WINSTON & STRAWN LLP

CLIENT ALERT

Opportunity Zone Funds Provide Fund Managers with a New Zone of Opportunity

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The “Tax Cuts and Jobs Act” of 2017 created new incentives for long-term private investment into certain qualified low-income communities throughout the United States that have been designated by the U.S. Treasury Department as Qualified Opportunity Zones (each a “Qualified Opportunity Zone”). On October 19, 2018, the Internal Revenue Service (the “IRS”) and the Treasury Department issued much needed proposed regulations (the “Proposed Regulations”) clarifying the rules regarding the establishment and operation of “qualified opportunity funds,” but leaving many issues unresolved. Qualified Opportunity Zones exist in every state and every major city has one or more Qualified Opportunity Zones.

Overview

The Qualified Opportunity Zone program allows taxpayers to roll their realized capital gains from the sale or exchange of any capital asset into a Qualified Opportunity Zone fund (“Qualified Opportunity Zone Fund”) and take advantage of three significant U.S. federal income tax benefits: (a) temporary deferral of tax on those capital gains; (b) permanent exclusion of up to 15% of those capital gains from their gross income; and (c) depending on how long their investment remains in the Qualified Opportunity Zone Fund, permanent exclusion of any gain from their investment in the Qualified Opportunity Zone Fund.

Specifically, a taxpayer that reinvests capital gains into a Qualified Opportunity Zone Fund during the relevant 180-day period can defer tax on those capital gains until the earlier of (i) the date on which the taxpayer’s investment in the Qualified Opportunity Zone Fund is sold or exchanged or (ii) December 31, 2026. If the taxpayer keeps the deferred gain in the Qualified Opportunity Zone Fund for at least 5 years, the basis of such investment is increased by 10% of the amount of the deferred gain. If the investment is retained for at least 7 years, the basis is increased by another 5% of the amount of the deferred gain. If the investment is retained until December 31, 2026, the deferred gain (as reduced for any increase in basis, as described above) would then need to be recognized as a realized capital gain for tax purposes. If the investment is held for 10 years, the basis of the taxpayer’s investment in the Qualified Opportunity Zone Fund can be stepped up to the fair market value on the date the investment is disposed of, which would result in all of such gain being tax-free.

The following example illustrates how the tax incentives work:

If a taxpayer realizes a gain of $1,000,000 from the sale of stock on January 1, 2019 and reinvests the $1,000,000 into a Qualified Opportunity Zone Fund prior to June 30, 2019, the taxpayer could defer the taxes owed on the $1,000,000 gain until the earlier of (i) the date on which the taxpayer's investment in the Qualified Opportunity Zone Fund is sold or exchanged or (ii) December 31, 2026. The taxpayer's initial basis in his investment in the Qualified Opportunity Zone Fund is $0. If the $1,000,000 deferred gain is left in the Qualified Opportunity Zone Fund for 5 years, the basis of the taxpayer's investment in the Qualified Opportunity Zone Fund steps up to $100,000 (i.e., a basis step-up equal to 10% of the $1,000,000 deferred gain). If the $1,000,000 deferred gain is left in the Qualified Opportunity Zone Fund for 7 years, the basis of the taxpayer's investment in the Qualified Opportunity Zone Fund steps up to $150,000 (i.e., a basis step-up equal to 15% of the $1,000,000 deferred gain). If the $1,000,000 deferred gain is left in the Qualified Opportunity Zone Fund until December 31, 2026, the taxpayer will owe taxes on the $1,000,000 deferred gain in 2026 of $850,000 (i.e., the $1,000,000 deferred gain less the step up in basis to $150,000). If the $1,000,000 deferred gain is left in the Qualified Opportunity Zone Fund for at least 10 years, and the taxpayer exits the Qualified Opportunity Zone Fund with a gain of $500,000 from the taxpayer's investment in the Qualified Opportunity Zone Fund (i.e., the fair market value of the taxpayer's interest in the Qualified Opportunity Zone Fund is $1,500,000), the taxpayer's basis in the Qualified Opportunity Zone Fund would be equal to $1,500,000, which would result in no additional taxable capital gain.

New Guidance

On October 19, 2018, the IRS released Proposed Regulations providing new guidance regarding the tax incentives for Qualified Opportunity Zones under Section 1400Z-2 of the Internal Revenue Code (the "Code"). Although the Proposed Regulations address many of the issues presented by the original legislation, some issues remain unresolved and will require additional guidance from the IRS, which is expected by the end of 2018. The key concepts of, and clarifications by, the proposed regulations are summarized below.

Eligible Taxpayers

The Proposed Regulations clarify that taxpayers eligible to elect deferral under 1400Z-2 are those that recognize capital gain for U.S. federal income tax purposes. These taxpayers include individuals, C corporations (including RICs and REITs), partnerships and certain pass-through entities, including common trust funds described in Code section 584, as well as qualified settlement funds, disputed ownership funds, and other entities taxable under Treasury Regulation Section 1.468B.

Special Rule for Partnerships

The Proposed Regulations provide special rules for the deferral of capital gain by a partnership or its partners. If the partnership elects to defer all or part of a capital gain to the extent of an eligible investment in a Qualified Opportunity Zone Fund, the rules provide that no part of the deferred gain will be taxed at the partner level in the year of the deferral. The partners would instead be taxed on the recognized gain upon the earlier of (i) the sale of the Qualified Opportunity Zone Fund interest by the partnership or (ii) December 31, 2026. If the partnership does not elect to defer its capital gain, each partner may elect to defer all or any portion of its allocable share of the gain to the extent that it satisfies all of the rules for eligibility under the Proposed Regulations (including that the sale or exchange did not arise with respect to a person that is related either to the partnership or to the partner) and makes an eligible investment in a Qualified Opportunity Zone Fund.

With respect to each partner, the 180-day investment period generally begins on the last day of the partnership's taxable year (and not the date on which the relevant asset is sold by the partnership), because that is the day on which the partner would be required to recognize the gain if the gain was not deferred. For example, if a partnership with a calendar tax year sells a capital gain asset on April 1, 2019 and does not make a deferral election, a partner in such partnership may invest its allocable share of the gain in a Qualified Opportunity Zone Fund during the 180-day period that begins on December 31, 2019. However, the Proposed Regulations alternatively allow a partner to invest its allocable share of the gain during the 180-day period beginning on the date that the partnership recognized the gain if the partnership does not itself elect to invest such gain in a Qualified Opportunity Zone Fund and the partner knows the date that the partnership recognized the relevant gain. To take advantage of this rule,

partners should consider requiring partnerships to provide appropriate notifications to partners for situations in which the partnership does not intend to elect to defer eligible gains.

The Proposed Regulations provide analogous rules to other pass-through entities (including S corporations, decedents' estates, and trusts) and to their shareholders and beneficiaries.

Eligible Capital Gains

While Code Section 1400Z-2(a) applies to gains from a sale or exchange of "any property" and is not expressly limited to gains from the sale or exchange of a capital asset, the Proposed Regulations clarify that only capital gains are eligible for deferral under Code section 1400Z-2(a). Furthermore, such capital gains must be gains that would have been recognized no later than December 31, 2026 (i.e., if the gains are recognized after December 31, 2026, they would not benefit from the Qualified Opportunity Zone tax incentives) and must be gains that did not arise from a sale or exchange with a related person.

Expiration of Qualified Opportunity Zone Designation

Prior to the new guidance, there was a question as to what might occur upon the loss of a Qualified Opportunity Zone designation. Specifically, the designations of all Qualified Opportunity Zones will expire on December 31, 2028, which raised the issue of whether, after the relevant Qualified Opportunity Zone loses its designation, investors may still make 10-year basis step-up elections for Qualified Opportunity Zone Fund investments that occur in 2019 or thereafter. The Proposed Regulations clarify that taxpayers are permitted to make the 10-year basis step-up election even after a Qualified Opportunity Zone designation expires. The ability to make that election is preserved until December 31, 2047, allowing for the potential to eliminate almost 30 years of investment appreciation in a Qualified Opportunity Zone Fund.

Treatment of Different Types of Contributions to Qualified Opportunity Zone Funds

If a taxpayer makes an investment in a Qualified Opportunity Zone Fund in which some amounts are subject to deferral and others are not, those amounts should be treated as separate investments. The Proposed Regulations clarify that deemed contributions under Code section 752(a) do not constitute an investment in a Qualified Opportunity Zone Fund and therefore do not result in a partner having a separate investment. Under Code section 752(a), an increase in a partner's share of liabilities is generally considered a contribution from the partner to the partnership.

Eligible Interests in Qualified Opportunity Zone Funds

The Proposed Regulations clarify that an eligible interest in a Qualified Opportunity Zone Fund must be an equity interest, including preferred stock or a partnership interest with special allocations. An eligible interest cannot be a debt instrument. Furthermore, provided that the eligible taxpayer is the owner of the equity interest for U.S. federal income tax purposes, status as an eligible interest is not impaired by the taxpayer's use of the interest as collateral for a loan, whether a purchase-money borrowing or otherwise.

Requirements for Qualified Opportunity Zone Funds

A Qualified Opportunity Zone Fund must be an entity that is classified as a corporation or partnership for U.S. federal income tax purposes that is created or organized in one of the 50 states, the District of Columbia, or a U.S. possession.[1] Both newly formed entities and existing entities that meet the relevant requirements are eligible to qualify. An eligible Qualified Opportunity Zone Fund is expected to self-certify as a Qualified Opportunity Zone Fund by filing new IRS Form, 8996, Qualified Opportunity Zone Fund, with its U.S. federal income tax return and indicating the month in which it intends to be treated as a Qualified Opportunity Zone Fund.

At least 90% of the Qualified Opportunity Zone Fund's investments must be in Qualified Opportunity Zone property; the remaining portion of the Qualified Opportunity Zone Fund's investments may be in any other asset. For purposes of this calculation, the Qualified Opportunity Zone Fund is required to use the "book" value of its assets as shown on its financial statements filed with the U.S. Securities and Exchange Commission or another U.S. federal agency (other than the IRS) that is prepared in accordance with U.S. GAAP or the value of its assets as prepared on

a certified financial statement prepared in accordance with U.S. GAAP. If the Qualified Opportunity Zone Fund does not have applicable financial statements, it must use the cost of its assets.

The Proposed Regulations provide a working capital safe harbor ("Working Capital Safe Harbor") that applies to cash and certain cash equivalents held by a Qualified Opportunity Zone Fund business, if the following conditions are met: (i) the Qualified Opportunity Zone Fund business designates the use of such working capital assets for the acquisition, construction, and/or substantial improvement of tangible property in a Qualified Opportunity Zone; (ii) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital asset that shows that the working capital assets will be spent within 31 months of the receipt by the business of the asset; and (iii) the working capital assets are actually used in a manner consistent with the written records described in clauses (i) and (ii). The Working Capital Safe Harbor should be particularly useful because it gives a Qualified Opportunity Zone Fund time to develop a property while still maintaining qualification as a Qualified Opportunity Zone Fund.

Compliance with the 90% asset test is determined by the average of the percentage of the Qualified Opportunity Zone property held in the Qualified Opportunity Zone Fund measured on the last day of the first 6-month period of the taxable year of the Qualified Opportunity Zone Fund and on the last day of the taxable year of the Qualified Opportunity Zone Fund. The Proposed Regulations provide that the phrase "first 6-month period of the taxable year of the fund" means the first 6 months each of which is in the taxable year and in each of which the entity is a Qualified Opportunity Zone Fund. For example, if a calendar-year entity that was created in February chooses April as its first month as a Qualified Opportunity Zone Fund, then the 90% asset testing dates for the Qualified Opportunity Zone Fund are the end of September and the end of December. Moreover, if the calendar-year Qualified Opportunity Zone Fund chooses a month after June as its first month as a Qualified Opportunity Zone Fund, then the only testing date for the taxable year is the last day of the Qualified Opportunity Zone Fund's taxable year.

If a Qualified Opportunity Zone Fund is unable to satisfy the 90% asset test, it will be subject to a penalty for each month until it is able to satisfy the test, unless the inability to satisfy the test can be shown to be due to reasonable cause.

Qualified Opportunity Zone Property

There are three types of property that may be deemed to be Qualified Opportunity Zone property:

- Stock in a domestic corporation if (i) such stock is acquired by the Qualified Opportunity Zone Fund on or after January 1, 2018, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash; (ii) as of the time such stock was issued, such domestic corporation was a Qualified Opportunity Zone business (or was organized to be a Qualified Opportunity Zone business if it is a newly formed entity) and (iii) during substantially all of the Qualified Opportunity Zone Fund's holding period for such stock, such domestic corporation qualified as a Qualified Opportunity Zone business.

- A partnership interest (e.g., a capital interest or a profits interest) in a domestic partnership if (i) such interest is acquired by the Qualified Opportunity Zone Fund on or after January 1, 2018, from the partnership solely in exchange for cash; (ii) as of the time such interest was acquired, such partnership was a Qualified Opportunity Zone business (or was organized to be a Qualified Opportunity Zone business if it is a newly formed entity) and (iii) during substantially all of the Qualified Opportunity Zone Fund's holding period for such interest, such domestic partnership qualified as a Qualified Opportunity Zone business.

- Business property (i.e., tangible personal property that is used in a trade or business) if (i) such property was acquired by the Qualified Opportunity Zone Fund from an unrelated party on or after January 1, 2018; (ii) the original use of such property in the Qualified Opportunity Zone commences with the Qualified Opportunity Zone or the Qualified Opportunity Zone Fund substantially improves the property; and (iii) during substantially all of the Qualified Opportunity Zone Fund's holding period for such property, substantially all of the use of such property was in a Qualified Opportunity Zone. With respect to clause (ii), a substantial improvement means that the additions to the basis of the property during the 30-month period commencing on the acquisition date must exceed the adjusted basis of the property as of the acquisition date. The Proposed Regulations provide that, for

purposes of the substantial improvement test, the basis attributable to land on which a building sits is not taken into account in determining whether the building has been substantially improved. For example, if property was acquired in a Qualified Opportunity Zone for $1,000,000, and $400,000 of that cost was allocated to an existing building and $600,000 of that cost was allocated to land, the property would qualify as Qualified Opportunity Zone business property if the Qualified Opportunity Zone Fund incurs at least $400,000 in costs that are properly capitalized into the basis of the building within the 30-month period beginning on the date that the property was acquired by the Qualified Opportunity Zone Fund.

A Qualified Opportunity Zone business is a business that satisfies the following criteria:

- substantially all[2] of the tangible property owned or leased by the taxpayer is a Qualified Opportunity Zone business property;
- at least 50% of the total gross income of such entity is derived from the active conduct of such business (including income derived from property that meets the Working Capital Safe Harbor);
- a substantial portion of the intangible property of such taxpayer is used in the active conduct of any such business (such use requirement is treated as satisfied during periods in which the business is proceeding in a manner that is substantially consistent with the Working Capital Safe Harbor);
- less than 5% of the average of the aggregate unadjusted bases of the property is attributable to nonqualified financial property (i.e., debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property specified in regulations but excluding property that meets the Working Capital Safe Harbor); and
- the business is not a specifically excluded business, such as a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store where the principal business is the sale of alcoholic beverages for consumption off-premises.

Next Steps

The Proposed Regulations address many of the open questions from the original legislation. While we are still waiting on additional guidance from the IRS, we believe that the original legislation along with the proposed regulations provide enough information for fund managers to structure Qualified Opportunity Zone Funds and Qualified Opportunity Zone investments.

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[1] If an entity is organized in a U.S. possession but not in one of the 50 states or in the District of Columbia, then it may be a Qualified Opportunity Zone Fund only if it is organized for the purpose of investing in Qualified Opportunity Zone property that relates to a trade or business operated in the possession in which the entity is organized.

[2] To satisfy the requirement that "substantially all" of the tangible property owned or leased by the taxpayer must be Qualified Opportunity Zone business property, the Proposed Regulations provide a bright-line rule that, if at least 70% of the taxpayer's tangible property is Qualified Opportunity Zone business property, the taxpayer satisfies this "substantially all" test.

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