Ballard Spahr LLP

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Qualified Opportunity Zones – Final Regulations

January 31, 2020

Form **8996**
(December 2018)
Department of the Treasury
Internal Revenue Service

Qualified Opportunity Fund

▶ Go to *www.irs.gov/Form8996* for the latest information.
▶ Attach to your tax return. See instructions.

OMB No. 1545-0123

Attachment Sequence No. **996**

Name

Employer identification number

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. ▶

Welcome and Introductions

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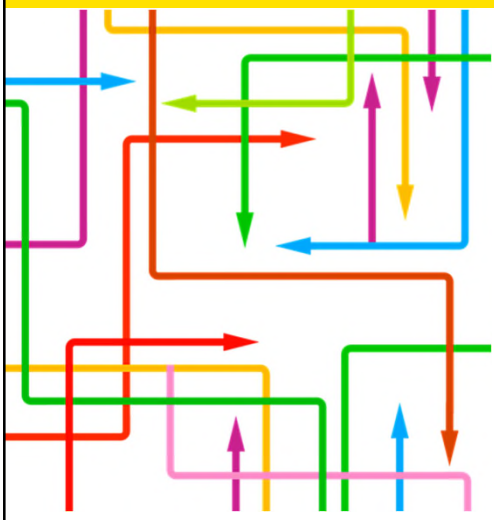
QOZ Program

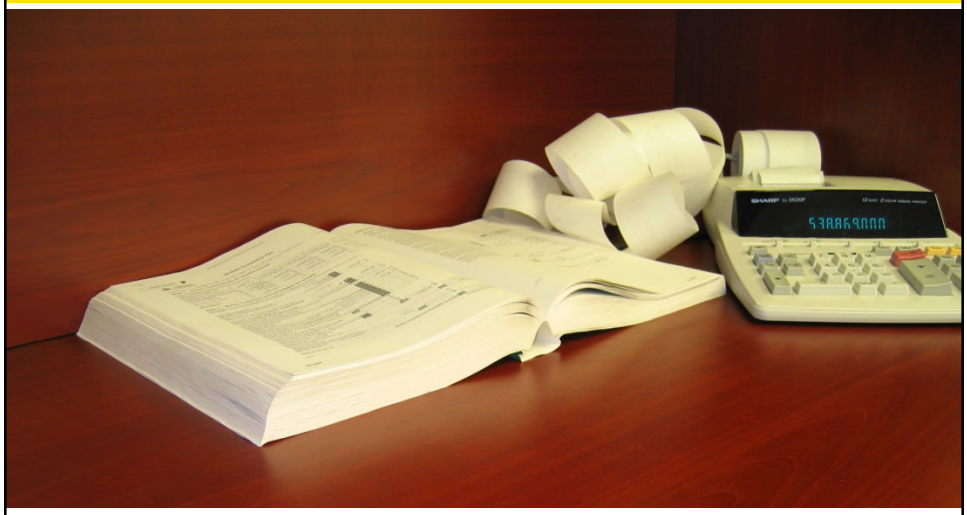


Intended to be accessible
but it is very complicated

Locating Designated QOZs

- More than 8,700 census tracts located in each State, DC and possessions have been designated
- The list is available from IRS organized by state
- States also have interactive websites for confirming address in a QOZ
- *http://www.arcgis.com/home/webmap/viewer.html?webmap=0901a81958474a54a333f9cc180f1852&extent=-86.9909,30.8937,-78.8775,34.8282*

Final Regulations



Qualified Opportunity Zones

Vocabulary

- QOZ – qualified opportunity zone
- QOF – qualified opportunity fund
- QOZBP – qualified opportunity zone business property
- QOZB – qualified opportunity zone business

Eligibility

- Taxpayer recognizes capital gain (long-term or short-term) from a sale to an unrelated person
  - Circular cash flow not allowed under Final Regulations
  - If a taxpayer sells property to an unrelated QOF or QOZB and, as part of a plan, invests the consideration from the sale in the QOF or QOZB, the transaction is treated as a contribution, not a sale. As a result, the "gain" is not eligible to be rolled over; the property is not acquired by purchase, and thus, it is bad property

Eligibility

- Within 180 days
  - Counting the day the gain is recognized with special rules for partners/partnerships
- Acquires a qualifying interest in a QOF from the QOF or the owner of an interest in a QOF
  - A carried interest or capital interest acquired for services is not a qualifying interest in a QOF
  - Carried interest or capital interest acquired for services is treated as an interest in a mixed fund

Eligibility

- A taxpayer includes individuals, corporations, partnerships, other pass-through entities such as S corporations, common trust funds, REITs, RICs, qualified settlement funds, and disputed ownership funds

Tax Benefits of Investing in a QOF

Qualified Investment in a QOF

- Investment in the QOF must be in equity, not debt
  - Can be preferred stock or a partnership interest with special allocations (but not a carried interest or a capital interest received for services)
  - Can invest property in a QOF and the investment is a qualified investment up to the adjusted tax basis, not the fair market value of the contributed property, unless the fair market value is less than the adjusted basis, and the holding period starts at the time of the contribution (there is no tacking)
  - Can acquire a qualifying QOF interest from a holder of such interest, not just from the QOF
  - Can borrow using QOF interest as collateral for the loan

Partnerships, Partners and Roll-Over Gain

- Either a partnership or its partners may roll over gain into a QOF
  - If the partnership rolls over the gain, the gain must be rolled-over within 180 days of the partnership's sale of the asset
  - If the partnership does not elect to defer the gain, one or more of the partners may elect to roll over their share of the gain
  - A partner's 180-day period starts (at the partner's election) on
    - The date the partnership recognizes the gain;
    - The last day of the partnership's tax year; or
    - The due date, without extension, for the partnership's tax year in which it recognized the capital gain (available only under the Final Regulations)

Pass-Through Entities

- Rules similar to the rules for partnerships and partners apply to S corporations and S corporation shareholders
- The Final Regulations provide special rules for REIT shareholders and mutual fund shareholders

1231 Gain

- 1231 property is depreciable property used in a trade or business held for more than 1 year and real property used in a trade or business held for more than 1 year
- Net 1231 gain is treated as a long-term capital gain (subject to certain recapture rules) and net 1231 loss is treated as an ordinary loss
  - Net 1231 gain and loss is determined at the taxpayer level (in the case of a partnership, at the partner level from all sources)

1231 Gain

- Taxpayers do not know until the end of their tax years whether they have net 1231 gain (and the amount of any such gain)
- The Proposed Regulations treat net 1231 gain as recognized on the last day of the tax year (and start the 180-day period on that date); therefore, only the net 1231 gain could be rolled over into a QOF

1231 Gain

- The Final Regulations fix issues caused by the Proposed Regulations by treating 1231 gains like other capital gains
  - No netting of gains/losses is required
  - Taxpayers are not required to wait until the last day of their tax years to start the 180-day period
  - Pass-through entity rules applicable to other capital gains apply to 1231 gains

1231 Gain

- Taxpayers who did not roll over 1231 gain within 180 days of the sale because they were relying on the Proposed Regulations to wait until December 31 must rely on all of the Proposed Regulations rather than on the Final Regulations
- When a taxpayer ultimately recognizes rolled-over 1231 gain on December 31, 2026 or earlier, the taxpayer will be required to recognize any 1231 losses it took in the 5 years prior to the recognition of the roll-over 1231 gain

Tax Benefits of Investing Gains Into QOFs

- Deferral
  - Deferral of roll-over gain until the earlier of December 31, 2026 or an Inclusion Event
- Gain Elimination
  - 10% of deferred gain if QOF interest is held for at least 5 years on or before December 31, 2026
  - 15% of deferred gain if QOF interest is held for at least 7 years on or before December 31, 2026
  - All gain on appreciation in QOF interest if the QOF interest is held for at least 10 years and there is a taxable disposition on or before December 31, 2047

Deferral Observations

- Only QOF interests received in exchange for eligible roll-over gain are eligible for QOZ benefits
- At least 85% of the rolled-over gain will be recognized
- The Final Regulations clarify that if the taxpayer dies, the gain still is recognized as described above. There is no step up at death, either before January 1, 2027 or after December 31, 2026. A decedent's beneficiaries step into the decedent's shoes.

Contrast this with a like-kind exchange of real estate. The gain deferred in a like-kind exchange can be eliminated forever if the exchanging taxpayer holds the replacement property until death.

Deferral Observations

- Gain retains the character that exists when it is deferred, *e.g.*, if the rolled-over gain is short-term capital gain, when recognized, it will be short-term capital gain
- Gain is taxed at rates when recognized, not rates in effect when deferred

Putting The Pieces Together

Electing Deferral

2019
Instructions for Form 8949
Sales and Other Dispositions of Capital Assets

Department of the Treasury
Internal Revenue Service

Future Developments

What's New

General Instructions

Purpose of Form

- Election is made on IRS Form 8949
- Election must be filed with the QOF investor's tax return for the year in which the capital gain would have been recognized absent an election

End of Deferral

All or part of the gain rolled over is recognized on the earlier of:

or Upon an Inclusion Event

End of Deferral – Inclusion Events

- The Proposed Regulations and Final Regulations provide extensive detail on transactions that end deferral - "Inclusion Events"
- Inclusion Events generally are events that reduce or terminate a QOF investor's direct or indirect QOF interest or cash out the QOF investor's investment

End of Deferral – Inclusion Events

- Among the Inclusion Events are:
  - Taxable dispositions of QOF interests
  - The Proposed Regulations treated a more than 25% change in ownership of an S corporation that owns a qualifying interest in a QOF as an Inclusion Event. The Final Regulations eliminate this Inclusion Event
  - Gifts
  - Distribution by a corporate QOF or partnership QOF that results in gain to the owner of the QOF interest

End of Deferral – Inclusion Events

- Distribution by a partnership QOF or a direct or indirect partnership owner of a QOF of cash or property to a partner that exceeds a partner's tax basis for its partnership interest (the purpose of this rule is to preclude direct and indirect partners from reducing the amount of deferred gain they must recognize)
- Partnership disguised sale transactions
  - Generally, certain transfers of property to a partnership followed by an actual or deemed distribution to the contributor partner can be treated as a taxable sale

End of Deferral – Inclusion Events

- The Final Regulations generally provide that a debt-financed distribution by a partnership QOF within 2 years of a roll-over contribution is an Inclusion Event
- So long as the partner retains its interest in the QOF partnership, it remains eligible for the 10-year benefit

End of Deferral – Inclusion Events

- A QOF investor may roll-over gain realized on a disposition of a QOF interest into another QOF; however, the holding period for the second investment in a QOF begins when the second investment is acquired

10-Year Benefit

- If a QOF investor holds its QOF interest for at least 10 years and disposes of that interest on or before December 31, 2047, the QOF investor will not recognize gain equal to the appreciation in its QOF interest
- Several issues were raised by this language and many QOFs were structured to own only a single property to more easily facilitate a sale by the QOF investors of their interests in the QOF

10-Year Benefit

- Will a QOF investor avoid gain recognition if, instead of the investor selling its QOF interest, the QOF sells its assets?
  - The Proposed and Final Regulations allow a QOF investor in a pass-through QOF to exclude capital gain from a QOF's sale of QOZBP or its interest in a QOZB if the gain is reported on a K-1
  - Under the Proposed Regulations the gain exclusion did not extend to gain from other property sold by a QOF or to ordinary income (such as depreciation recapture) recognized by the QOF
  - Under the Proposed Regulations, this gain exclusion applied *only* to gain recognized by a QOF, not by a QOZB

10-Year Benefit

- The Final Regulations extend the 10-year benefit to sales of assets by QOZBs, not just QOFs
- The Final Regulations also eliminate all recapture – ordinary income recognition on a sale by a QOF or QOZB of assets

10-Year Benefit

- Ordinary income will be recognized on a sale of inventory
- However, even under the Final Regulations, there may be a disadvantage for a multi-asset QOF or QOZB that sells a single asset and does not distribute all of the net proceeds

10-Year Benefit

- If a QOF or QOZB sells an asset and does not distribute all of the net proceeds (sale price less debt included in the sales price that is a qualified liability for disguised sale purposes), the net proceeds are deemed to be distributed to the QOF investors and recontributed by the QOF investors as a mixed fund investment
- This distribution-recontribution construct creates uncertainty as to whether all of the gain from a later sale of another asset (purchased as part of the original QOF investments) can be excluded

10-Year Benefit

- If a partner in a QOF partnership that has debt sells its QOF interest, will it recognize gain?
  - When a partner in a partnership sells a partnership interest, the sales price, for tax purposes, is the sum of the cash received by the partner plus the partner's share of the partnership's liabilities
  - The Proposed and Final Regulations solve this problem by stepping-up the QOF investor's tax basis for its partnership QOF interest immediately before the sale to the sum of (x) the fair market value of the partnership QOF interest and (y) the investor's share of the partnership QOF's liabilities

Establishing and Qualifying a QOF

A QOF is self-certified by attaching an IRS Form 8996 to the QOF's tax return beginning with the first tax year that the entity is a QOF and continuing for each year the QOF exists

- To be a QOF, 3 tests must be satisfied on an ongoing basis:
    1. Organization Test
    2. Purpose Test
    3. Asset Test

What is a QOF?

Organization Test:

- To be a QOF, an entity must be organized as a corporation or partnership, including an LLC treated as a partnership for tax purposes
    - A pre-existing entity can self-certify and establish an initial date as a QOF if the entity otherwise qualifies
    - A QOF cannot be a disregarded entity

What is a QOF?

Purpose Test:

- To be a QOF, the corporation or partnership must be an "investment vehicle" formed for the purpose of investing in QOZ Property (QOZBP or an interest in a QOZB)
  - Form 8996 requires a certification that the QOF organizing documents include a statement of purpose to invest in QOZ Property and a description of the QOZ business or businesses
  - Future changes to Form 8996 may require additional information about the QOZ Property

Organizing a QOF

- Not necessarily a "fund" but an investment vehicle
- No limit on the number of investors in the QOF or amount that may be invested in the QOF (other than the 100 owner issue raised by the publicly traded partnership rules)
- Investment must be an equity interest in QOF
  - May establish different/preferential classes of equity

Organizing a QOF

- Both roll-over gain investors and others permitted (*i.e.* mixed fund)
- QOF can own any percentage in partnership subsidiary QOZBs (but not 100%)

What is a QOF?

Asset Test:

- To be a QOF, the corporation's or partnership's assets must be comprised of at least 90% QOZBP and/or interests in a QOZB
- The 90% test is an average on two snapshot dates: (1) the last day of the first 6-month period of the QOF's tax year, and (2) the last day of the QOF's tax year
- Six-month grace period: Contributions to a QOF are ignored provided such amounts are held by the QOF in cash, cash equivalents or debt instruments with a term of 18 months or less
  - A calendar year QOF with an initial start date of July 1 has effectively 364 days before the 90% test must be met

What is a QOF?

- A QOF has 5 days to convert any property it receives as a capital contribution to cash, cash equivalents or debt instruments with a term of 18 months or less
- A QOF cannot contribute property to a QOZB
- A QOF may not invest in another QOF
- Cash, working capital, goodwill, etc. are not "good assets" for purposes of the QOF 90% test

- A QOF cannot have more than 10% of its assets in "bad assets," which includes working capital and intangibles, such as goodwill, but a QOF's subsidiary QOZB can hold reasonable working capital and some intangibles used in its trade or business

What is a QOF?

- Failure to satisfy the 90% test, unless due to reasonable cause, will subject the QOF to a penalty, unless the failure is cured within 6 months of the date the QOF failed to qualify
  - Penalty is equal to the federal income tax underpayment interest rate divided by 12 multiplied by the excess of 90% of the QOF's aggregate assets over the aggregate amount of QOZ Property held by the QOF
  - Only one cure is allowed
- A QOF may voluntarily decertify to avoid penalties
- The calculation of the 90% test is made on Form 8996

What is a QOF?

- Valuation methods
  - Applicable financial statements - use book value (after depreciation and amortization) reported on financial statements filed with the SEC or federal agency other than IRS, or financial statements prepared in accordance with U.S. GAAP
    - For leased property, the value reported on a GAAP financial statement may be used if GAAP assigns a value to the leased property
  - Alternative – use QOF's cost basis of assets on date of acquisition

What is a QOF?

- Under the alternative valuation method property that is not purchased from an unrelated person or constructed for fair market value must be valued at fair market value, as of the testing date
  - QOF's interests in a QOZB seemingly must be valued on each testing date at fair market value
  - Also, self-generated goodwill of a QOF apparently must be valued at fair market value. This also means bad property must be revalued at fair market value at each testing date and consequently, appreciating bad property could present a qualification problem
- For leased property, value is determined at the start of the lease by calculating the present value of the lease payments using the short-term AFR (based on semi-annual compounding) as the discount rate (and using that value for the entire lease term)

What is a QOF?

- QOF may elect each taxable year which method to use and must use a consistent method each taxable year for all assets

QOZB - QOZ Stock/QOZ Partnership Interest

- Stock or a partnership interest in a subsidiary of the QOF acquired at original issuance solely for cash after December 31, 2017
- When the stock or partnership interest is issued, the subsidiary is a QOZB or it is being organized for purposes of being a QOZB

QOZB - QOZ Stock/QOZ Partnership Interest

- During at least 90% of the time the QOF owns the interest in the subsidiary, the subsidiary qualifies as a QOZB (applied cumulatively at the relevant testing date)
- The QOF can avail itself of a safe harbor by testing the QOZB on the last day of the QOZB's tax year ending on or before the QOF's testing date

Partnership QOF

- Ordinary rules applicable to inclusion of partnership liabilities in a partner's tax basis for its partnership interest apply to a partner in a partnership QOF
- This generally means a QOF investor in a partnership QOF that has leverage will be able to receive debt-financed distributions and (subject to other loss limitations) deduct losses allocated to it from the partnership QOF
- Possible Inclusion Event for debt-financed distributions within 2 years

QOF Formation Issues

- QOFs involve traditional entity formation issues inherent in any partnership agreement, operating agreement, investor rights agreement, buy-sell agreement
- Standard topics for negotiation:
  - Board, manager, general partner appointment, removal, scope of authority, compensation
  - Protective provisions, equity holder approvals
  - Rights of first refusal, co-sale, tag along/drag along rights, participation rights

QOF Formation Issues

- Intense focus in QOF formation on:
  - Approvals over events that (1) disqualify the QOF; (2) result in QOF investors not meeting 5/7-year holding periods (Inclusion Events); and (3) result in QOF investors not meeting the 10-year holding period
  - Approvals over changes that may disqualify QOZB subsidiary
  - Trend toward QOZ investor class approvals on these items
  - Consequences for failure to qualify as a QOF, assessment of non-compliance penalties
- Clash between long-term requirements of QOZ program and shorter-term aims of investors

Churning

- A QOF may reinvest (x) a return of capital from the QOF's investment in a QOZB and (y) proceeds from a sale or disposition by the QOF of QOZBP or an interest in a QOZB into other QOZBP or a QOZB provided that:
  - The reinvestment is made within 12 months
  - During the 12-month period, the proceeds are invested in cash, cash equivalents, or debt instruments with a term of 18 months or less

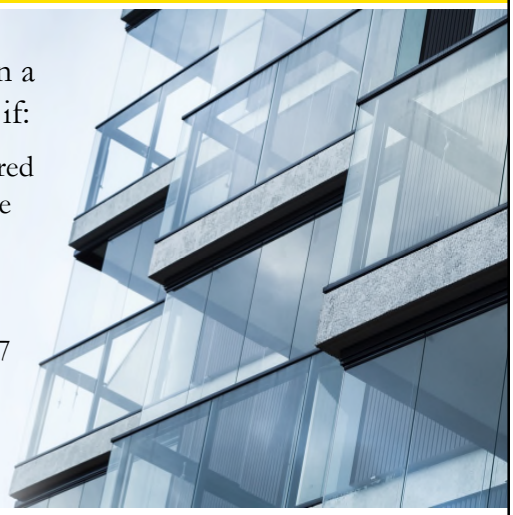
Churning

- If these rules are satisfied, the QOF investor's holding period for its QOF interest is not reset, the QOF investor's deferred gain is not recognized, and the QOF's 90% asset test is not impacted
- But – and this is a BIG but – a QOF investor in a pass-through QOF or a corporate QOF must recognize the gain on such sale
  - QOF investor may reinvest in another QOF if gain is recognized on or before December 31, 2026

Ground Up Development in Places Where There is No or Little Development

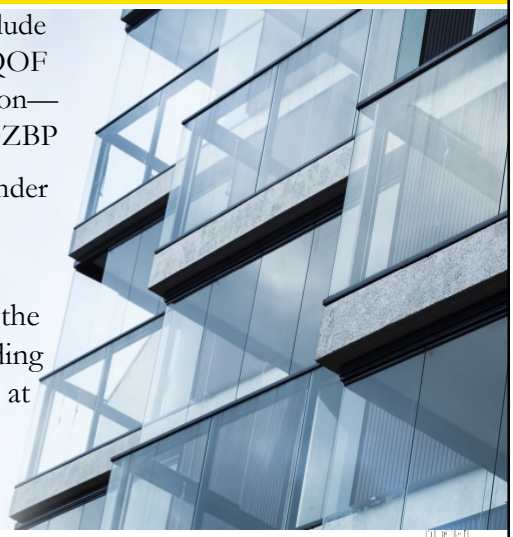
QOZ Business Property (QOZBP)

- Tangible property used in a QOF's trade or business if:
  - The property was acquired by the QOF by purchase from an unrelated party (no more than 20% common ownership) after December 31, 2017



QOZBP

- "Purchase" does not include property acquired by a QOF from a capital contribution—such property is not QOZBP
- The property is leased under a lease entered into after December 31, 2017
- During at least 90% of the QOF's or QOZB's holding period for the property, at least 70% of the use of such property was in a QOZ



QOZBP – Original Use

- The original use of such property in the QOZ commences with the QOF or the QOF substantially improves the property
  - According to the Proposed and Final Regulations, original use means placed in service by any person
    - Subject to certain vacancy rules, if property has been placed in service by any person, it has been originally used and, if that original use was in a QOZ, the property must be substantially improved
    - Improvements made to leased property are treated as originally used

QOZBP – Original Use

- Relief from the original use requirement is provided by the Final Regulations for property, including a building or other structure that is acquired by purchase from an unrelated person after December 31, 2017:
  - That was vacant for the 1-year period prior to the date of the Notice designating the census tract in which the parcel is located as a QOZ and was vacant when acquired by the QOF or QOZB; or
  - That has been vacant or unused for at least 3 years before acquisition by the QOF or QOZB and is still vacant at the time of acquisition

QOZBP – Original Use

- Original use property is not required to be substantially improved
- Vacancy for real property (land and buildings) means 80% of the square footage of the land or building is not currently being used

QOZBP – Substantially Improved

- Substantial improvement means that during *any* 30-month period after the QOF acquires the property, the QOF makes capital improvements in an amount that is more than the QOF's tax basis for the property at the beginning of the 30-month period
- If the QOF acquires land and improvements by purchase from an unrelated person after December 31, 2017, only an amount equal to the cost allocable to the improvements must be spent to constitute a substantial improvement, and the cost of the land is included in the QOF's 90% test and the QOZB's 70% test

QOZBP – Substantially Improved

- Land purchased from an unrelated person after December 31, 2017, or leased under a lease entered into after December 31, 2017, is not required to be substantially improved
- Bad property cannot be substantially improved
  - This means if a QOF or QOZB buys a building it intends to rehabilitate from a related person or acquires such building by contribution, not only will the bad property remain bad but the improvements will not be good property

QOZBP – Substantially Improved

- Solution: Lease and then purchase
- It seems as if a new building can be built on bad land and the building could qualify as good property

- The Preamble to the April 2019 Proposed Regulations provides that whether tangible property is QOZBP and must be substantially improved is determined on an asset-by-asset basis
  - The asset-by-asset test causes challenges for existing businesses in a QOZ

QOZBP – Substantially Improved

- The Final Regulations provide some relief
  - "Eligible Building Group" may be treated as a single property
    - All buildings within the borders of a single parcel described in a single deed, or
    - Buildings within contiguous parcels described in separable deeds to the extent each building is operated as one or more trades or business that (1) are operated exclusively by the QOF or QOZB, (2) share facilities or centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, HR, or IT resources, and (3) are operated in coordination with, or reliance on, one or more of the trades or business, such as supply chain interdependences or mixed use facilities

QOZBP – Substantially Improved

- A QOF or QOZB can include the cost of purchased property that otherwise would be QOZBP to determine if non-original use property is substantially improved if the purchased property is
  - (1) in the same or contiguous QOZ as the non-original use property,
  - (2) used in the same trade or business as the non-original use property, and
  - (3) improves the functionality of the non-original use property
    - How does one improve the functionality of chairs, desks, etc.?

QOZBP – Substantially Improved

- If a QOF or QOZB elects to use purchased property to satisfy the substantial improvement test, the purchased property will not count as original use property
  - Example: QOZB purchases assets, including land, building, and FFE to be rehabilitated into a hotel. To determine if it has done a substantial improvement, the QOZB can include in the costs of purchasing new linens, mattresses and furniture, new exercise equipment, etc. But, these assets are not original use property for purposes of the QOF's 90% asset test or the QOZB's 70% asset test

QOZBP – Substantially Improved

- Contiguous QOZBs are not defined for this purpose but are defined for purposes of straddle property
  - Two or more tracts or parcels of land that share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream, or similar property.
  - But, tracts or parcels touching only at a common corner are not contiguous

QOZBP and Leased Property

- Leased property is QOZBP if:
  - The property is leased under a lease entered into after December 31, 2017
  - When the lease is entered into, its terms are arms-length
  - During at least 90% of the QOF's or QOZB's holding period for the leased property, 70% of the leased property's use is in a QOZ

QOZBP and Leased Property

- Property may be leased from a related party (more than 20% common ownership) if the QOF or QOZB meets special rules
  - Lessee cannot prepay rent for a period exceeding 12 months
  - If the leased property is tangible *personal* property and the original use of such property in the QOZ did not commence with the lessee, the lessee must become the *owner* of tangible property with a value at least equal to the value of the tangible *personal* property leased from the related person within the earlier of (a) 30 months after the lessee receives possession of the property or (b) the end of the lease term

QOZBP and Leased Property

  - There must be a substantial overlap in the QOZs where the leased property and the property acquired to satisfy the second test is used
- There is a presumption that leases between unrelated parties are at arms-length terms and leases with governments are deemed to be at arms-length
- Under the Final Regulations, if there is a plan, intention or expectation that leased property (including unimproved land) will be acquired by the QOF or QOZB for other than the fair market value of such property, the property never will be QOZBP

QOZBP and Leased Property

- Under the Proposed Regulations, unimproved land was excluded from this prohibition
- Similarly, purchased real property is not QOZBP if, at the time of acquisition, there is a plan, intent, or expectation that the real property will be repurchased by the seller other than at fair market value (*i.e.*, there is a fixed-price repurchase option)

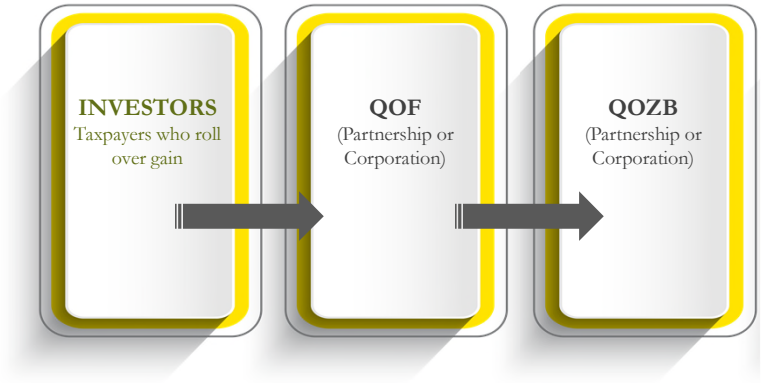
• Property leased after December 31, 2017 is not required to be substantially improved

Structuring QOF Investments

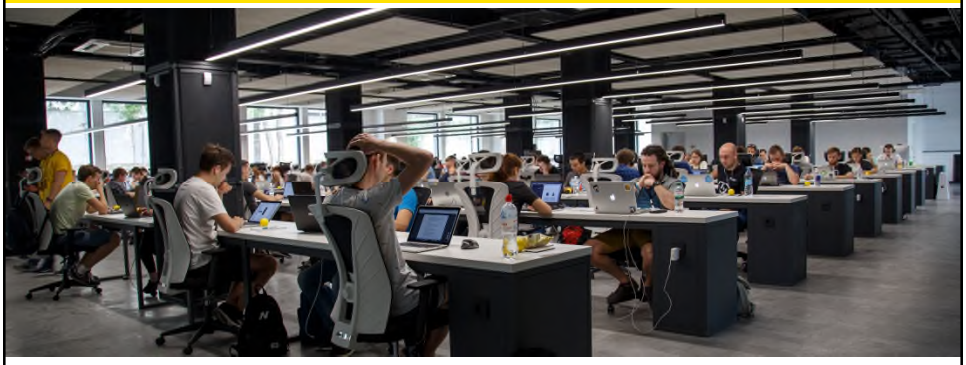
Direct investment by QOF in QOZBP

Structuring QOF Investments

QOF investment in QOZB



QOF Conducts Business Through QOZB



- If a QOF invests in a subsidiary, the subsidiary must be a QOZB for at least 90% of the time the QOF owns an interest in the subsidiary (applied cumulatively at the relevant testing date)

QOF Conducts Business Through QOZB

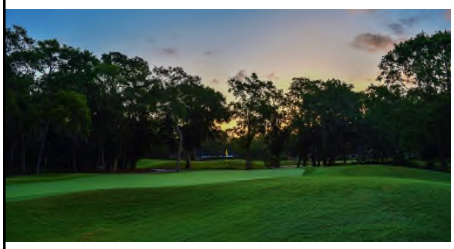
- For a subsidiary to qualify as a QOZB it must be:
  - A trade or business in which at least 70% of its tangible property (owned or leased) qualifies as QOZBP
  - For property held by a QOZB, but not a QOF, property that ceases to be QOZBP will continue to be treated as QOZBP for the lesser of: (a) 5 years after the property ceased to qualify, or (b) the date the property no longer is held by a QOZB
  - At least 50% of the total gross income of the QOZB is derived from the active conduct of the QOZB's business in the zone
  - At least 40% of the QOZB's intangible property is used in the active conduct of the QOZB's business in the zone

QOF Conducts Business Through QOZB

- Less than 5% of the aggregate unadjusted basis of the QOZB's property is Nonqualified Financial Property
  - Nonqualified Financial Property is debt, stock, partnership interests, options, future contracts, forward contracts, warrants, national principle contracts, annuities, and other similar properties to be set forth in regulations
  - Reasonable amounts of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less are not Nonqualified Financial Property

QOF Conducts Business Through QOZB

- The QOZB is not a "sin business"- a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, race track or other facility used for gambling, and any store the principal purpose of which is the sale of alcoholic beverages for consumption off the premises



QOF Conducts Business Through QOZB

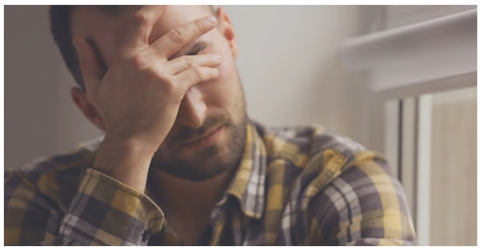
- A QOZB cannot lease 5% or more of its assets to a sin business

Active Conduct

- At least 50% of a QOZB's gross income must be from the active conduct of a trade or business in a QOZ
  - Neither the Proposed nor Final Regulations define what constitutes active conduct of a trade or business
  - Special Rule for Real Estate
    - Ownership and operation, including leasing, of real property used in a trade or business is treated as the active conduct of a trade or business

Active Conduct

- Merely entering into a triple net lease is not the active conduct of a trade or business
  - Focus seems to be on whether the tenant pays all costs, not what services are provided by the landlord



Active Conduct - Sourcing

- The Final Regulations provide 3 safe harbors for sourcing gross receipts to a QOZ
  - Hours Test – at least 50% of a QOZB's services are performed by the QOZB's partners (seemingly, compensated by guaranteed payments), employees, independent contractors, and employees of independent contractors in the QOZ
  - Compensation Test – at least 50% of the amount paid by a QOZB to its partners compensated by guaranteed payments, employees, independent contractors, and employees of independent contractors is for services performed in the QOZ

Active Conduct - Sourcing

- Qualitative Test – the tangible property of the QOZB located in a QOZ <u>and</u> the managerial/operational functions of the QOZB that are performed in a QOZ are each necessary to produce at least 50% of the QOZB's gross income
- Facts and circumstances indicate that at least 50% of the QOZB's gross income is sourced to the QOZ

Active Conduct - Property Straddling a QOZ

- For purposes of determining if at least 50% of a QOZB's gross income is generated in a QOZ, real property is deemed to be located in a QOZ if the QOZB's real property located within the QOZ is substantial as compared to the QOZB's real property located outside of the QOZ.
- The relief provided for contiguous property is only for purposes of the 50% gross income test, the 40% intangible property test, and whether at least 90% of the time a QOF or QOZB holds QOZBP, at least 70% of the use of that QOZBP is in a QOZ
- This relief does not apply for purposes of the QOZB's 70% asset test or the QOF's 90% asset test

Active Conduct - Property Straddling a QOZ

- The Final Regulations provide a QOZB's real property outside of the QOZ will be deemed to be located in a QOZ if
  - (1) The real property located inside and outside the QOZ is used by the QOZB in carrying on its business activities,
  - (2) the property within the QOZ is substantial as compared to the property outside the QOZ and
    - The unadjusted cost of the real property within the QOZ is greater than the unadjusted cost of the real property outside of the QOZ or
    - The square footage of property located within the QOZ is more than the square footage located outside of the QOZ

Active Conduct - Property Straddling a QOZ

- (3) the real property located outside of the QOZ is contiguous to all or part of the property located within the QOZ
- Contiguous is defined for this purpose as two or more tracts or parcels of land that share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream, or similar property. However, tracts or parcels that touch only at a common corner are not contiguous

QOF Directly Conducts Business vs. QOF Conducts Business Through QOZB

QOF Owns QOZBP Directly

QOZBP is:

- Tangible property used in QOF's business
- The tangible property was acquired from an unrelated person by purchase after December 31, 2017 or leased under a lease entered into after December 31, 2017
- Original use of the tangible property in the QOZ commences with the QOF or the tangible property is substantially improved

QOF Owns Subsidiary Partnership or Corporation that Conducts QOZB

- At least 70% of the QOZB's tangible property (owned or leased) is QOZBP (same as what QOF can own or lease directly)
- At least 50% of the gross income of the QOZB is from the active conduct of the QOZB
- At least 40% of the QOZB's intangible property is used in the active conduct of its business

Directly Conducts Business vs. QOF Conducts Business Through QOZB

QOF Owns QOZBP Directly (Continued)

- During substantially all the QOF's holding period for the tangible property, substantially all the use of such property was in a QOZ

QOF Owns Subsidiary Partnership or Corporation that Conducts QOZB (Continued)

QOZB:

- Less than 5% of the aggregate unadjusted basis subsidiary's property is "Non-qualified Financial Property"
- **Reasonable working capital and accounts receivable are permitted**
- QOZB is not a "sin business" nor can it lease 5% or more of its assets to a sin business

Reasonable Working Capital

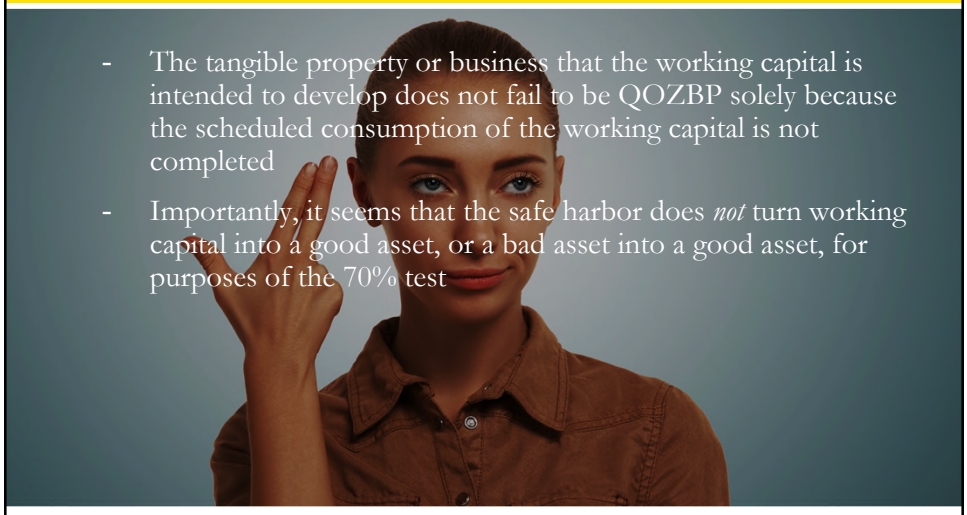
- There is a safe harbor for reasonable working capital that can be held by a QOZB, but not by a QOF
  - Working capital may be held for 31 months if:
    - the amounts are designated in writing for acquisition, construction, and/or substantial improvement of tangible property or the development of a business in a QOZ,
    - there is a written schedule consistent with the ordinary start-up of a trade or business for spending the working capital,

Reasonable Working Capital

- the working capital must be spent within 31 months of receipt, and
- the working capital is actually used in a manner consistent with the above

- If these requirements are satisfied:
  - For purposes of determining if at least 50% of a QOZB's gross income is sourced to a QOZ, gross income derived from reasonable working capital is deemed to be from the active conduct of the QOZB's business in the QOZ
  - For purposes of determining if at least 40% of a QOZB's intangible property is used in the QOZ, reasonable working capital is deemed to satisfy this requirement

Reasonable Working Capital



- The tangible property or business that the working capital is intended to develop does not fail to be QOZBP solely because the scheduled consumption of the working capital is not completed
- Importantly, it seems that the safe harbor does *not* turn working capital into a good asset, or a bad asset into a good asset, for purposes of the 70% test

Reasonable Working Capital

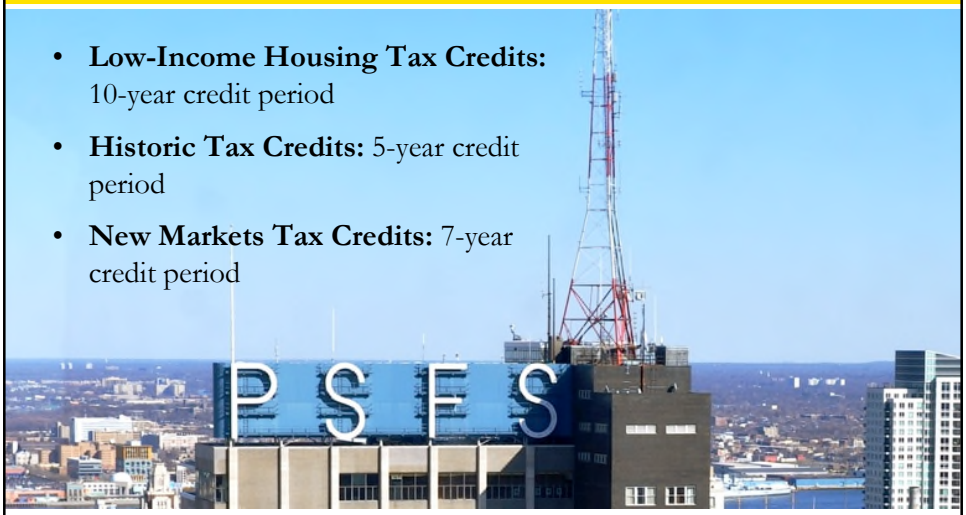
- A QOZB may have multiple, sequential 31-month safe harbor periods
- The 31-month period for the initial working capital infusion can be extended for another 31 months (for a total of 62 months) if the QOZB:
  - Receives multiple overlapping or sequential infusions of substantial amounts of working capital, each of which complies with the working capital safe harbor, and
  - The subsequent infusions of working capital form an integral part of the plan covered by the initial 31-month safe harbor

Reasonable Working Capital

- It appears that multiple properties can benefit separately from the 62-month periods

Combining Tax Credits with QOZs

- **Low-Income Housing Tax Credits:** 10-year credit period
- **Historic Tax Credits:** 5-year credit period
- **New Markets Tax Credits:** 7-year credit period



Capitalizing the QOFs

Funding of QOFs Involves Offering of Securities

- Traditional securities exemption analysis applies
- Securities Act of 1933, state securities ("blue sky") laws, Investment Company Act of 1940, broker-dealer registration
- Three kinds of offerings: (1) registered, (2) exempt and (3) illegal

Consequences of Unregistered, Non-Exempt Offering

- Remedy of rescission
- Private right of action
- Enforcement actions
- Jeopardize future capital raising
- Reputational risk
- Liability to individual D&Os, controlling persons

Securities Strategies

- Illegal is not an option
- Exempt Offerings – only a few workable
  - Section 4(a)(2) – transaction not including a public offering
  - Regulation D – safe harbor limits investor recourse
  - Regulation A+ – requires SEC filing and mandated disclosure

Review of Particular Exemptions

- Rule 506(b)
  - unlimited dollars, max 35 non-accredited
  - no general solicitation or advertising
  - restricted, covered security (limits "blue sky" issues)
  - reasonable belief of accredited status (check the box)
  - If non-accredited investors, must provide Rule 502 information
  - no "bad actors"
  - no specific information requirements if all investors are accredited
- Rule 506(c)
  - unlimited dollars, only accredited
  - general solicitation and advertising permitted
  - restricted, covered security (limits "blue sky" issues)
  - must "verify" accredited status – additional burden/challenge
  - no "bad actors"
  - no specific information requirements

Accredited Investor

- "Accredited Investor"
  - For individuals
    - Income: $200,000/$300,000
    - Net Worth: $1 million (excluding principal residence)
    - Status: director, executive officer, general partner
  - For entity
    - Assets: $5 million in assets / not formed for purpose of the investment
    - Ownership: all equity owners are accredited
    - Status: banks, broker/dealer, insurance company

General Solicitation, General Advertising

- "General Solicitation" or "General Advertising"
  - advertisements, articles, notice or communication published in newspaper, magazine, or broadcast
  - any seminar or meeting whose attendees have been invited by any general solicitation or advertising
  - Social media, open websites are de facto "general solicitation" and "general advertising"
  - To avoid, show "pre-existing, substantive relationship"

Offering Information in QOF Context

Antifraud Provisions

- Untrue statement of material fact
- Any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading
- Consider what information has been provided (or not provided) to prospective investors
- Best practices in disclosure documents become even more critical in QOF context

Areas of Risk for QOFs

- Financial Information
- Projections, Pro Formas
- Returns to Investors
- Use of Proceeds
- Explanation or Assurances Re: Tax Consequences to Investor or QOZ Program
- Related Party Transactions

QOF Offering Issues

- QOF offerings are time sensitive / fact intensive
  - Escrows for minimums can be challenging with 180-day requirement
  - 90% of QOFs assets must be QOZBP or invested in subsidiary QOZB
  - Subsidiary QOZB's tangible assets must be composed substantially all (at least 70%) of QOZBP/ "active conduct" tests

QOF Offering Issues

- Securities, tax lawyers must work hand-in-glove with client to understand:
  - Profile of target investors
  - Current and future compensation to finders/agents
  - Use of proceeds to purchase QOZBP or invest in subsidiary QOZB
  - Governance decisions of subsidiary
- Assumptions that drove formation governance decisions will be tested, possibly necessitating changes mid-offering

We Help You Get Through The Maze

Resources

For updates on this topic and more visit:
https://www.ballardspahr.com/trac

A copy of these slides and a recording of the presentation will be available at: *https://www.ballardspahr.com/opportunityzones*

To contact a member of Ballard Spahr's QOZ team:
https://www.ballardspahr.com/practiceareas/initiatives/qualified_opportunity_zones/people.aspx

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Questions?

Thank you for your time!