

Qualified Opportunity Zone Frequently Asked Questions

1 Who Can Invest?

U.S. or foreign investors and pass-through entities recognizing U.S. capital gains.

2 What Type of Capital Gain Qualifies?

Long term and short term capital gains qualify.

Ordinary income and depreciation recapture cannot be used/apply (depreciation recapture is ordinary income). Net gains under Internal Revenue Code ("Code") Section 1231 (i.e., real estate gains) should qualify.

The capital gain can't be generated by a sale of property to a related party (a Related party is determined under Code Section 267(b) and 707(b)(1) by substituting 20% for 50% each place it appears in Code Sections 267(b) or 707(b)(1)).

3 What are the Mechanics?

The taxpayer must invest proceeds from a sale resulting in capital gain in an entity that is a Qualified Opportunity Fund ("QOF") formed as a corporation or partnership (LLCs which own property in an opportunity zone are ok). Self-certification by the QOF is explained at Proposed Regulation § 1.1400Z-2(d)-1(a).

4 How Can One Organize a Qualified Opportunity Fund?

Two basic forms of organization:

- Form a QOF that directly invests in property in an Opportunity Zone (single QOF structure); or
- Form a QOF that owns stock in a corporation or an interest in a partnership (a QOF can be an LLC that is taxed as a partnership) that owns the property.

A QOF cannot own an interest in another QOF.

A pre-existing entity can be a QOF, but the QOF must have acquired the property by purchase after 12/31/17 and the QOF must have made an election to be a QOF before it received deferred gain contributions from investors.

5 When Must the Investor Invest?

Within 180 days after the date of the sale or exchange of the asset that triggers a capital gain. Gains passed through to members or partners in LLCs or partnerships have different time frames for reinvestment [See Item (12) below.]

6 What is the Tax or Economic Benefit?

Tax deferral and stepped up tax basis in the QOF investment held by taxpayer, but the original deferred gain is included in the investor's income on 12/31/2026.

If the interest in a QOF is held for:

- 5 years: 10% of the deferred gain that resulted when the capital gain was realized (i.e., the sale or exchange of the asset) is added to the tax basis of the QOF interest.
- 7 years: an additional 5% (a total of 15%) of the deferred gain that resulted when the capital gain was realized is added to the tax basis of the QOF interest.

If the QOF interest is sold after 10 years or more, then the basis in the interest is adjusted (stepped up) for 100% of the appreciation in value created after the interest was acquired up through the date of sale or exchange (i.e., at exit).

Gains allocated by the QOF to the QOF investor, after the ten year holding period is met, can be excluded from the investor's income. Ordinary income or depreciation recapture inherent in the interest can also be excluded. This favorable rule does not appear to apply to gain allocated to the QOF from lower tier partnerships held by the QOF.

Gains recognized by the QOF from the sale of Qualified Opportunity Zone Business Property cannot be reinvested by the QOF and deferred under the qualified Opportunity Zone program but can be reinvested in qualifying property within twelve months to meet the 90% test discussed in Item (7) below.

IMPORTANT:

In order to take advantage of the tax deferral benefits for the 7 year holding period, the QOF must be formed and funded on or before 12/31/19.

In order to take advantage of deferral benefits for the 5 year holding period, the QOF must be formed and funded on or before 12/31/22.

Promotes or carried interests are not eligible for Qualified Opportunity Zone benefits.

7 How Does the Investment Remain Compliant with §1400Z-1 and 2?

- A. If the QOF's investment in the tangible property is made using a single QOF structure (with no ownership in lower tier subsidiary entities or partnerships), then the QOF's investment in "Qualified Opportunity Zone Business Property" must meet the following requirements:
 - i. The property must be used in a trade or business under Code Section 162 (mere triple net leases may not be sufficient).
 - ii. In the case of tangible property owned or leased by the QOF, during substantially all of the QOF's holding period (90% of such holding period), substantially all of the property's use must be in a Qualified Opportunity Zone (70% of such use must be in the "Zone"). Unimproved land used in a trade or business can qualify.
 - iii. Property must have its "original use" with the QOF or there must be a "substantial improvement" of the property. A building that has been vacant for at least five consecutive years before being placed in service by the QOF can be an "original use" of the building and no substantial improvements are required with respect to such vacant building.
 - iv. A substantial improvement means that the costs of improving the property are at least equal to the original cost basis of the property (excluding land cost if a purchase is made of an existing building) and such improvements must generally be made within 30 months from the date of the acquisition of the property.
 - v. The property must be acquired by "Purchase" as provided in Code Section 179(d)(2) (by substituting 20% for 50% each place it appears in Code Sections 267(b) or 707(b)).
 - vi. 90% of the QOF's total assets must be Qualified Opportunity Zone Business Property

(which includes an interest in a lower tier partnership described in (6)(B) below). The 90% test is determined based on the average of the percentage of Qualified Opportunity Zone Business Property on hand on the last day of June and December (the first year an asset is held has a different rule). A QOF may choose to invest contributions made to the QOF during the prior six months for purposes of determining its compliance with the 90% test, so long as the contribution is held in cash or cash equivalents. The single QOF structure cannot easily accommodate intangible property nor are there specific rules regarding working capital (the working capital safe harbor discussed below is not available to the QOF).

vii. Leased property can qualify for purposes of the 90% test and there is no original use or substantial improvement requirement for leased property. With certain restrictions the leased property can also be leased from a related party.

viii. Unimproved land can be a good asset for purposes of the 90% test.

B. If the QOF invests in a lower tier partnership that owns property the following requirements must be met by the lower tier partnership :

- i. The partnership interest must be owned by the QOF.
- ii. A substantial portion of gross income (at least 50%) of the partnership must be derived from the active conduct of business in the Zone; Proposed Regulation § 1.1400Z – 1(d)(5)¹. Three safe harbors are provided in the second set of Proposed Regulations.
- iii. A substantial portion of intangible property of the lower tier partnership must be used in the business (no percentage test exists); Proposed Regulation § 1.1400Z – 1(d)(5).
- iv. Only an amount equal to less than 5% of the average of the aggregate unadjusted basis of the lower tier partnership's property can be nonqualified financial assets (cash, securities etc.). Under the working capital safe harbor, working capital can be excluded from nonqualified financial assets² for 31 months [See Item (11) below.]
- v. The business can't be a golf course or sin business. (Code Section 144(c)(6)(B)).
- vi. 70%³ of the tangible property owned or leased by the lower tier partnership must be Qualified Opportunity Zone Business Property, meeting all the requirements of Item (6)(A) above, except the 90% test in Item (6)(A)(vi).

8 What are the Exit Strategy Options?

The sale of the investment in the QOF after the ten year hold is one option to take advantage of the ten year holding period exclusion. The last date for any sale or exchange of the interest in the QOF is 2047. Also, see Item 5 above discussing the sale of assets and distributions by the QOF to its investors.

9 When Does the Program End?

Ability to use QOF benefits for any realized capital gain of an investor ends for any sale or exchange occurring after 12/31/26.

¹ Income from reasonable working capital under the working capital safe harbor is counted toward the 50% gross income test.

² Nonqualified financial property is defined in § 1397C(e). Reasonable amounts of working capital in the form of cash, cash equivalents and debt with a term of 18 months or less are excluded from the calculation.

³ Use applicable financial statement to determine value of each asset for 70% test or if no applicable financial statements then use the original cost of the assets.

10 What is the “Substantial Improvement” Rule?

In order to meet the “substantial improvement” test, either the QOF, or the lower tier partnership owned by the QOF, must double their cost basis within 30 months of acquisition of the property.

11 What are Other Issues Regarding the Use of Working Capital?

A. Working Capital Safe Harbor only applies to, and helps, the lower tier partnership owned by the QOF and not the QOF itself.

If the QOF owns an interest in a lower tier partnership, the lower tier partnership, but not the QOF, can benefit from the working capital safe harbor if:

- i. The lower tier partnership has a written plan that designates that the funds are being held for the acquisition, construction and “substantial improvement” of tangible property or the development of a trade or business in the Zone.
- ii. The lower tier partnership has a written schedule for the planned use of working capital to be used for such purposes within 31 months after it receives the funds. The 31 month period can be extended for governmental inaction or delay.
- iii. The amounts are actually used in a manner that is substantially consistent with the designation and schedule.

12 Special Rules in Territories, Especially Puerto Rico.

Local entities are fine as long as they keep the same general tax structure contemplated by Code Section 1400Z. The LLC form of entity can be used in Puerto Rico but must make an election to be treated as a partnership in Puerto Rico by filing Form SC 6045 in Puerto Rico and Form 8832 with the IRS. House Bill 1544 signed by the Governor as Act 257 on 12/10/18, applicable to tax years beginning after December 31, 2018, provides that gain on the sale of partnership interests will be treated as Puerto Rico Source income to the extent a deemed sale of the partnership assets, regardless of the residence of the partner, would generate Puerto Rico source income (income from the sale of real estate in Puerto Rico would be Puerto Rico source income). 15% withholding tax could apply.

If Puerto Rico does not provide the same local law exemption for investors who invest in QOFs in Puerto Rico the investor could be required to pay a capital gains tax on the sale of the QOF interest at 15% of any gain.

However, Internal Revenue Code Sections 1400Z-1 and -2 will apply to investments in Puerto Rico opportunity zones.

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