Qualified Opportunity Funds And Affordable Housing

NIXON PEABODY

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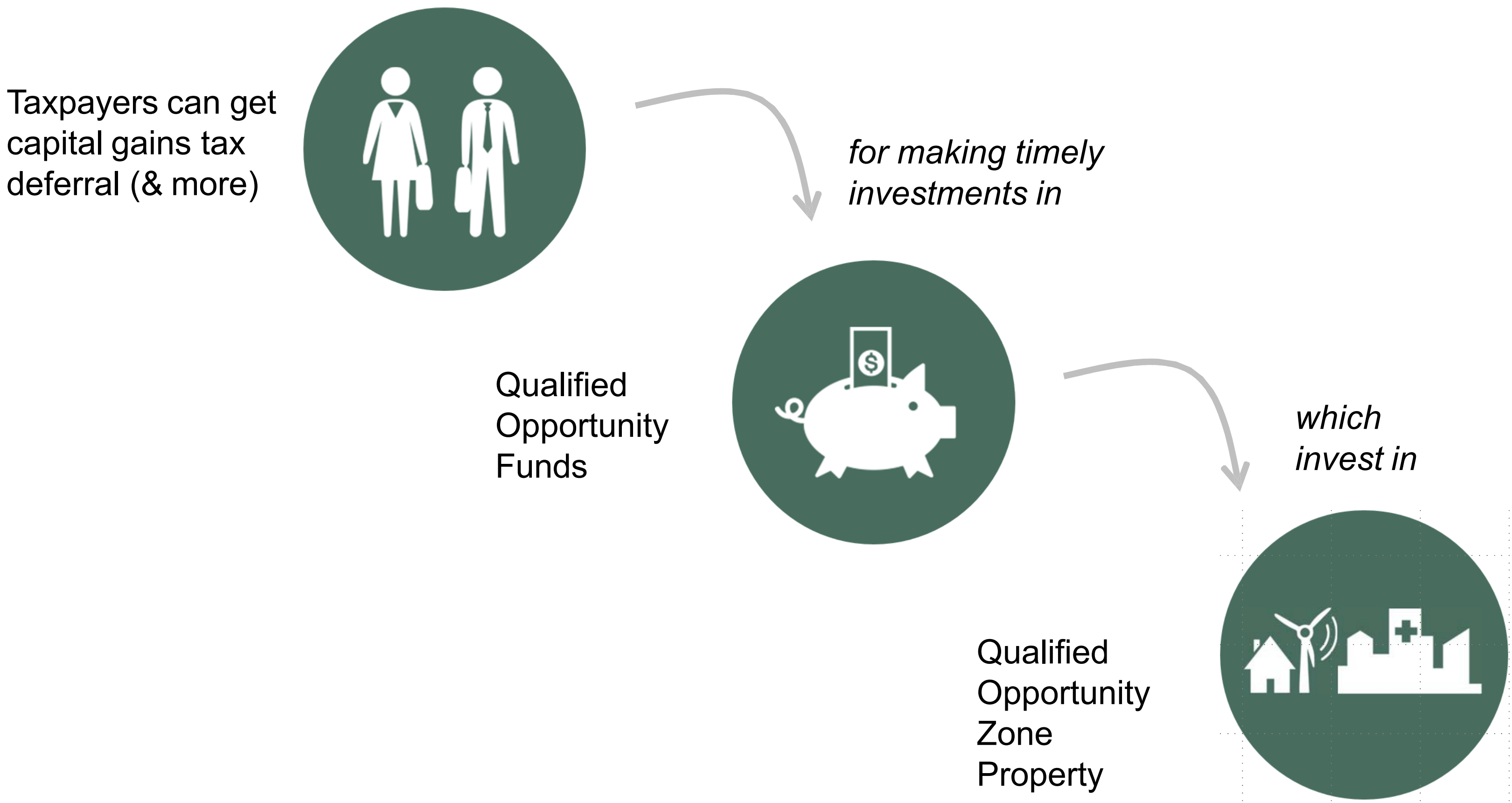

Taxpayers can get capital gains tax deferral (& more)
for making timely investments in
Qualified Opportunity Funds
which invest in
Qualified Opportunity Zone Property

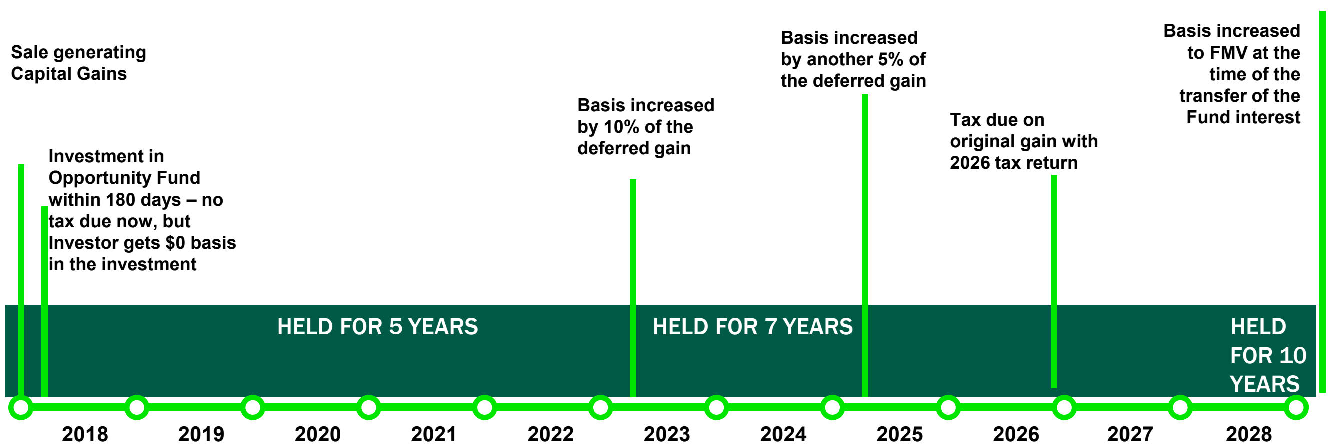
1. What are the basic benefits?

1. **Gain Deferral** – Investing capital gains in a Qualified Opportunity Fund ("O-Fund") delays the tax owed on those gains until December 31, 2026 (unless you sell your investment earlier). (But you have a $0 basis in your investment.)

2. **Partial forgiveness** – You receive a "step up in basis" to 10% after 5 years and to 15% after 7 years.

3. **Forgiveness of additional gains** – After 10 years, your basis goes to 100% of the FMV
   - Woo hoo, no tax! – except you still had to pay tax on the original gain in 2026
   - Basis = FMV for sales of the interest in the fund (not the fund's assets)

2. Timeline


Sale generating Capital Gains
Investment in Opportunity Fund within 180 days – no tax due now, but Investor gets $0 basis in the investment
Basis increased by 10% of the deferred gain
Basis increased by another 5% of the deferred gain
Tax due on original gain with 2026 tax return
Basis increased to FMV at the time of the transfer of the Fund interest
HELD FOR 5 YEARS
HELD FOR 7 YEARS
HELD FOR 10 YEARS
2018
2019
2020
2021
2022
2023
2024
2025
2026
2027
2028

3. Where are Opportunity Zones?

- OZs are 25% of a state’s “low-income communities” (“LICs”) as designated by the governor. The designation period is OVER.
- There are 8,700 OZs; about 11% of all census tracts.
- Full list of opportunity zones can be found on the CDFI Fund’s website: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

4. Fund Formation

- A Qualified Opportunity Fund is an investment vehicle set up for investing in eligible property that is located in a Qualified Opportunity Zone.
- Self-certified by filing a form with the IRS
- Investment must be acquired after December 31, 2017
- An Opportunity Fund must be taxed as a Corporation or Partnership.
  - Can include LLCs, if taxed as one of these (So: not a single-member LLC).
  - Note that a “fund” does not have to be formed by a broker; it can be a simple partnership with two friends or family members.

5. Qualified O- Zone Business

- A trade or business in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property

- See your tax professional.

- Pretty broad, but:
  - Not a “sin business”
  - Not lending

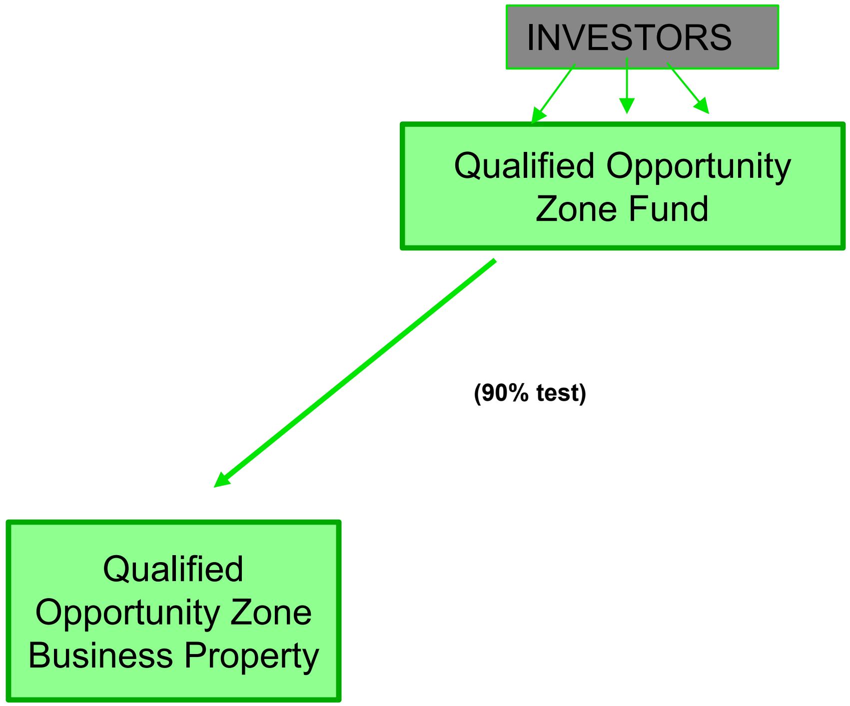
6. Capital Gains

- Tax benefits are for capital gains. Not ordinary income.
- The tax benefits only apply to the investment of the capital gains.
  - If the taxpayer invests more than this amount, then it must keep track of the excess as if it was a separate investment and it does *not* qualify for any of the tax breaks.
  - In particular, it does not qualify for the no-tax-after-a-ten-year hold rule.

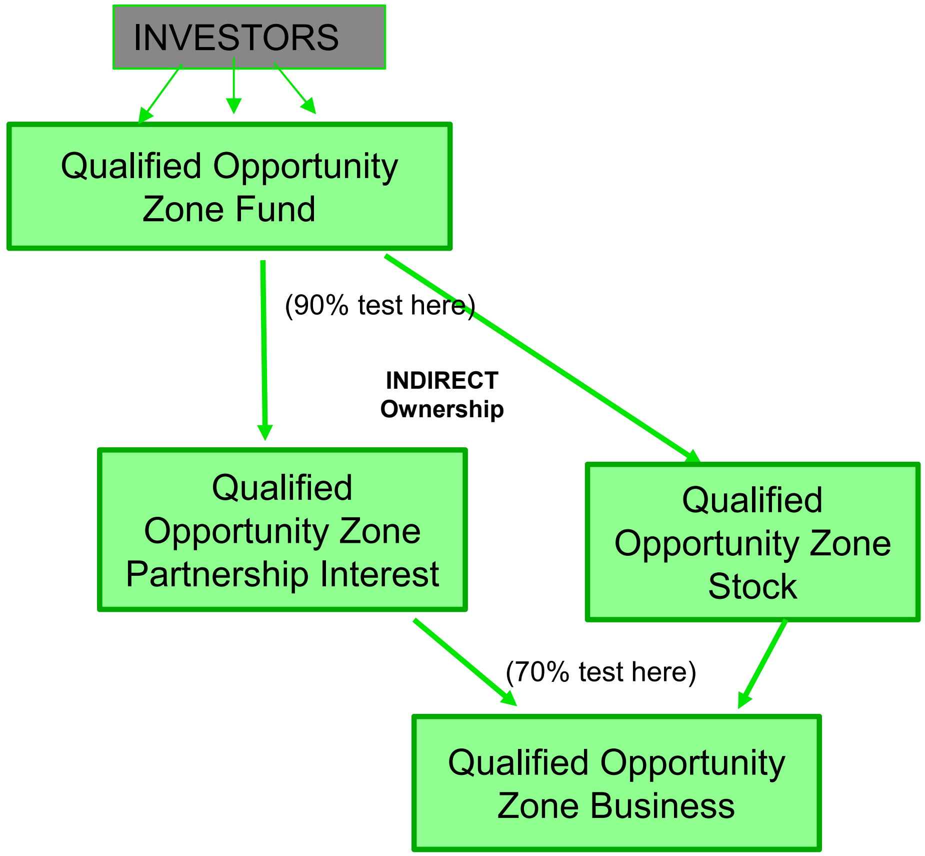
7. Direct vs. Indirect Ownership

- You’re incentivized to own the assets through an indirect structure.
- If the O-Fund owns the assets directly, 90% of its assets must be Qualified Opportunity Zones assets. (There are 6-month and year end testing dates)
- If the O-Fund uses the indirect structure, the test is easier: at least 70% of the subsidiary entity’s assets must qualify.
- See your tax professional.

Direct ownership structure



Indirect ownership structure



Key Concepts:
8. Substantial Improvement Test

- O-Fund investment in property must be for its “original use” (eg, new construction)
- **Substantial Improvement Test:** If not the original use, O-Fund must invest an amount equal to the acquisition price w/in 30 months (eg, acq/rehab)
  - Cost of land is excluded.
  - Example: Fund acquires property for $5M, consisting of $1M of land and $4M of building. It must have capital expenditures with respect to the project of $4M.

Key Concepts:
9. 31-month safe harbor

— You may hear folks talking about a 31-month safe harbor and worrying about having a “written plan” for rehab

- The Opportunity Fund is not supposed to have cash on hand, it’s supposed to invest it and put it work improving life in the Opportunity Zone
- But what if you need cash to rehab the property?
- This safe harbor gives you 31 months to complete the rehab.

Key Concepts:
10. Related parties

There is a strict related party test – 20% limit

Topics we would discuss if we had all day (come geek out with me after)

- **Pricing. It's Low.**
- **Can you combine Opportunity Zones and LIHTCS?**
  - Yes, but they should be the same fund.
  - There might be a play for the GP to be the O-Fund (but of questionable value)
  - Tough because you have to figure out multiple equity installments, the 100% basis step up isn't really valuable (yet!) & for acq/rehab, must stay within 20% (plus the substantial improvement test)
- **Using Opportunity Zones as gap filler instead of LIHTCs.**
  - I'm talking to you, FHA lenders – RAD, RAD for PRAC…!!

Recap of Key Timing Concepts

- Must invest capital gains in an Opportunity Fund within 180 days
- Can't own the investment before December 31, 2017
- Tax on original capital gains due December 26, 2026
- Step up in basis at 5 years, 7 years, 10 years
- 6 months / year-end: test dates when O-Fund must have 90% of its assets in Qualified Opportunity Zone Property
- 30 months: deadline for Substantial Improvements Test
- 31 months – safe harbor deadline for rehab according to a written plan (allowing for having cash-on hand)

References

— 26 USC §1400z-1 (rules for designating the Ozs)
26 USC §1400z-2 (rules for Opportunity Funds)

— The Treasury has released one round of proposed Regs: https://www.govinfo.gov/content/pkg/FR-2018-10-29/pdf/2018-23382.pdf and one Revenue Ruling 2018-29, https://www.irs.gov/pub/irs-drop/rr-18-29.pdf

— There are also FAQs at https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions

— Further Regs are expected soon.

— Even with the Code provision and the other guidance, the rules have lots of holes and uncertainties.

QUESTIONS?

Call me, let's geek out on this stuff!

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