to a "partner" is an inclusion event only if the distribution exceeds the partner's basis in its QOF interest.

### Basis Credit:

- a) Investor has zero basis on investment.
- b) 10% basis after 5 years (before December 31, 2026).
- c) Additional 5% basis (for a total of 15%) after 7 years (before December 31, 2026).
- d) Full basis credit at or after December 31, 2026.
- e) Partner receives basis credit for its share of any underlying debt (non-recourse).

# Big Takeaways from Qualified Opportunity Zone Regulations 2.0

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6. Zero Basis Rule – Suspended Depreciation Questions
  - a) Can investors take depreciation if they lack basis?
  - b) If not, are the losses suspended?
  - c) What about recapture if investor exits after fair market value basis step up election?
7. Exit Structuring: Sale of "Interests: vs. Sale of "Property"
  - a) Permit 10 year asset sale election by QOZ Fund. Unclear if election applies to sale of property by **QOZ business**.
  - b) Note: **Cannot rely on the 10-year asset sale elections until regulations are finalized.**
8. Related Party Leases
  1. Leased property can qualify if the lease was:
    - a) Entered into after 2017,
    - b) Arm's length – standard market terms and,
    - c) Substantially all of the use of the lease property is in an opportunity zone for substantially all of the period for which the property is being leased by QOF or QOZ business.

# Big Takeaways from Qualified Opportunity Zone Regulations 2.0

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2. Neither original use nor substantial improvement requirements apply to lease property.
3. Improvements made to lease/property can satisfy original use requirement.

Ex: QOF or QOF business can be tenant on ground lease of an affiliate and can build new property that should qualify as QOZ business property.

Note: if the affiliate "purchased" the land, it would not be QOZ property if the seller retained a greater than 20% interest in the QOZ fund buyer or QOZ business buyer.

4. Additional related party lease requirements.
  - a) No prepayments greater than 1 year.
  - b) No plan to purchase the property for less than fair market value.
  - c) QOZ Fund or QOZ business has sufficient other owned qualified opportunity business property.

# Big Takeaways from Qualified Opportunity Zone Regulations 2.0

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## 9. Operating Businesses

- a) Substantially all (70%) tangible property owned or leased.
- b) 50% gross income desired from active conduct of a trade or business safe harbor.
  - 1) Hours performed within the QOZ – employees and independent contractors.
  - 2) Cost of compensation performed within the QOZ – employees and independent contractors.
  - 3) Property and management if:
    - i. Tangible property in the zone.
    - ii. Manageable or operational functions performed for the QOZ business in the zone are each necessary to generate 50% of the gross income of the trade or business.
- c) Intangible Property – 40% of the FMV of intangible property must be used in the active conduct of a trade or business in a QOZ.
- d) No sin business for direct investments.

# Big Takeaways from Qualified Opportunity Zone Regulations 2.0

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10. Code Section 1231 gain
  11. Profit Interests/Promote
  12. Misc.
- Other topics covered in the 2.0 Proposed Regulations include:
    - ▣ Definitions for the meaning of substantially all in various QOF and QOZB requirements;
    - ▣ Additional flexibility for investors to acquire an interest in QOF either by contributing property or by purchasing an existing QOF interest;
    - ▣ Clarification that the substantial improvement test applies on an asset by asset basis;
    - ▣ Helpful provisions which permit QOFs to develop property that is partly within and partly outside of an opportunity zone – 50%;
    - ▣ Clarity that owning and operating real property (including leasing) qualifies as a trade or business but not a triple net lease;
    - ▣ Rules relating to the required inclusion of deferred gain in connection with certain transfers and reorganizations, but the transfer of a QOF interest upon death of the investor will not trigger inclusion and the heirs step into the shoes of the original investor; and
    - ▣ Future reporting requirements.

# Pitfalls: Obvious Mistakes

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- Investing in QOZ business but moving the business outside the zone.
- Commingling the QOZ cash or assets with non-qualifying cash or assets equal to more than 10% of value of fund, unless through a tiered structure.
- Making an investment in 100% QOZ qualified assets at outset but letting non-qualified assets creep in over time.
- Acquiring assets from a “related party” (20% rule).
- Delaying the investment in the QOF (December 31, 2026 drop dead date).
- Potential basis/ passive loss limitations.

# How to Report – IRS Forms 8949 and 8996

Form **8949** Sales and Other Dispositions of Capital Assets OMB No. 1545-0074  
 Department of the Treasury Internal Revenue Service  
 ▶ Go to [www.irs.gov/Form8949](http://www.irs.gov/Form8949) for instructions and the latest information.  
 ▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.  
**2018** Attachment Sequence No. 12A

Name(s) shown on return Social security number or taxpayer identification number

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

**Part I Short-Term.** Transactions involving capital assets you held 1 year or less are generally short-term (see instructions). For long-term transactions, see page 2.  
**Note:** You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

**You must check Box A, B, or C below. Check only one box.** If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- (A) Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- (B) Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
- (C) Short-term transactions not reported to you on Form 1099-B

1	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the <b>Note</b> below and see Column (g) in the separate instructions	Adjustment, if any, to gain or loss if you enter an amount in column (g), enter a code in column (f). See the separate instructions.		(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
						(f) Code(s) from instructions	(g) Amount of adjustment	

The proposed regulations state “it is currently anticipated that taxpayers will make deferral elections on Form 8949, which will be attached to their Federal income tax returns for the taxable year in which the gain would have been recognized if it had not been deferred.”

Form **8996** Qualified Opportunity Fund OMB No. 1545-0123  
 (December 2018) Department of the Treasury Internal Revenue Service  
 ▶ Go to [www.irs.gov/Form8996](http://www.irs.gov/Form8996) for the latest information.  
 ▶ Attach to your tax return. See instructions.  
 Attachment Sequence No. 996

Name Employer identification number

**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 taxpayer'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? <input type="checkbox"/> <b>Yes.</b> Enter -0- on this line and file this form with your tax return. <input type="checkbox"/> <b>No.</b> 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)

# IRS Form 8996

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Form 8996 (12-2018)

Page **2**

**Part IV Line 13 Penalty**

If you checked "No" in Part III, line 13 complete Part IV to figure the penalty. Enter the number from line 8 below on Part III, line 13. See instructions if Part I, line 3 is "Yes."

	(a) Month 1	(b) Month 2	(c) Month 3	(d) Month 4	(e) Month 5	(f) Month 6	(g) Month 7	(h) Month 8	(i) Month 9	(j) Month 10	(k) Month 11	(l) Month 12
1 Total assets on the last day of the month . . . . .												
2 Multiply line 1 by .90 . . . . .												
3 Total Qualified Opportunity Zone Property on the last day of the month . . . . .												
4 Subtract line 3 from line 2. If less than zero, enter -0- . . . . .												
5 Underpayment rate . . . . .												
6 Multiply line 4 by line 5 . . . . .												
7 Divide line 6 by 12.0. Round up to two decimal places. See instructions if Part I, line 3 is "Yes"												
<b>8 Penalty.</b> Add columns (a) through (l) of line 7. Enter the total here and on Part III, line 13 . . . . .												\$

Form **8996** (12-2018)

DRAFT AS OF  
October 19, 2018  
DO NOT FILE

# Drafting Errors

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- Note that the reference in I.R.C. §1400Z-2(b)(2)(A) to IRC §1400Z-2(a)(1)(A) should be to §1400Z-2(b)(1).
- IRC §1400Z-2(b)(2)(B)(ii): the term “such property” should be “such investment”.
- IRC §1400Z-2(c): the term “such property” should be “such investment” or vice versa.
- §1400Z-2(d)(2)(D)(ii): the reference to “(A)(ii)” should be “(D)(i)(II)”.
- §1400Z-2(d)(2)(D)(iii): the reference to “(A)(i)” should be “(D)(i)(I)” and the reference to paragraph (8) should be “subsection (e)(2)”.
- IRC §1400Z-2(f)(1) – the reference to subsection (c)(1) should instead be to (d)(1).

# Questions?

# Thank You!

# Brad Cohen

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[BCohen@jmbm.com](mailto:BCohen@jmbm.com)

Direct: 310.201.3575

Brad Cohen's practice emphasizes business planning related to complex corporate and partnership transactions, including mergers and acquisitions, financing and business succession planning, income tax planning, and estate tax planning, all on an integrated basis.

He is best known for his business and tax advice related to the motion picture, television, music, emerging media and sports industries. One of the focuses of his practice is coordinating the relationships among the entertainment, advertising and nonprofit industries.

# Megan Jones

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[megan.jones@withersworldwide.com](mailto:megan.jones@withersworldwide.com)

Direct: 310.228.5742

Megan Jones is an attorney in the private client and tax team at Withers Bergman LLP. She advises individuals, family offices, investors and companies on domestic and international tax planning. Her practice includes succession planning and complex estate planning.

Previously an investment banker at a global firm with an international focus, Megan has done extensive cross border work. She has also advised startup companies and their founders, from the foundational stages to a recognition event. Megan also understands how to plan in the context of intangible assets or innovative technology. Her grasp of complex financial statements adds a level of sophistication to her practice.



# Qualified Opportunity Zones

**Megan Jones**

Withers Bergman LLP

[Megan.jones@withersworldwide.com](mailto:Megan.jones@withersworldwide.com)

310-228-5742

**Brad Cohen**

Jeffer Mangels Butler & Mitchell LLP

[BCohen@jmbm.com](mailto:BCohen@jmbm.com)

310.201.3575

April 23, 2019

**withersworldwide**