Qualified Opportunity Zone Funds

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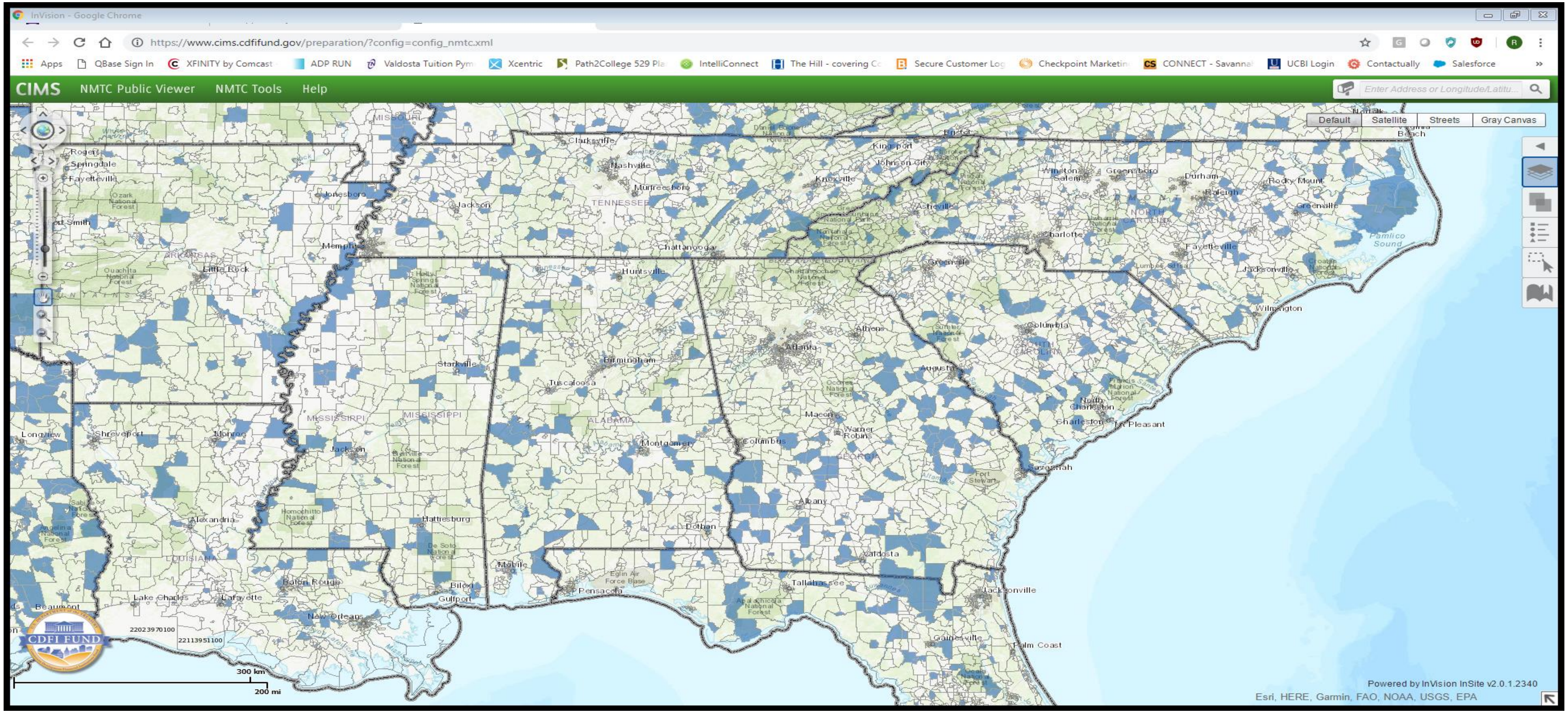
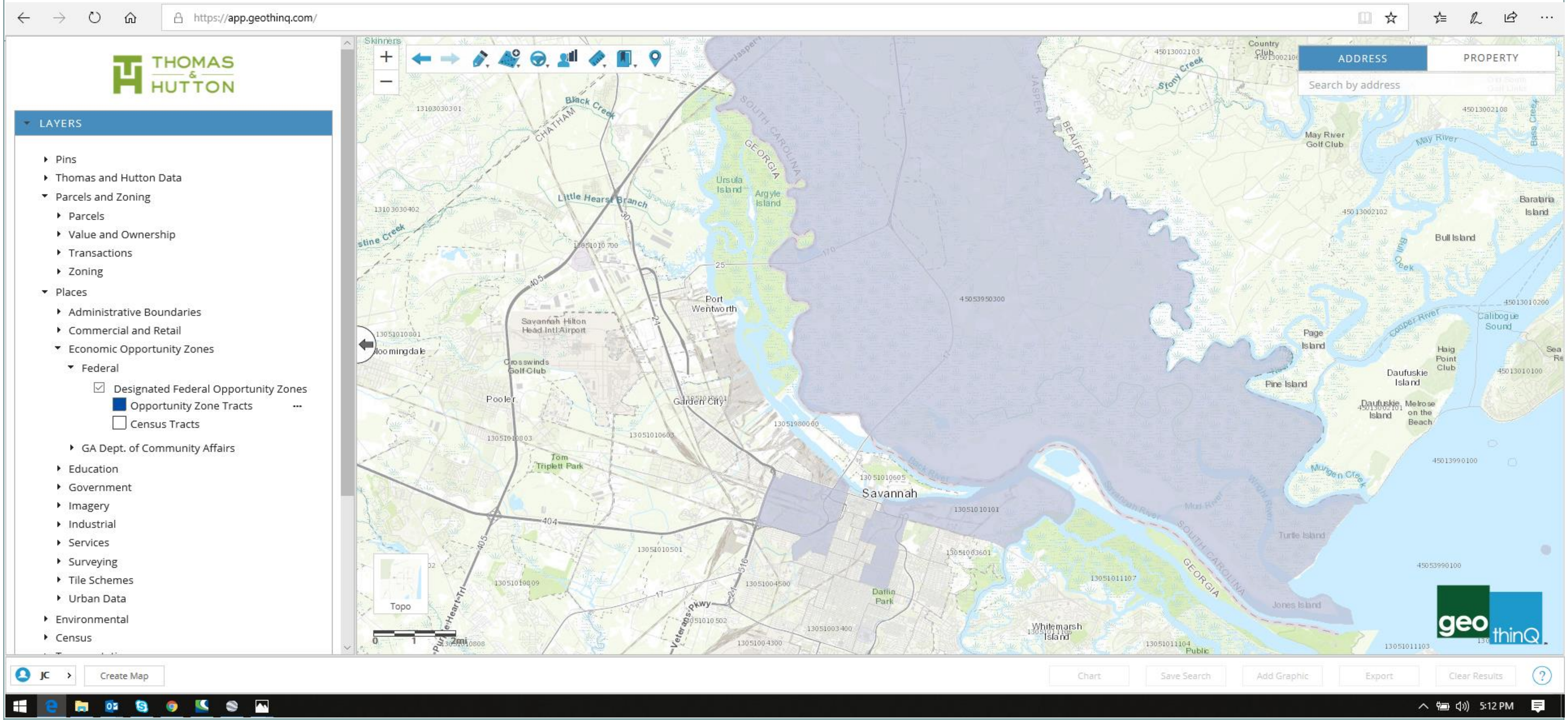
- Overview & Background
- How it works for Taxpayer
- How it works for QOF
- A Practical Approach & Discussion

Background of Opportunity Zones



What is an Opportunity Zone?



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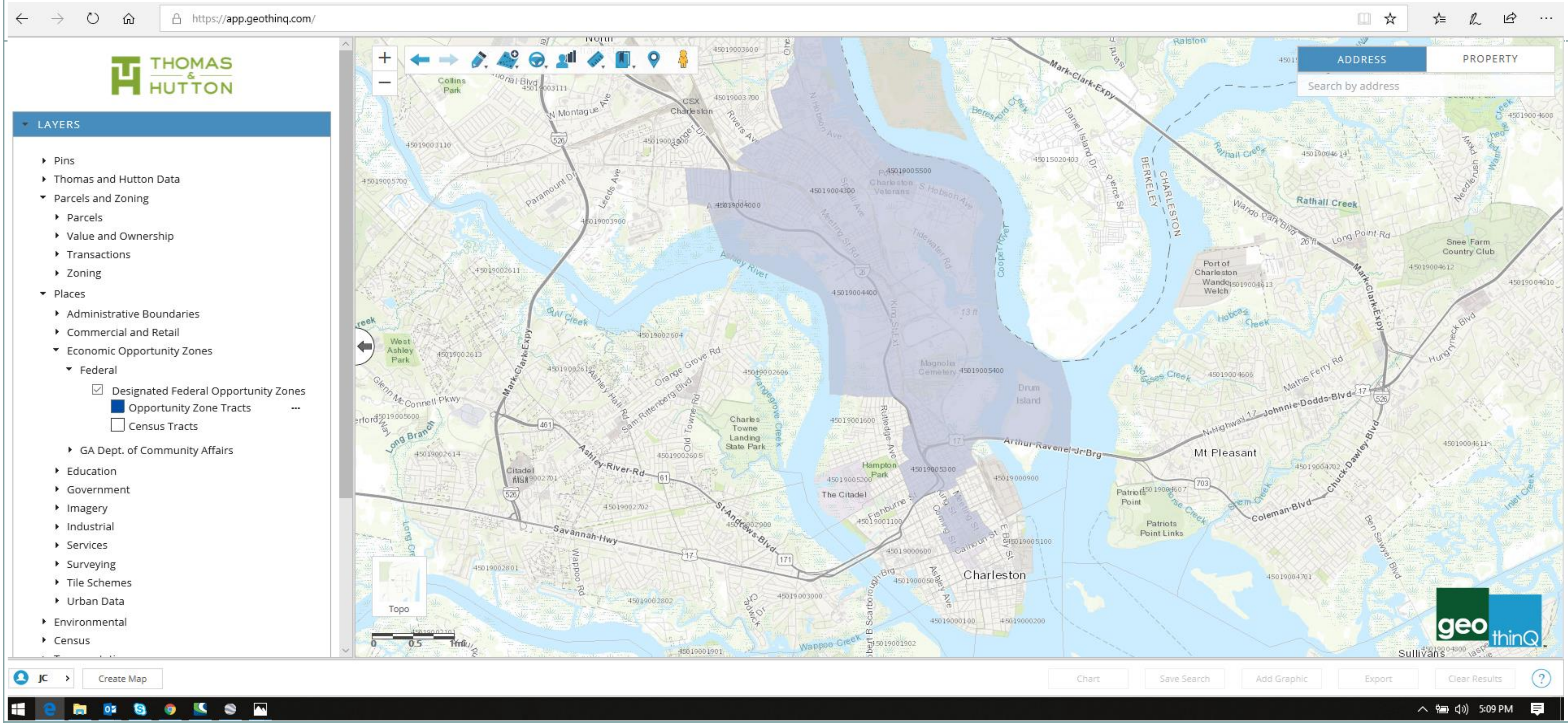
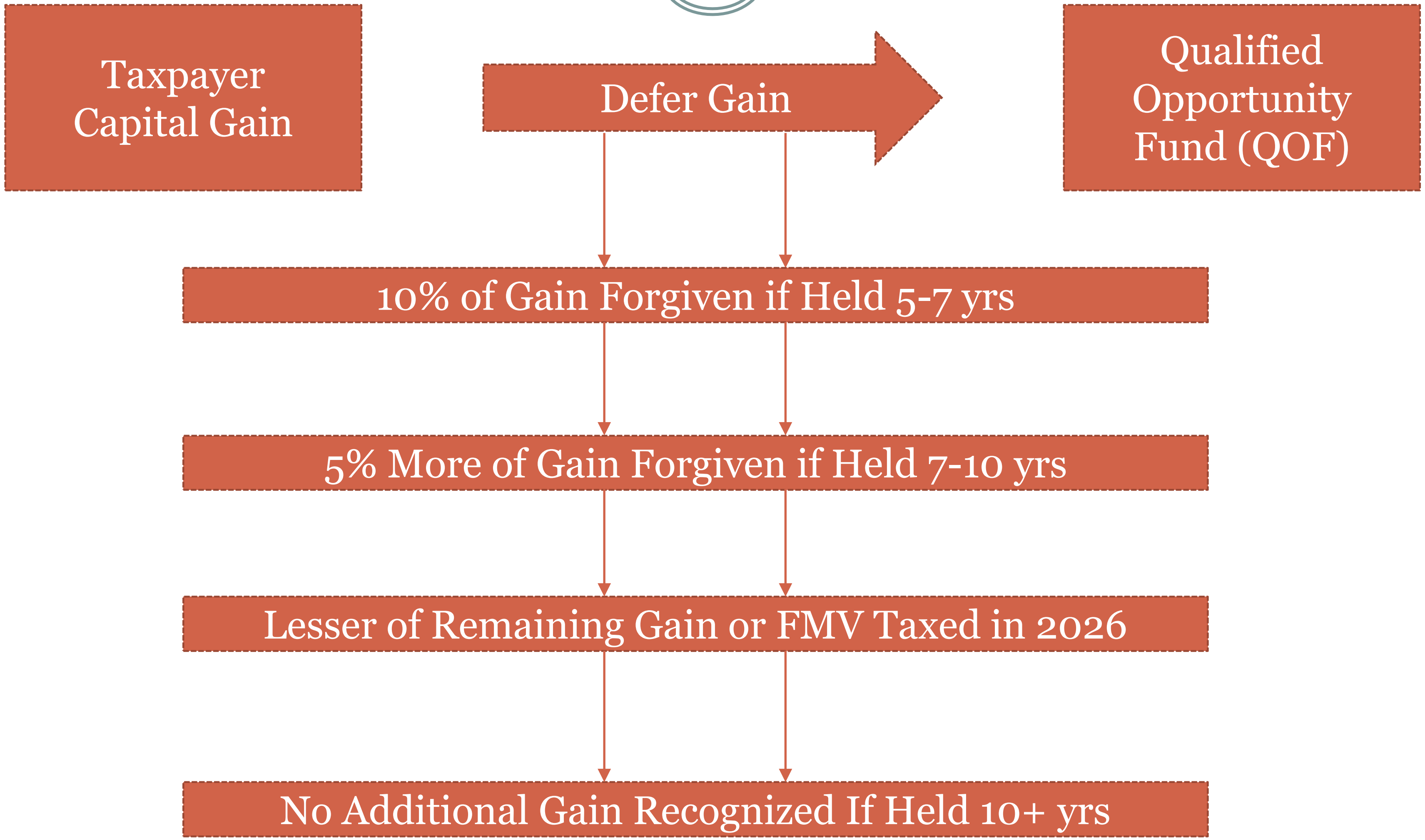


What's in it for the Taxpayer?

Opportunity Zone – Big Picture

Tax Advantage



Example of Tax Benefits

Tax Benefits for Deferred Gain

2018
defer paying $200,000 tax on gain (i.e., 20% tax on $1 MM gain)

2023
$20,000 of tax forgiven (5-yr holding period for 10% tax reduction)

2025
$10,000 of tax forgiven (7-yr holding for 5% more reduction)

2026
regardless of holding period: must pay $170,000 of tax (i.e., $200,000 less $30,000) so 17% tax rate on $1 MM gain from 2018

Tax Benefits for OZ Investment

2018
$1 MM investment in QOF with zero outside tax basis

2023
$20,000 outside tax basis increase

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$10,000 outside tax basis increase

2028 to 2047
Outside tax basis in the Fund increases to fair market value of Fund interest (i.e., can sell Fund interest with no tax) at the time of sale of the interest; provided, met 10-yr holding period & before end of 2047

180 Day Rule


Taxpayer Capital Gain
Defer Gain
Qualified Opportunity Fund (QOF)
180 Days to Invest

How the QOF Works

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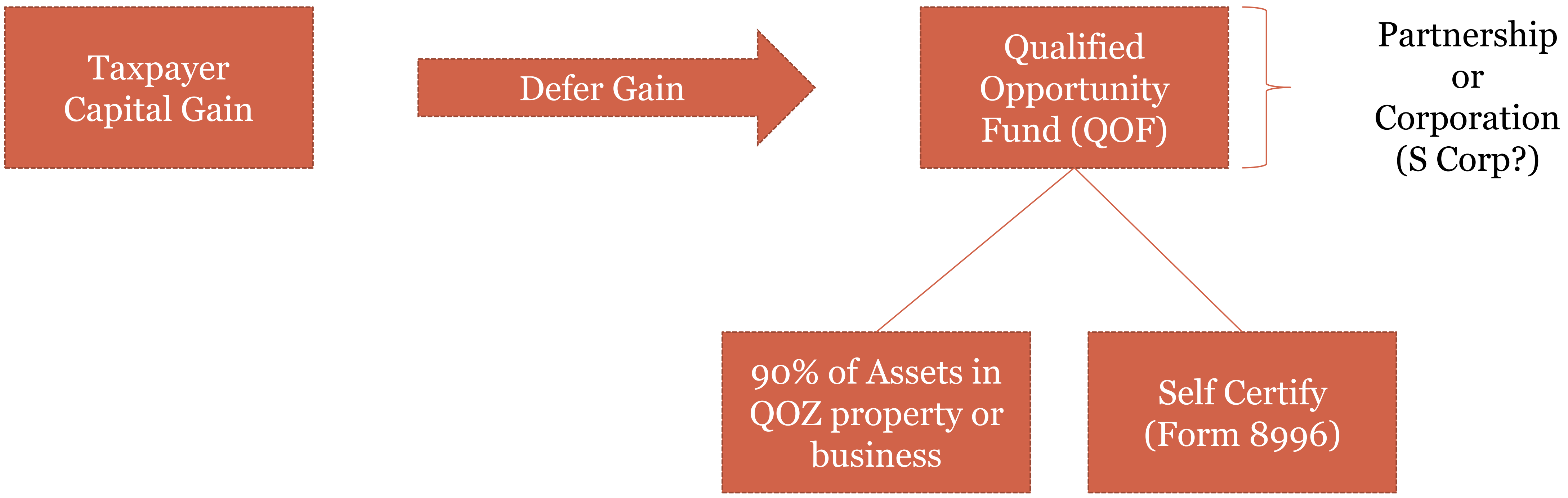
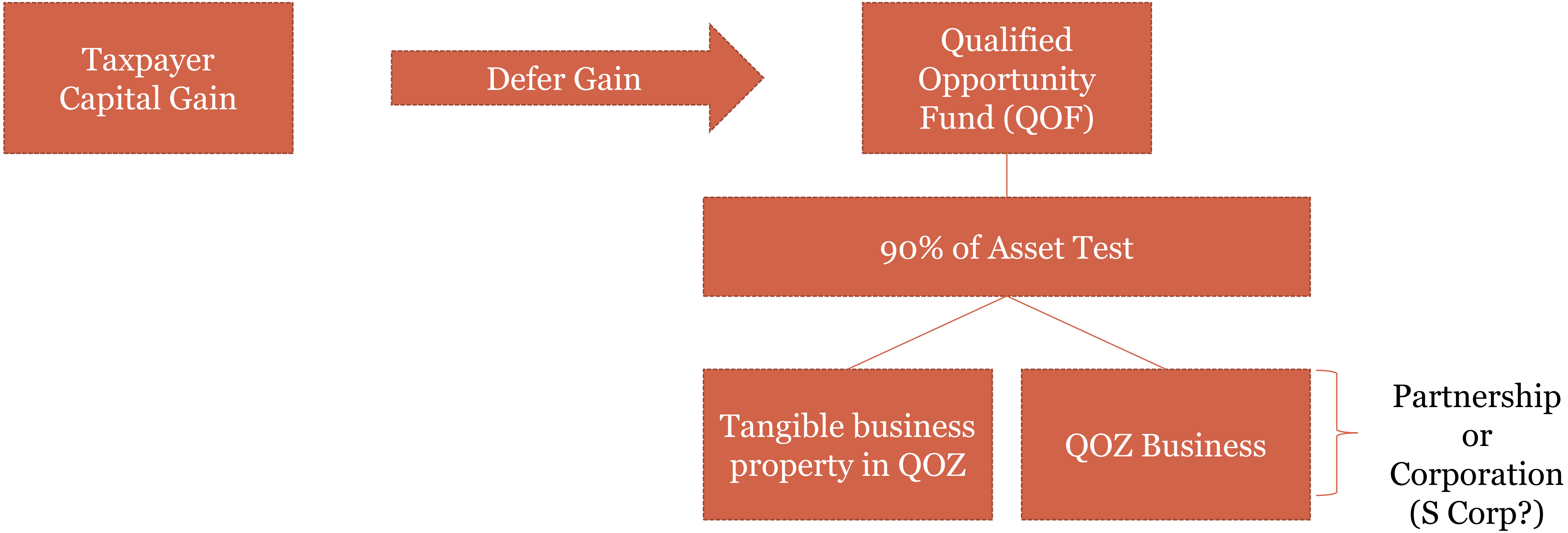
Qualified Opportunity Fund



Qualified Opportunity Fund



QOZ Business Property

- Tangible property (e.g., equipment, real estate) used in business in a QOZ that is acquired after December 31, 2017 and is:
  - Land in a QOZ
  - Building in a QOZ that is first used by the QOF or the qualified opportunity business
  - Building in a QOZ that was previously used but is "substantially improved" by the QOF or the qualified opportunity business
  - Equipment that was never previously used in a QOZ or
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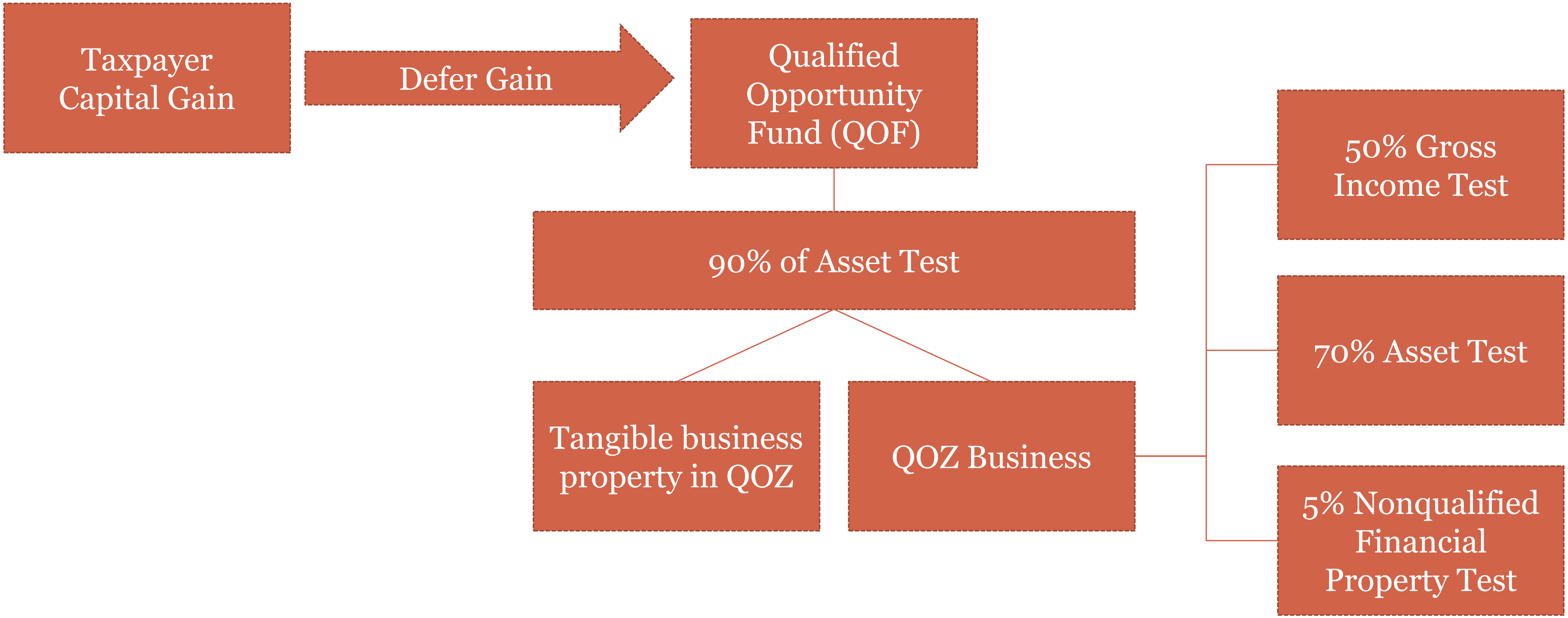
“Substantial Improvement”

- Applies to tangible property, other than land, that was used in a QOZ prior to its acquisition by the QOF (or the qualified opportunity business)
- “Substantial improvement”
  - QOF (or qualified opportunity business) must invest more in the tangible property during any 30-month period than the adjusted basis in the property (excluding land) at the beginning of such period

"Substantial Improvement" Example

- A QOF buys an existing commercial building for $10 million on March 1, 2019
- Assume that $2 million is attributable to the land and $8 million is attributable to the structure
- Under the rules, it appears that the building will satisfy the original use requirement if, at any time during the holding period of the building, the amount invested in rehabilitating the building over a 30-month period <u>exceeds the adjusted basis</u> of the building ($8 million)

Qualified Opportunity Business



Sin Business

- A qualified opportunity business may not operate the following so-called "sin businesses:"
  - Golf course
  - Country club
  - Massage parlor
  - Hot tub facility
  - Suntan facility
  - Racetrack
  - Casino
  - Sale of alcohol to be consumed away from the premises
- *Prohibition on leasing real estate to such businesses?* Apparently not, so long as the qualified opportunity business is not operating the sin business itself

Cash Rules

- General rules for holding cash and securities:
  - "Nonqualified financial property" = debt, stock, partnership interests, options, futures, swaps and similar property
  - Amount of "nonqualified financial property" that can be held in the business limited to 5% of the average unadjusted basis of property held in such trade or business
  - Working capital held in cash (or cash equivalents) is not treated as "nonqualified financial property"
- Working capital safe harbor (no limit as to amount):
  - QOF needs to prepare a written plan to invest its cash in tangible property (real or personal) in the QOZ within 31 months
  - Cash will not be treated as nonqualified financial property during that period
  - Working capital must be expended substantially consistently with the plan

OZ Property vs OZ Business Example

- If a QOF has $10 million in assets it can invest $9 million in a partnership that is an "active business". The partnership invest $6.3 million (i.e.,70% of its assets) in qualified opportunity zone business property. Must meet the 5% nonqualified financial property test.
- In contrast, if the QOF opted to purchase the qualified opportunity zone business property itself, it would have to buy <u>$9 million</u> of qualified opportunity zone business property, all of which would have to constitute tangible assets, and could then hold the remaining $1 million in cash, stocks, the S&P 500, nonqualifying real estate, etc.

A Practical Approach & Discussion

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THE BIG WIN WITH QOZ PROPERTY:

FLEXIBILITY, BOTH LEGALLY AND PRACTICALLY

- Two-Tiered Structure allowable for a QOZ-selling entity allows for greatest benefits and **flexibility** ***and*** **transferability**

A Guns'n'Roses Example

Net Worth Range: Axl- $150M; Slash- $90M; Duff- $40M; Izzy- $28M;

<u>Range of Est. Net Worths (L to R):</u>

Duff - $40M
Izzy - $28M
Axl - $150M
Steven Adler - $5M
Slash - $90M

(Not Pictured:
Dizzy - $40M
"Frank Ferrer" –Poster Signed by Real GNR Members)

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Get in the Ring Holdings, LLC

A Qualified Opportunity Zone Fund Offered by Guns'n'Roses

- GET IN THE RING HOLDINGS, LLC ("*GNR HOLDINGS*") ACQUIRES QOZ PROPERTY FOR $1M
    - APPRAISED STRUCTURAL VALUE = $300K
    - APPRAISED LAND VALUE = $700K
- GNR HOLDINGS CONSISTS OF TWO OPPORTUNITY ZONE FUND MEMBER LLCS:

  DUFF QOF, LLC, & IZZY QOF, LLC
- $1M INVESTED IS REINVESTED FUNDS FROM DUFF AND IZZY'S SALE OF ANYTHING CREATING TAXABLE CAPITAL GAIN THAT WOULD OTHERWISE BE TAXED IF NOT REINVESTED
    - EXAMPLE: SALE OF ANY NON-QOZ PROPERTY; SALE OF EQUITIES; ETC., ETC., ETC.

Get in the Ring Holdings, LLC: A Qualified Opportunity Zone Fund

Requirements:

- GNR Holdings, LLC (Single-Purpose Entity) must Invest 90% into "SUBSTANTIALLY IMPROVING" Property
    - The Substantial Improvement Test applies to building & structure improvements, not land.
- In ANY 30-month Period, must Invest $300,000 (Structure Appraised Value) into Property

Get in the Ring Holdings, LLC: A Qualified Opportunity Zone Fund

SOME ADVANTAGES:

- Original Gain DEFERMENT UNTIL 2026: In 2026, and not before (unless Property sold), IZZY QZF and DUFF QZF will pay LESSER OF:
  - 85% of Cap gain taxes each QZF originally deferred in 2019
    - Paying 85% of past-deferred amount could well be WORST CASE
  - OR "FAIR MARKET VALUE" of their stake in QOZ Property

Get in the Ring Holdings, LLC: A Qualified Opportunity Zone Fund

- Determining “Fair Market Value” of Interest in QZF Property:
  - Is it even transferable for any value at all in 2026?
  - Is Property encumbered by debt?
  - Does Operating Agreement restrict or disallow free transferability of OZF’s interest in GNR’s holding entity?
- Expect some clarity on applicability questions from IRS
  - **but** IRS cannot change language of QZF Statute as written in US Code

Get in the Ring Holdings, LLC: A Qualified Opportunity Zone Fund

- <u>Refinancing Debt on QOZF Property:</u>
  It ***appears*** that the QOF will be permitted to refinance its property and distribute cash to the investors, because the same general tax basis rules that apply to partnership debt apply to QOFs
- <u>Gain on Sale of Property</u>:
  GNR Holdings, LLC sells Property in 2029 for $2m, the $1m gain – which would otherwise be payable if funds were not invested in QOZ Property - is TAX FREE

Get in the Ring Holdings, LLC: A Qualified Opportunity Zone Fund

<u>Notes:</u>

- To take advantage of the "**Fair Market Value**" conditional flexibility and ensure structural flexibility and transferability of QZF entities, considerable care should be taken in drafting Organizational Docs of QZF Entities and Single-purpose holding entities
    - Preferably by someone familiar with QZF statutes in place <u>and</u> with working knowledge of IRS regulations to come
- New Statutes: Attention should be paid by QZF Investors to construction and application of QOZ statutes in coming years

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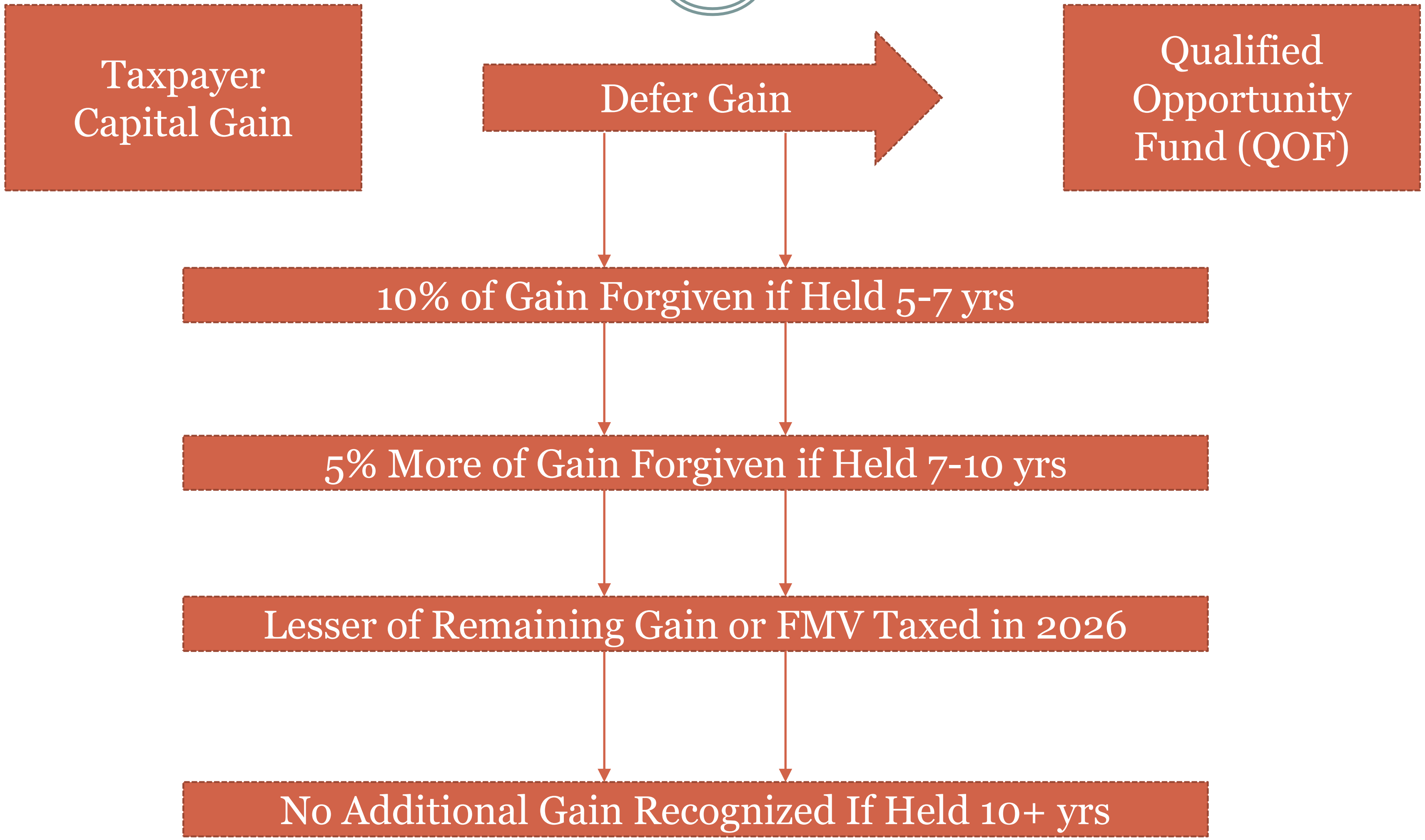
APPENDIX

Opportunity Zone – Big Picture

Who's Eligible?

- Only capital gains from both actual and deemed sales or exchanges, including:
  - Section 1231 gain (from the sale of real estate used in a trade or business) and
  - Unrecaptured Section 1250 gain ("capital gain" taxed at a higher rate)
  - Depreciation recapture is not eligible for deferral
- Individuals, C corporations (including a regulated investment company (RIC) or real estate investment trust (REIT)), partnerships, S corporations, and trusts or estates are all eligible taxpayers
- Partnerships and other pass-through entities are eligible to defer gains by investing in a QOZ directly
  - Partnerships can elect to pass-thru gains to individual partners, who may elect to defer their allocable shares

Tax Advantage



Overview of Tax Implications

- Eligible taxpayers can defer capital gains recognized from virtually any investment by investing an amount of the gain into a Qualified Opportunity Fund (QOF)
- Current income from the Qualified Opportunity Zone Business is subject to tax
- Capital gain deferral from original transaction can be deferred until 2026
- Disposition gain from the OZ investment can be tax-exempt if the OZ investment is held for at least 10 years

10 Year Rule

- A taxpayer is entitled to step up its basis in its investment in a QOF to fair market value if it has held that investment for at least 10 years
- Possibility to avoid any tax on the disposition of the QOF investment
  - Taxpayers who have not met the 10-year holding period by December 31, 2026, can merely continue to hold their investment until the 10-year holding period is achieved, despite their QOF technically ceasing to be one
  - Step-up to fair market value for any sale of an interest in a QOF allowed until <u>December 31, 2047</u>

Disposition of the Investment

- General rule: The original deferred gain from the sale of the capital asset must be recognized by the taxpayer at the earlier of 2026 or the date on which the taxpayer sells its interest in the QOF
- A taxpayer may use its QOF's interest as collateral for a loan, whether as part of a purchase-money borrowing or otherwise, without triggering the deferred gain
- Generous provisions for roll-overs:
  - If a QOF disposes of qualified opportunity zone business property, the taxpayer may make a qualifying investment in a new qualified opportunity business property and continue to defer the original gain
  - The gain must be triggered – and rolled over - by the end of the date at which all deferred gains must be recognized
  - Waiting for more regulations to address if the gain from QOZ property must be a “capital gain” to roll it over

Gain when Deferral Ends

- At the end of the deferral period, taxpayer must include in income the excess of:
  i. The <u>lesser</u> of (A) the eligible gain that the taxpayer rolled-over or (B) the fair market value of the taxpayer's QOF's investment as of the end of the deferral period over
  ii. The taxpayer's basis for the QOF investment
- The gain to be included has the same attributes in the taxable year of inclusion that it would have had if tax on the gain had not been deferred

Overview of Tax Benefits

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180 Day Rule

180 Days to Invest

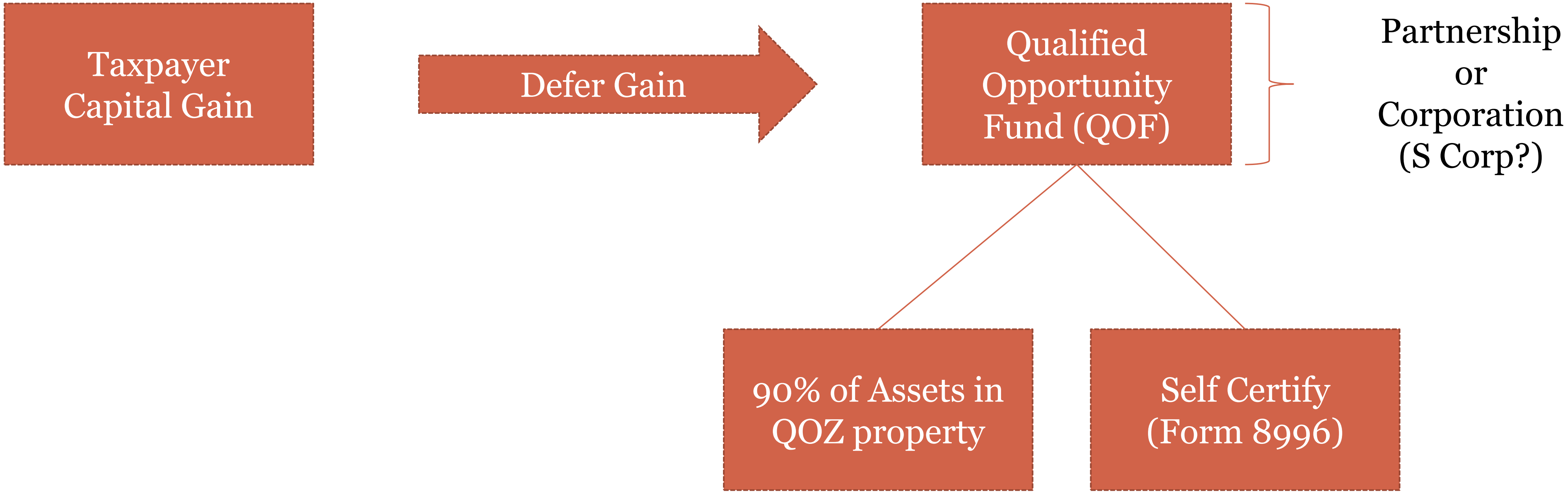
180 Days To Invest

- Taxpayers must invest an amount equal to the gain to be deferred in a QOF within 180 days of the sale of the property
- The <u>180-day period</u> begins on the day on which the gain would be recognized if the taxpayer did not elect to defer recognition of that gain

Special Flow Through Entity Rules

- Special rules for partnerships and other pass-through entities:
  - The flow through entity's 180-days begin on the date that the entity recognized the capital gain
  - If entity passes through the gain, the 180-days does not begin until the last day of the of the entity's taxable year, because that is the day on which the partner would be required to recognize the gain if it was not deferred
  - Partners may elect to begin its own 180-day period on the same date as the start of the partnership's 180-day period

Qualified Opportunity Fund



QOF & Eligible Investments

- Qualified Opportunity Fund (QOF) must be a partnership or a corporation
  - Appears to permit S corporations, but the Proposed Regulations are silent
- Election to be to be treated as QOF as of a specified month in 2018 or later
- <u>90%</u> of its assets in eligible property or eligible partnership interests or stock at 2 semi-annual testing dates
- Investment must be in "equity" for income tax purposes
  - Preferred equity is ok
  - Partnership interests entitled to special allocations, such as cashflow or liquidation preferences, are ok

QOZ Business Property

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Self Certification of QOF

- Corporations and partnerships can self-certify that they meet the requirements to be treated as QOFs
- The IRS released draft Form 8996 with the proposed regulations
- Entities that desire to be treated as QOFs must include Form 8996 with their regular tax returns

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.

Part II **Investment Standard Calculation**

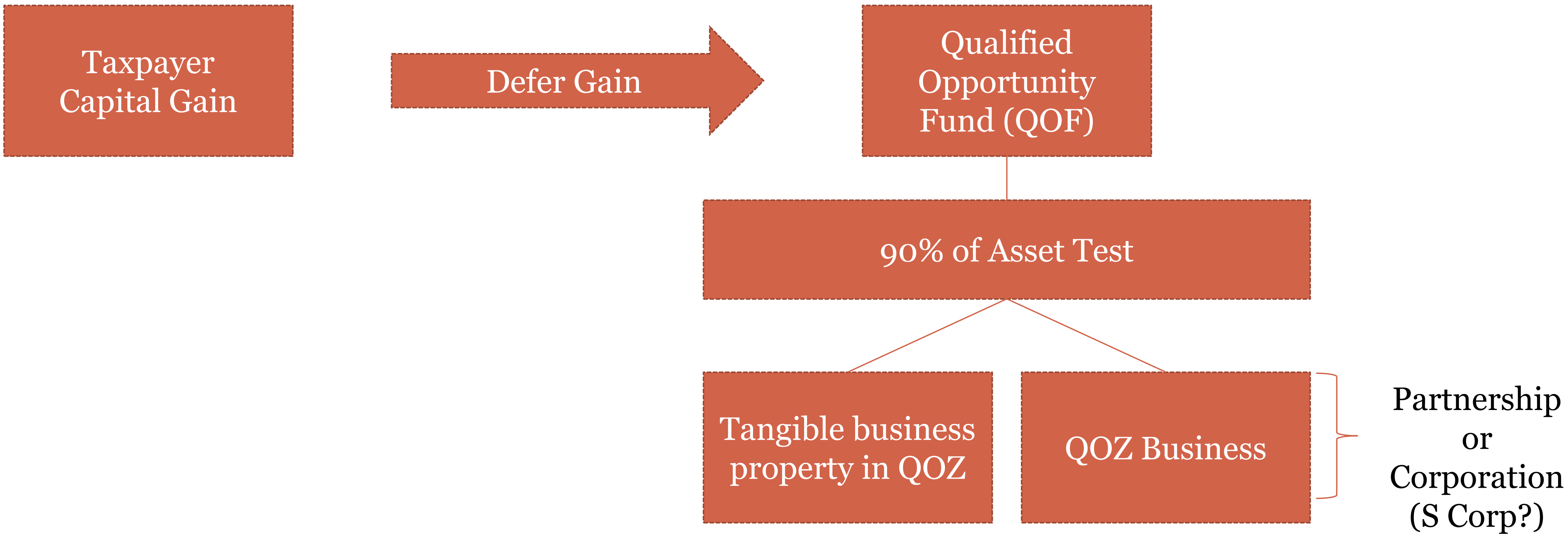
5	Total qualified opportunity zone property held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes"	5	
6	Total assets held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions 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 taxpaye'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? ☐ **Yes.** Enter -0- on this line and file this form with your tax return. ☐ **No.** 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)

Qualified Opportunity Fund



90% Qualifying Assets Test

- A QOF must hold 90% of its assets in "qualified opportunity zone property," which can be one of following three items:
  1. Newly issued stock of a corporation
  2. Newly issued partnership interests or
  3. Tangible business property in a QOZ
- In cases *#1* and *#2*, for stock or a partnership interest to constitute qualified opportunity zone business property, the corporation or partnership must conduct a "qualified opportunity business"
- Rules are much more lenient for investments into corporations and partnerships conducting qualified opportunity property directly

QOZ Business Requirements

- The QOF can opt for the qualified opportunity zone business route (i.e., investing in a subsidiary partnership or corporation), rather than directly investing in qualified opportunity zone property
- In this case, that business is subject to the following four requirements:
  1. 50% “active” gross income
  2. Use of a substantial portion of the intangible assets in the “active” business
  3. 5% limit on financial assets
  4. No “sin” business investments
- Those requirements are inapplicable if the QOF holds qualified opportunity zone business property directly

Sin Business

- A qualified opportunity business may not operate the following so-called "sin businesses:"
  - Golf course
  - Country club
  - Massage parlor
  - Hot tub facility
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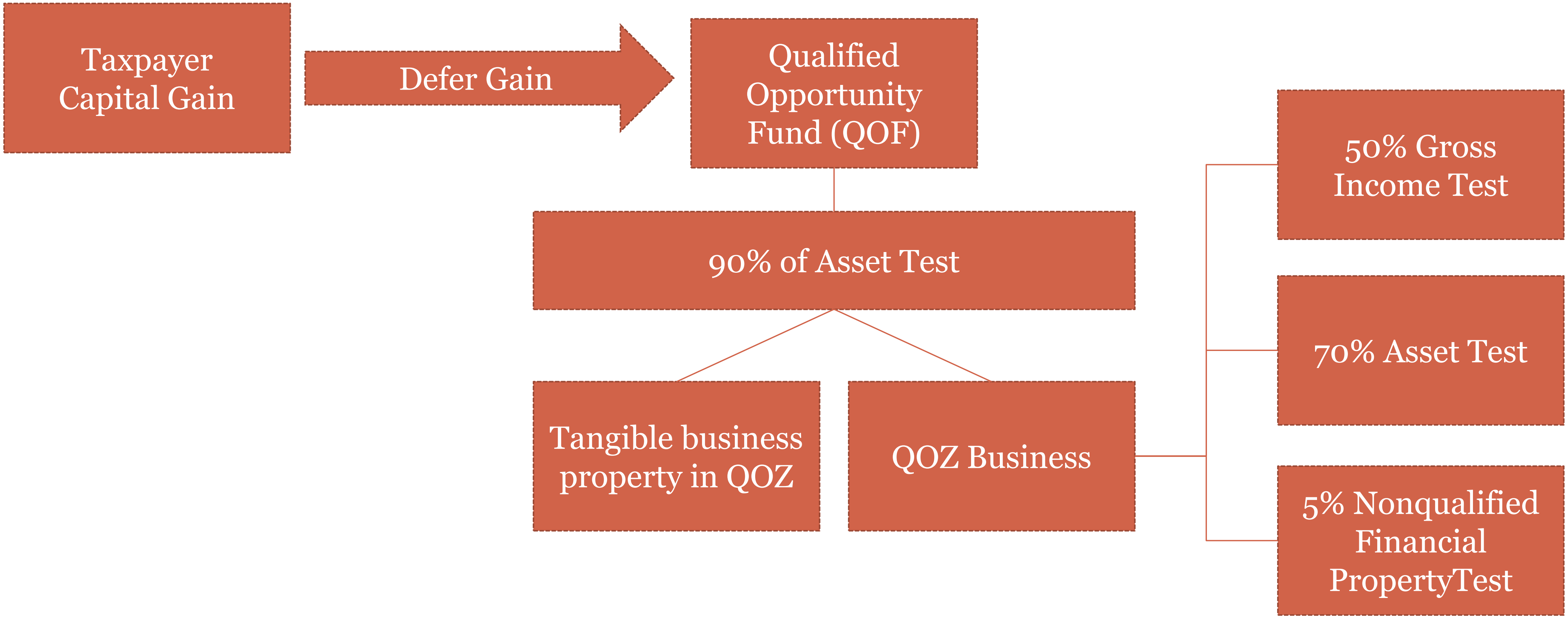
Qualified Opportunity Business



50% "Active" Gross Income & Asset Requirement

- At least 50% of the qualified opportunity zone business's gross income must be from the "active conduct" of a business in a QOZ
- A corporation or partnership can meet the qualified opportunity business requirement even if only 70% of its tangible property is held for use in qualified opportunity zone business
- A substantial portion of the intangible assets must be used in the active business
- Proposed Regulations lack the definitions of:
  - "Active business" -- *Can net leasing qualify as "active?"*
  - *Can an active business be conducted by independent contractors (rather than employees)?*
  - "Substantial portion" (i.e., 90%, 70%, or other)

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- General rules for holding cash and securities:
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