2019 MIDYEAR TAX MEETING
Tax Bridge on the Road
The Essentials of Opportunity Zones Funds

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Panelists:
Kelley C. Miller, Reed Smith LLP, Washington, DC;
Richard C. LaFalce, Morgan, Lewis & Bockius LLP, Washington, DC
Qualified Opportunity Zone Fund Agenda

• Background on Qualified Opportunity Zones
• Tax Benefits from Investing in Qualified Opportunity Zone Funds
• Background on Qualified Opportunity Zone Funds
• The Ins and Outs of Qualified Opportunity Zone Businesses
Background on Qualified Opportunity Zones
What is a Qualified Opportunity Zone?

• A Qualified Opportunity Zone (QOZ) is a census tract selected by the Governors of individual states (and approved by the Treasury) that meets a definition of a “low-income community” for purposes of encouraging investment in such QOZs.

• Represents roughly 11% of the U.S.

• There are approximately 8,700 QOZs, which are located in every state, DC, Puerto Rico, and the Virgin Islands.

• The US Treasury’s Community Development Financial Institutions (CDFI) Fund website maintains the full list of QOZ designations and accompanying map: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx
# Investing in Qualified Opportunity Zone Fund

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<td>1</td>
<td>Investor recognizes capital gain</td>
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<td>2</td>
<td>Investor invests capital gain in a Qualified Opportunity Zone Fund (QOF)</td>
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<td>3</td>
<td>QOF makes investment in:</td>
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<td>• property or certain businesses located in Qualified Opportunity Zones</td>
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Tax Benefits from Investing in Qualified Opportunity Zone Funds
Overview of Tax Benefits of Investing In Qualified Opportunity Zone Funds

• Three new significant tax advantages to taxpayers that invest their capital gain in a Qualified Opportunity Fund (QOF):
  
  (1) For any capital gain recognized by a taxpayer that is invested within 180 days into a QOF (the “Deferred Gain”), such gain can be deferred until the earlier of December 31, 2026, or disposition of the taxpayer’s interest in the QOF.
  
  (2) If an investor holds its interest in a QOF for at least 5/7 years, their basis in the QOF is increased by 10%/15%, such that they recognize 10/15% less of the Deferred Gain.
  
  (3) If an investor holds its interest in a QOF for at least 10 years, their interest in the QOF is stepped-up to FMV on disposition, such that any gain recognized by the investor attributable to its investment of Deferred Gain in the QOF is effectively eliminated.

• Facts:
  
  • Investor (X) holds a limited partnership interest in private equity fund (Y).
  
  • Y disposes of an asset during the year and X is deemed to received its distributive share of the $2 million of capital gain on December 31, 2018 (i.e., the last day of Y’s calendar year).
  
  • X takes $3 million of cash on hand (or borrows such cash) and contributes such cash for an equity investment in a QOF by June 29, 2019 (i.e., within 180 days of recognition of such gain) and makes an election to roll such gain into the QOF.
  
  • X has a basis in the QOF equal to $1 million (not $3 million; the $2 million of Deferred Gain creates no basis).

• Note:
  • X can invest more or less than its gain in a QOF.
  • X can also spread its gain amongst multiple QOFs.
  • X does not need to roll the proceeds of a sale into QOF; it just needs gain.
  • Gain that was previously deferred via investment into a QOF could be rolled into another QOF within a reasonable time, provided the entire amount of such gain is rolled.
  • In this example, Fund Y does not make an available election to roll the partnership’s gain into a QOF; rather Fund Y permits its LPs to make the election with respect to their distributive share of capital gain.
    • Note: as an alternative, Fund Y could make the gain deferral election with respect to the entire partnership-level gain; however, this would create administrative burdens associated with entering and exiting partners.
Example (Pt. 3 of 3): Mechanics of Recognition of the Deferred Gain

- For illustration, assume there is no change in the value of the QOF:

<table>
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<tr>
<th>X sells its QOF interest after holding its investment for less than 5 years</th>
<th>X holds its QOF interest for more than 5 years but less than 7 years</th>
<th>X holds its QOF interest for more than 7 years</th>
</tr>
</thead>
</table>
| • X recognizes the full amount of the Deferred Gain (assuming the sales proceeds exceed the Deferred Gain) at the time of sale. | • X receives a special 10% basis step-up on the $2 million Deferred Gain.  
   • Thus, if X later sells its QOF interest (or is allocated capital gain within 5-7 years), X recognizes only 90% of the Deferred Gain (assuming the sales proceeds exceed the Deferred Gain) at the time of sale. | • X receives a special 15% basis step-up on the $2 million Deferred Gain.  
   • Thus, if X later sells its QOF interest (or is allocated capital gain after 7 years), X recognizes only 85% of the Deferred Gain (assuming the sales proceeds exceed the Deferred Gain) at the time of sale. |
| • Same result if X allocated capital gain within 5 years. | | |

- If X still holds its interest in QOF on December 31, 2026 (the end of the deferral period), X recognizes the Deferred Gain as adjusted by the applicable step-up in basis.
Mechanics of the Exclusion of Appreciation for a 10-year investment in a QOF

• Assuming X invested in a QOF on January 1, 2019 and holds its interest in the QOF until at least January 1, 2029 (min. 10-year holding period):
  • The portion of the appreciation attributable to the Deferred Gain is tax-free upon disposition.
  • This means that only the appreciation attributable to the $2 million of Deferred Gain is available for the exclusion.
  • Any appreciation attributable to the regular $1 million capital contribution is not eligible for the exclusion.
  • Gain allocated to an investor in a QOF is not eligible for the 10-year exclusion.
Mechanics of the Exclusion of Appreciation for a 10-year investment in a QOF
Additional Tax Considerations For Investing in a QOF

- **Operating Income** (e.g., rental income, dividends, etc.) from the underlying QOF’s investments are subject to tax under traditional tax rules.
  - In the case of a QOF taxed as a partnership, such operating income flows through to the limited partners of the QOF on their Schedule K-1.
  - In the case of QOF taxed as a corporation, such income is taxed at the 21% tax rate, before being distributed to the QOF’s shareholders as dividends.

- **Basis Considerations:** The investor in a QOF initially takes a $0 basis on the Deferred Gain rolled into a QOF. Such basis is increased at the time the investor recognizes the Deferred Gain.
  - A QOF organized as a partnership may limit an investor’s ability to utilize net losses of the QOF.
Additional Tax Considerations For Investing a QOF –cont’d.

• QOF Sales of Assets:
  • In theory, prior to December 31, 2026, the QOF could elect to reinvest such assets in another QOZB or QOZBP to defer such gain.
  • Alternatively, the limited partners in the QOF could re-invest their distributive share of the capital gain allocated to them by the QOF prior to December 31, 2026.

• Exiting a QOF prior to December 31, 2026:
  • An investor that recognizes gain (i.e., holds its interest in a QOF less than 10 years) can reinvest such gains prior to December 31, 2026 into another QOF.
Background on Qualified Opportunity Zone Funds
What is Qualified Opportunity Fund?

• A Qualified Opportunity Fund (QOF) is:
  • An entity classified as a partnership or corporation for tax purposes.
  • >90% of the fund’s assets must be QOZ business (QOZB) equity (capital or profits) interests or QOZ business property (QOZBP).

*while the QOF could hold QOZBP directly, we anticipate that most investors will use a two-tier structure (see slide 23)
How is the 90% Test Applied?

• With respect to QOZB equity interests:
  • QOZB equity must be acquired by the fund after December 31, 2017 in an original issuance solely in exchange for cash.
  • The business must have been a QOZB (or in the case of a new business, be organized for the purposes of being a QOZB) at the time the QOF acquired the QOZB stock.
  • Note: an investment in another QOF is not an eligible investment (i.e., it does not qualify as a QOZB equity interest).

• Generally tested twice a year, but can average results for the year.

• A QOF self-certifies satisfaction of the 90% Test on new IRS Form 8996.

• Failure to comply with the 90% Test (without reasonable cause) results in a penalty tax—it’s unclear under the new rules whether failure could lead to disqualification; additional guidance is forthcoming.
The Ins and Outs of Qualified Opportunity Zone Businesses
Qualified Opportunity Zone Businesses

A QOZB is generally a domestic trade or business other than certain “sin” businesses (i.e., massage parlor; gambling; liquor store; golf course; sun-tanning, country club; race track; hot tub facility) with the following characteristics:

<table>
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<tr>
<th>Income</th>
<th>Assets</th>
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<tr>
<td>• ≥50% of its gross income must be derived from the active conduct of the trade or business in the QOZ</td>
<td>• A substantial portion of the business’ intangible property is used in active conduct of the trade or business</td>
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<td>• &lt;5% of the average aggregate unadjusted bases of the business’ property is attributable to nonqualified financial property (e.g., stocks, bonds, and certain other financial property other than certain amounts of working capital assets), but there is a working capital safe-harbor (discussed later).</td>
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<td>• Substantially all (&gt;70%) of the property owned or leased by the business in a QOZ is tangible property that is QOZBP</td>
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What is Qualified Opportunity Zone Business Property?

<table>
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<tr>
<th>If Property Not Yet Used/Located in QOZ</th>
<th>If Property Already Used/Located in QOZ</th>
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<tr>
<td>• Original use in QOZ commences with the business.</td>
<td>• The business substantially improves the property</td>
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<td>o Within a 30-month period after acquiring the property, improvements equaling at least the cost basis of the property at the beginning of the 30-month period are made (“doubling down”).</td>
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<tr>
<td></td>
<td>o You get to exclude basis of land from such calculation and you do not have to improve land.</td>
</tr>
<tr>
<td>• Substantially all of its use is in a QOZ for substantially all of the time period held by the business.</td>
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<tr>
<td>o “Substantially all” is undefined under the rules</td>
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<tr>
<td>• “Purchased” within the meaning of Section 179(d)(2) after December 31, 2017</td>
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<tr>
<td>o Not acquired from certain related parties or between certain members of the same controlled group</td>
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<tr>
<td>o The basis of the property isn’t determined in whole or part by the adjusted basis in the hands of the transferor or under Section 1014(a) (FMV step-up in basis upon death of transferor)</td>
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<tr>
<td>• Must be tangible property used in the trade or business</td>
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Working Capital Safe Harbor

• An exception in the rules provides a safe harbor for a reasonable amount of cash, cash equivalents, or debt treated as “working capital”, provided that certain requirements are met:
  
  • The amount is designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ;
  
  • There is a written schedule that is consistent with the ordinary start-up of a trade or business for the expenditure of the working capital (and the working capital assets must be spent within 31 months); and
  
  • The working capital assets are used in a manner substantially consistent with the two requirements above.
Working Capital Safe Harbor (cont’d)

- If the working capital assets satisfy the Working Capital Safe Harbor:
  - The working capital assets are not treated as non-qualified financial property for purposes of the QOZB test;
  - Any gross income derived by the working capital assets is counted toward the requirement that 50% of the business’ gross income is derived from the active conduct of a trade or business;
  - The substantial use of the intangible property requirement is satisfied during any period in which the business is proceeding in a manner substantially consistent with the Working Capital Safe Harbor; and
  - If the tangible property to be acquired, constructed, or substantially used under the written plan would satisfy the QOZBP test when completed, it will not be treated as failing such test, because the scheduled consumption of working capital is not yet complete.
QOF holding QOZBP Directly vs Utilizing First-Tier QOZB

- Assume QOF has $50 million in assets.

<table>
<thead>
<tr>
<th>Direct investment in QOZBP</th>
<th>QOF invests through QOZB</th>
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<tr>
<td>• In order to satisfy the 90% test the QOF must purchase at least $45 million of QOZBP.</td>
<td>• In order to satisfy the 90% test the QOF must invest at least $45 million in equity of a QOZB.</td>
</tr>
<tr>
<td>• The remaining $5 million could be held in cash or other non-qualifying property.</td>
<td>• The QOF could hold the remaining $5 million in cash or other non-qualifying property.</td>
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<tr>
<td>• Working capital safe-harbor does not apply to deployment of QOF assets directly.</td>
<td>• The QOZB in turn must purchase at least $31.5 million of QOZBP (i.e., 70% of $45 million).</td>
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<td>• The QOZB could then hold $2.25 million in cash (i.e., 5% of $45 million) and $11.25 million in non-qualifying tangible assets.</td>
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<td>• QOZB may utilize the working capital safe-harbor to deploy its assets.</td>
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Challenges for Certain Businesses

- It may be difficult for an existing operating business to satisfy the requirement that ≥70% of the property owned or leased by the business is QOZBP at the time of the fund’s investment.
  - Any tangible property acquired prior to January 1, 2018 will not count toward the 70% QOZBP requirement.
  - Compare the requirements for a new business, which merely needs to be organized for the purpose of being a QOZB at the time the QOF acquired the QOZB stock.

- Service businesses may face particular challenges, because the 70% test applies to all tangible property that is owned or leased by a purported QOZB, but leased property does not appear to qualify as QOZBP.
  - Example: Pizza Parlor, LLC rents space in a QOZ from Landlord. As the statute is structured, the leased real property would not count as QOZBP for Pizza Parlor, LLC, because it did not acquire the property by purchase and its original use in the QOZ was not with Pizza Parlor, LLC. However, the leased property would be considered tangible property factoring into the denominator for purposes of the 70% QOZBP test.
ADDITIONAL OBSERVATIONS AND QUESTIONS
THANK YOU