Kramer Levin

Qualified Opportunity Zones

GENERAL OVERVIEW

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Overview

- New program to provide incentives to spur economic development in "Opportunity Zones."
- Over 8,700 zones have been identified across the U.S.
- Qualifying investments include real estate and operating businesses in the designated opportunity zones.
- The states have proposed and the Treasury Secretary has certified the qualified opportunity zones ("QOZ") in each state.
- A zoomable map for all QOZs available here: https://esrimedia.maps.arcgis.com/apps/View/index.html?appid=77f3cad12b6c4bffb816332544f04542.

Benefits

- Capital Gain Deferral
  - Gain from the sale or exchange of property invested in a qualified opportunity fund ("QOF") is deferred ("Deferred Gain") until the earlier of:
    - The sale of the investment; or
    - December 31, 2026.
- Capital Gain Exclusion
  - A portion of the Deferred Gain may be permanently excluded from tax as follows:
    - 10% of the Deferred Gain excluded if the investment in the QOF is held for five years prior to December 31, 2026;
    - An additional 5% of the Deferred Gain is excluded if the investment in the QOF is held for seven years prior to December 31, 2026;
    - Thus, to take the full advantage of the gain exclusion, the investment in the QOF must be made by December 31, 2019.
  - When the Deferred Gain is recognized, the character of the gain is preserved (i.e., short-term, collectible, etc.).

Benefits (cont'd)

- Exclusion of the gain on appreciation in QOF held for 10 years
  - Upon a sale, an investment in a QOF that is held for at least ten years will have no taxable gain on the appreciation during those ten (or more) years.
  - The end date for the taxpayer to take advantage of this provision is December 31, 2047.

Mechanics

- Eligible gain is any realized capital gain (e.g., does not have to be from the sale of real estate or other specified class).
  - Eligible gain includes gain from sale of stock or securities.
  - Sale or exchange needs to be made to an unrelated party.
- Only the amount of the gain needs to be reinvested—not the full amount of the proceeds.
- Needs to be an equity interest issued by the QOF, including preferred stock and partnership interests, with special allocations.
- The gain must be invested within 180 days from the date of the sale.
- Investor must make an election to defer the gain (by attaching Form 8949 to investor's return for the year).

Qualified Opportunity Fund

- A qualified opportunity fund is:
  - An entity classified as a corporation or a partnership;
  - Organized for the purpose of investing in qualified opportunity zone property (but not in another qualified opportunity fund); and
  - Holds at least 90% of its assets in qualified opportunity zone property.
    - The 90% threshold is measured by the average percentage on the last day of the first six-month period of the taxable year of the fund and on the last day of the taxable year of the fund. The value of the assets is measured as provided on financial statements, or, if not available, cost.
    - Failure to meet the 90% requirement results in a monthly penalty.
      - There is an exception from the application of the penalty if the QOF can show "reasonable cause" for failing to meet the 90% test.
- The fund must certify itself as a qualified opportunity fund on its first tax return by including a Form 8996 (draft of which has been released).
- The fund may identify the first month in which it wants to be treated as a QOF (default is the first month of the taxable year).
  - Any investments in the fund prior to the effective date of the election will not be eligible as an investment in a QOF.

Qualified Opportunity Zone Property

- A qualified opportunity zone property is
  - Qualified opportunity zone domestic stock;
  - Qualified opportunity zone domestic partnership interest; or
  - Qualified opportunity zone business property.

Qualified Opportunity Zone Stock or Partnership Interest

- Stock in a domestic entity classified as a corporation or profits or capital interests in a domestic entity classified as a partnership;
- Acquired after December 31, 2017 at original issue solely for cash;
- At the time of the issuance, the entity was a "qualified opportunity zone business" or was organized for the purpose of being a qualified opportunity zone business; and
- During substantially all of the qualified opportunity fund's holding period, the entity qualified as a qualified opportunity zone business.
- Certain redemptions of the QOF stock within one or two years before and after the issuance can disqualify the stock.

Qualified Opportunity Zone Business Property

- Tangible property used in a trade or business of a qualified opportunity fund;
- Acquired from an unrelated party after December 31, 2017;
- The original use of the property in qualified opportunity zone commences with the qualified opportunity fund or the qualified opportunity fund substantially improves the property; and
- During substantially all of the qualified opportunity fund's holding period for the property, substantially all of the use of the property was in a qualified opportunity zone.
- Substantial Improvement
    - A property is treated as substantially improved by the qualified opportunity fund only if, during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period in the hands of the qualified opportunity fund.
        - For example, if the purchase price for the property is $50 million, improvements of at least $50 million need to be made to the property to qualify it as substantially improved.

Qualified Opportunity Zone Business

- Substantially all of the tangible property owned or leased by the entity is qualified opportunity zone business property.
- "Substantially all" is defined as 70%.
- May provide additional flexibility compared to ownership of qualified opportunity zone property (e.g., working capital flexibility, 70% rather than 90% test would apply);
- The entity cannot operate or lease land to any 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;
- At least 50% of the total gross income of the entity is derived from active conduct of such business.
- A substantial portion of the intangible property of such entity is used in the active conduct of any such business; and
  - Any intangible property that a business holds (i.e., trademarks, patents) must be used in its trade or business.
- Less than 5% of the entity's property is attributable to nonqualified financial property.
  - The business may not hold a significant amount (i.e., more than 5%) of debt instruments, stock, partnership interests, annuities, and derivative financial instruments.