Brownstein Hyatt Farber Schreck

Qualified Opportunity Funds

May 8, 2019

Background

- Concept developed by Economic Innovation Group in 2015
- Introduced as a separate bill with bipartisan support in 2017 well before Tax Cuts and Jobs Act
- Ultimately enacted as late addition to Tax Cuts and Jobs Act
- Primary goal: encourage private capital investment in economically challenged areas

Opportunity Zones

- Each State and territory have designated opportunity zones
- Up to 25% of low-income/high poverty census tracts and limited number of contiguous tracts
- Approximately 8,000 census tracts
- No further formal role for state in administration of opportunity zones
- For interactive map of Colorado opportunity zones, see https://choosecolorado.com/oz/

Designation of Colorado Zones

- 126 census tracts
- Diverse portfolio attractive to a variety of investment types (businesses, commercial real estate, housing, other infrastructure) and high-profile targeted projects
- Focus on areas where designation could be catalytic
- If area is already growing rapidly, instead of generating new activity OZ may only increase profits and encourage gentrification (e.g., RiNO)
- If area does not have existing activity or key assets, the OZ status will not by itself catalyze any new activity (e.g., very remote rural tract)

Key Projects Covered

Regional Tourism Projects:
National Western Center, US Olympic Museum, Professional Bull Riders University, near Stanley Film Center

Colorado Springs:
Catalyst Campus, National Cybersecurity Center, Colorado Springs Airport

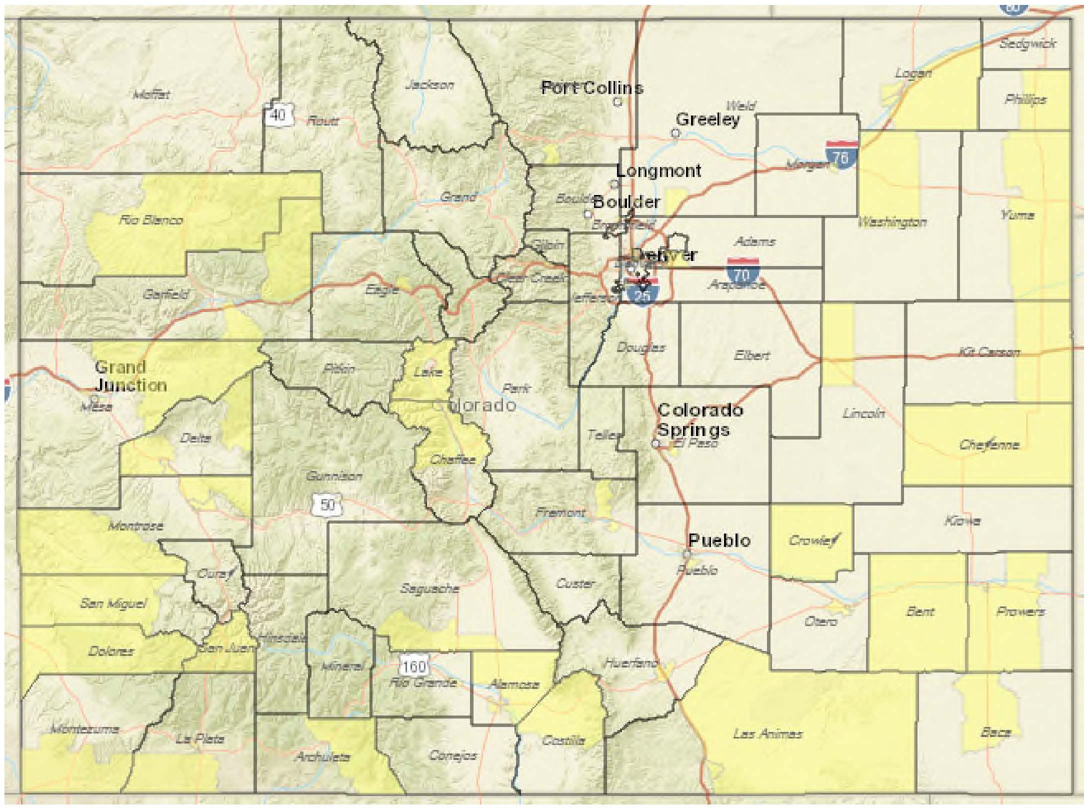
Aurora:
Anschutz & Aerotropolis

Sun Valley Redevelopment in Denver

Outdoor Recreation Projects:
Mayfly Colorado Outdoors Park in Montrose, Bonsai Design Riverfront at Las Colonias Park in Grand Junction, Powderhorn Ski Resort

Pueblo:
Evraz & adjoining Excel site, State Fair, Riverwalk

Colorado's Opportunity Zones



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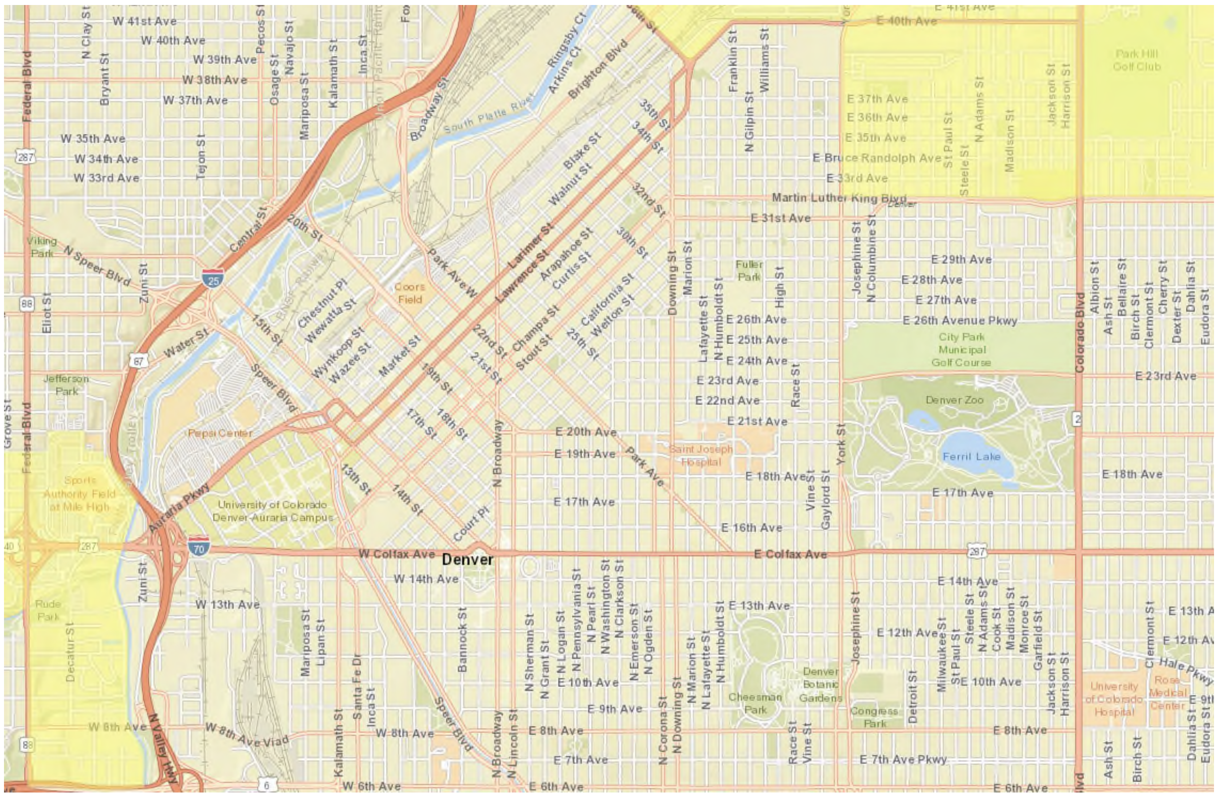
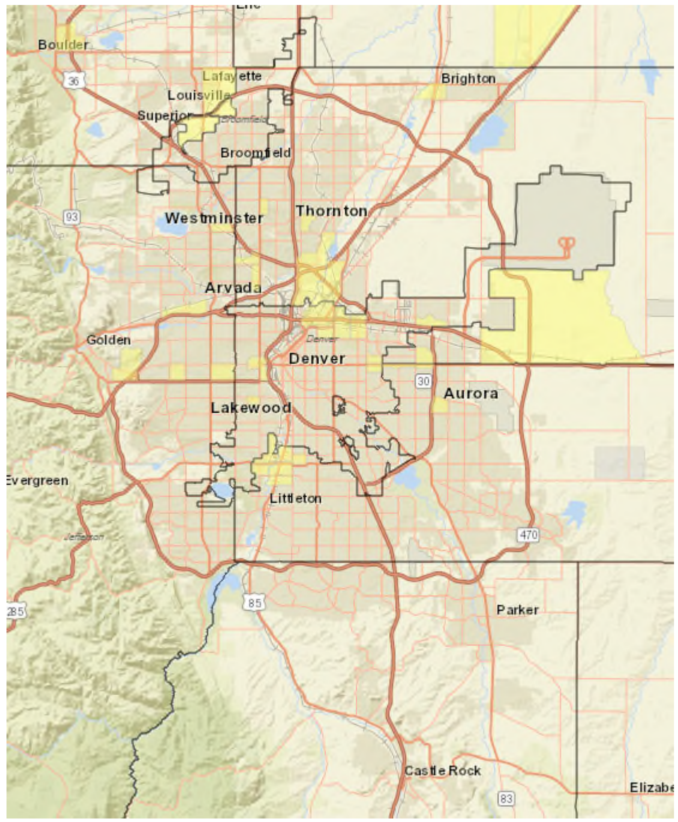


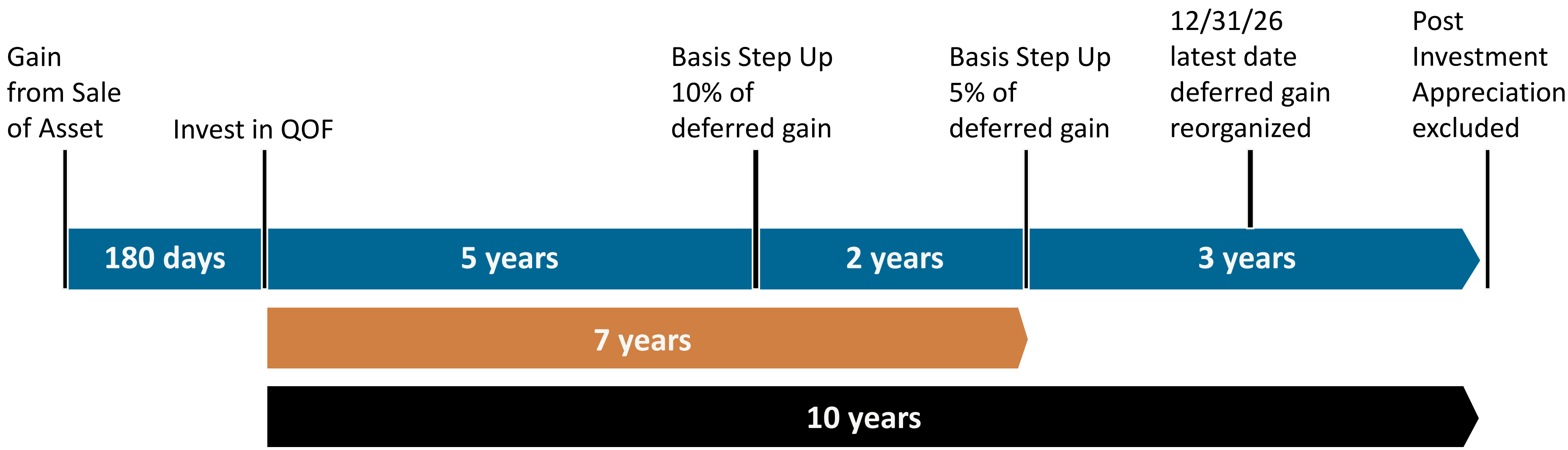
Colorado's Opportunity Zones



Simple Concept

- Fund invests in qualified property, corporations, or partnerships
- Reinvest capital gain in Fund (equity interest in Fund only)
- Receive tax benefits
  - Defer tax on reinvested gain
  - Permanently exclude part of reinvested gain
  - Permanently exclude post-investment gain

Timeline for Investment



If investment made after 2019, not eligible for last 5% gain exclusion on deferred gain

If investment made after 2021, not eligible for gain exclusion on deferred gain

The Investor – Recognize Gain

Step 1 – Recognize Capital Gain

1. Must be Capital Gain, *not ordinary income*

   Includes:

   - 1250 gain
   - gain on sale of collectibles
   - stock sales
   - real estate sales

2. Must be recognized by end of 2026
3. Must be gain from sale to, or exchange with, an unrelated party
   - 20% test

The Investor – Find a QOF

Step 2

- Find or create a qualified opportunity fund
  - can be a corporation (including a REIT) or a partnership (including a multi-member LLC)
  - cannot be a disregarded entity
  - QOF will typically be a tax partnership, either as an LLC or limited partnership

The Investor – Invest in a QOF

Step 3:

- Contribute cash or property in exchange for interest in QOF
  - although property contributions are allowed, practically will be rare
  - QOF cannot contribute property to a lower-tier partnership or corporation
  - Cash codes not have to be traced to original proceeds
- New rule: Investor can purchase an interest from an existing QOF owner
- Carried Interest
  - interest received in exchange for services does not qualify for QOF benefits

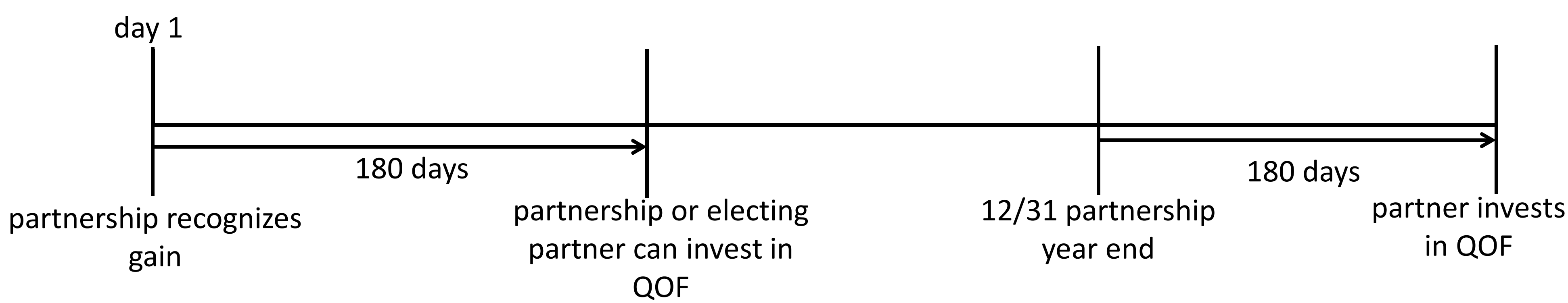
The Investor

- General rule: contribution to QOF must be made within 180 days after recognition of gain

Exception – gain from partnership

- If partnership is not QOF Investor, 180-day period begins either on day partnership recognition or last day of tax year of partnership (typically 12/31)

- If gain is 1231 gain, 180 day period begins on last day of tax year
  - problem: currently no ability to elect earlier recognition date for 1231 gain



The Investor – Wait a long time

Step 4: Wait…

The Investor – Wait a long time

Wait…

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Wait…

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Wait…

The Investor – Wait a long time

- Wait more than 10 years, but before 2048, and sell your interest in the QOF

The Investor – Or, get out earlier

- Alternative – sell your interest before 2026
  - pay tax on all or a portion of your deferred gain (or if less, value of your QOF interest)
- Sell all of your interest in QOF and reinvest in another QOF with 180 days
  - no gain recognized as result of sale
  - does not work for sales of interests after 2026

The Investor – Some events that trigger deferred gain early

- Inclusion events that can trigger tax event on initial invested deferred gain
    - reduce equity interest in QOF
    - distribution of property from QOF
    - claim a loss for worthlessness
    - QOF ceases to exist
    - transfer of interest in QOF by gift

The Investor – Some events than do not trigger gain

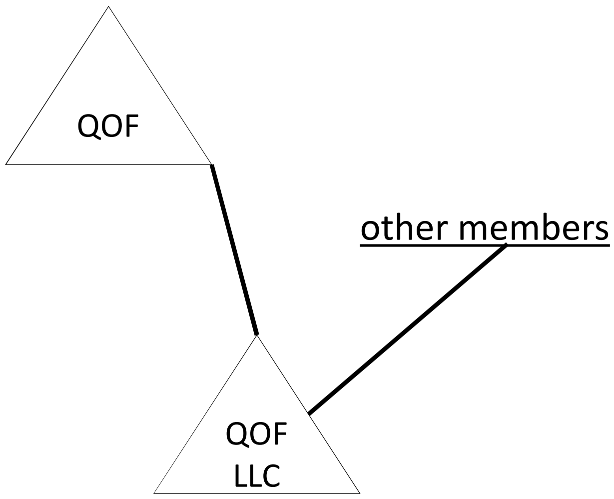
- Transfer of QOF interest upon death
- Transfer to grantor trust
- Transfer of QOF interest to a partnership (if QOF does not terminate)

The Fund

- Investment vehicles organized as a corporation or partnership
- Organized for purpose of investing in qualified opportunity zone property
- 90% of assets of fund must be held in qualified opportunity zone property
  - Tested twice per year
  - Value based on QOF's applicable financial statement or cost basis (owned property) and present value (leased property)
- QOF self certifies (Form 8996)

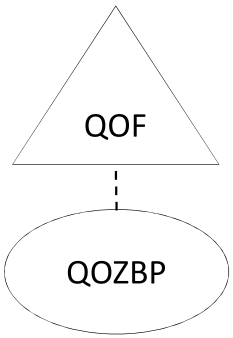
The Fund

- Typical Structure
  - Invest in lower tier partnership

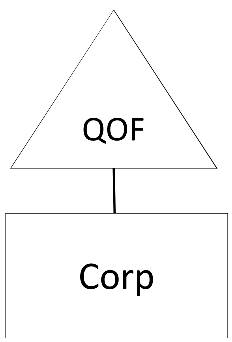


The Fund

- Alternative 1
  - hold QOZBP directly instead of through a lower tier partnership
    - unlikely because
      - intangible property limits
      - no working capital safe harbor
      - no 70/30 test



- Alternative 2
  - invest in lower tier corporation
    - maybe, but issues if plan is to have debt financed distributions



The Fund - Permissible Fund Investments

Qualified Opportunity Zone Property

- Qualified Opportunity Zone Business Property (direct investment)
- Qualified Opportunity Zone Stock (indirect investment)
- Qualified Opportunity Zone Partnership Interest (indirect investment)

Permissible Fund Investments

1. Qualified Opportunity Zone Business Property (QOZBP)

- Tangible property used in a trade or business
- Acquired by purchase or lease after 2017
- Original use in the zone commences with the fund or the fund substantially improves the property
- Substantially all (70%) of the use of such property is in the zone for substantially all (90%) of the fund's holding period

First use or substantial improvement requirement

- If not original use property must meet substantial improvement criteria.
  - “original use”:
    - means property has not previously been placed in service for depreciation/amortization in the zone
    - also includes property that has been vacant for 5+ years
- For substantial improvement: during a 30-month period after the date of acquisition of property, additions to basis exceed the QOF’s adjusted basis at the beginning of the 30-month period.
- if acquire land + improvements, measured by basis of improvements only
- no original use requirement for leased property

Permissible Fund Investments

2. Qualified Opportunity Zone Stock

3. Qualified Opportunity Zone Partnership Interest

- Domestic corporation or partnership acquired after 2017 as original issue
- Solely in exchange for cash
- During substantially all of the holding period, the corporation or partnership is a qualified opportunity zone business

Qualified Opportunity Zone Business (QOZB)

- This is what the subsidiary corporation or partnership must be:
  - Trade or business
  - Substantially all (70%) of the tangible property owned or leased is qualified opportunity zone business property (QOZBP)
  - Substantial portion of intangible assets (40%) used in active conduct of business in the zone
  - 50% of gross income derives from active conduct of trade or business in the zone
    - 3 safe harbor tests: employee hours; payments for services; conjunctive (assets + operations/management)
  - Not a listed “sin” business
    - e.g., casino, golf course, liquor store, suntan facility, racetrack, massage parlor, racquet sport and skating facilities
  - Less than 5% of assets attributable to non-qualified financing property
  - Reasonable working capital allowed

The Fund – Asset Test

Find Qualified Opportunity Zone Property

- Hold at least 90% of its assets in qualified opportunity zone property (QOZP)
  - tangible property acquired by purchase from an unrelated party after 2017
  - qualifying partnership interest
  - qualifying stock
  - certain leased property

The Fund – Asset Test

Measurement of 90% asset test

- For calendar year funds, measured end of June and December
- Cash received in the preceding 6 months not taken into account if:
  - continuously held in cash, cash equivalents, or short term debt instruments
- Asset values can be based on applicable financial statements or cost

Cash, is bad, unless…

- **<u>Fund Level (investment entity)</u>**
- 90% of QOF assets must be QOZP
- Cash is not QOZP
  - cash invested in QOF in 6 months prior to test date is ignored
  - cash obtained upon sale of QOZP is treated as QOZP if reinvested in new QOZP within 12 months
- **<u>QOZB Level (lower-tier entity)</u>**
- QOZB can hold reasonable working capital reserves
  - Working capital is reasonable if:
    - there is a written plan for the development of a business, or the acquisition, construction or substantial improvement of tangible property in an OZ;
    - there is a reasonable written capital deployment schedule for expenditure of the working capital, which schedule shows the working capital being deployed within 31 months (extended if government causes delay) ; and
    - working capital is used in a manner consistent with the written schedule

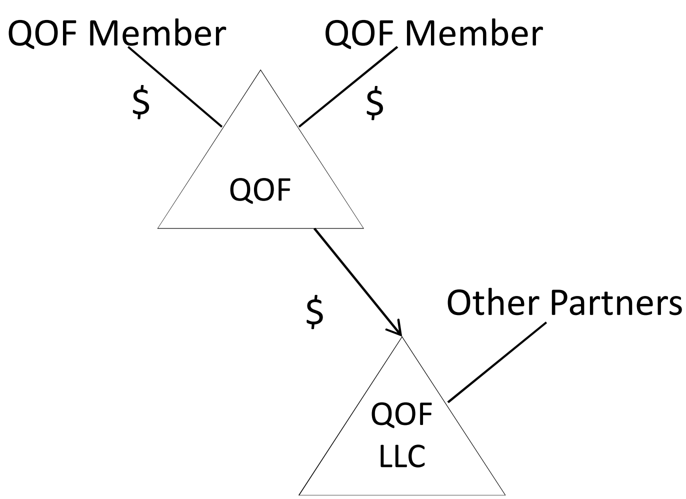
Failure to Meet 90% Investment Standard Penalty

- QOF pays monthly penalty at underpayment rate (currently 5%)
- Applied to extent value assets which are not QOZP exceed 10% of value of all assets of QOF
- Appears to require a penalty of 5% per month, but probably 5% per year
- If QOF is a partnership, partners pay penalty
- Reasonable cause exception to penalty

The Fund – How to deal with cash

Don't hold too much cash too long

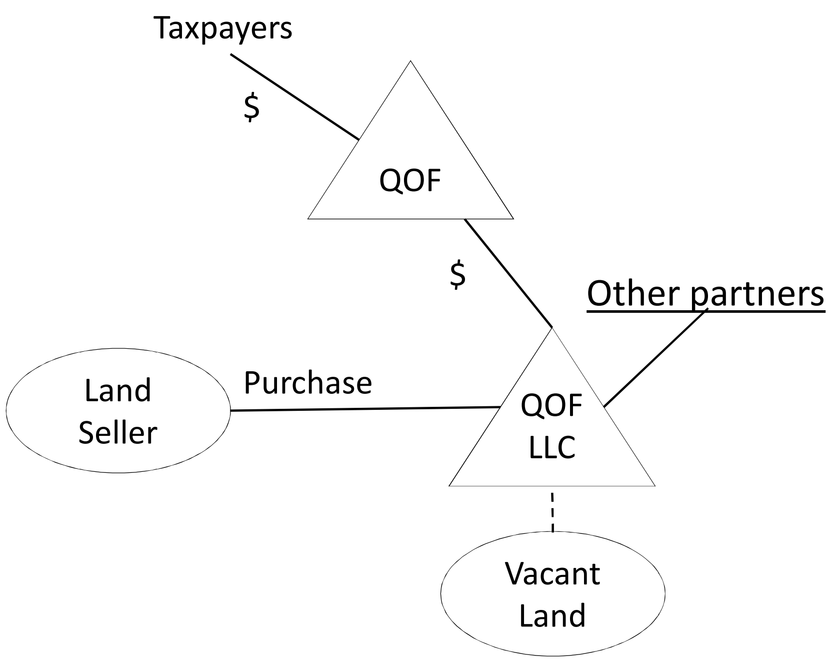
- Most likely contribute it to a lower tier partnership in exchange for a partnership interest



The Fund – Ground Up Construction example

Real Estate Acquisition / Development Issues

- QOF Partnership acquired land, develops project



The Fund – Ground Up Construction example

- QOF does not take cash into account for first 90/10 testing date
- Before 2nd 90/10 test date, cash contributed to QOF Partnership
- QOF partnership has written plan to spend cash within 31 months and substantially complies
  - 31 months extended if delay caused by government approvals
- No substantial improvement required

The Fund – Vacant land acquisition

- Acquisition of vacant land
  - no requirement to improve land
  - but, must be in a trade or business
    - farming does not seem to count
    - Anti-abuse rules to prevent land banking
  - might be a problem if acquire large parcel, develop a small piece and hold the rest

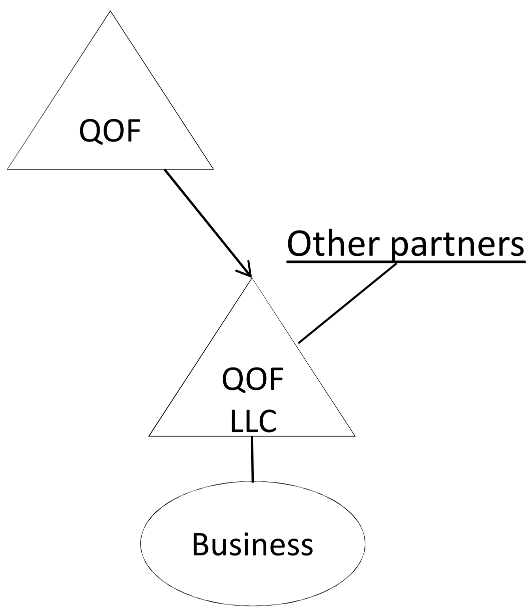
The Fund – Acquisition of existing building

- Same as ground up development, except structure must be substantially improved
- Improvements equal to 100% of cost basis allocated to buildings
  - asset by asset test
  - do not need to improve costs allocated to land
- Lease exception to substantial improvement
- No substantial improvement requirement for building vacant for 5 years

Good Rules for Leases

- Leased tangible property may be treated as qualified opportunity business property for 90/10 test and 70/30 test if:
  - lease entered into after 2017
  - substantially all of the leased property is used in the QOZ during substantially all of the lease term
  - lease must be market rate and no prepayments of more than 12 months allowed
- Leased property not subject to original use requirement
- Favorable valuation rules create more QOZBP for 90/10 and 70/30 test
- Leased property not subject to substantial improvement requirement
- Leased property not subject to related party rules
  - if a lease of personal property, lessee must also acquire equal value of tangible personal property during shorter of lease term or 30 months

The Fund – Acquiring an operating business



The Fund-Operating Business

- Operating business will almost always be in lower-tier partnership
  - No rules to allow for intangible property as a good asset at QOF level
  - No working capital safe harbor at QOF
  - No 70/30 test at QOF level

50% Gross Income Requirement

- **50% of gross income must be from active conduct of a trade or business within the zone**

- **50% Trade of Business Safe Harbors**
  - Hours
    - at least 50% of the services performed for the trade or business are performed in the opportunity zone
  - Fees
    - at least 50% of the amount paid for services are for services performed in the QOZ by employees, independent contractors, or employees of independent contractors
  - Conjunctive
    - the tangible property of the business is in a QOZ and management or operational functions performed in the QOZ are each necessary for generating at least 50% of the gross income of the trade business

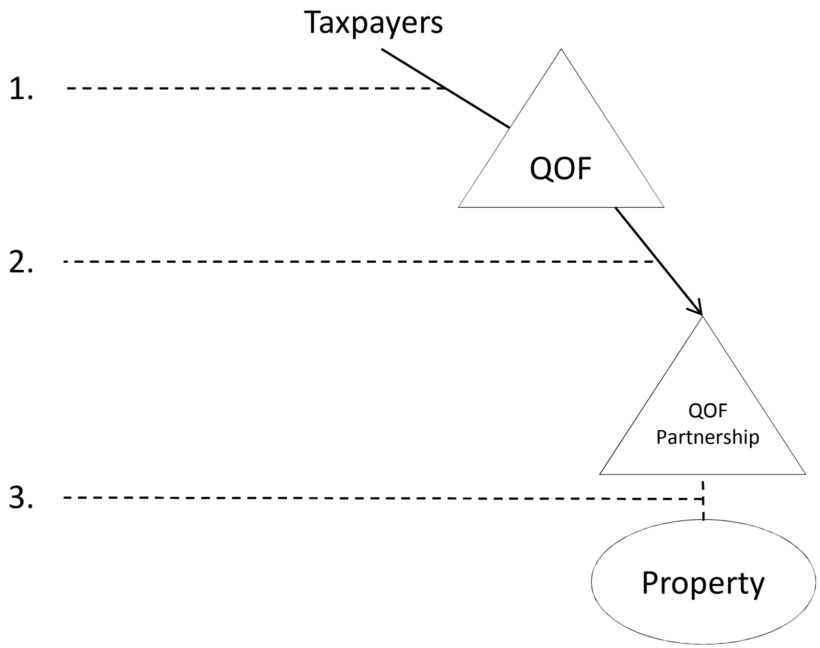
Intangible Assets of QOZB

- Substantial portion of intangible property of QOZB must be used in the active conduct of a trade or business in the QOZ
  - substantial portion = 40%
  - no sourcing rules

Getting Cash Out Before Sale

- Operating income and distributions subject to general tax rules
- Debt financed distributions allowed tax free if:
  - 2 years after investment
    - just a presumption
  - sufficient basis in QOF interest

Exit Strategies



1. Taxpayer sells interest in QOF – full exclusion
2. QOF sells interest in QOF Partnership – capital gain excluded
3. QOF Partnership sells property - taxable

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Thank you

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