Opportunity Zones: A Remarkable Opportunity

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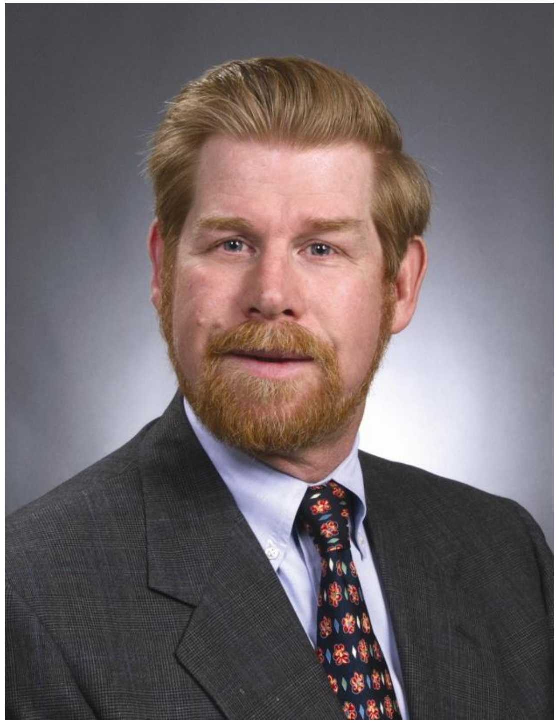

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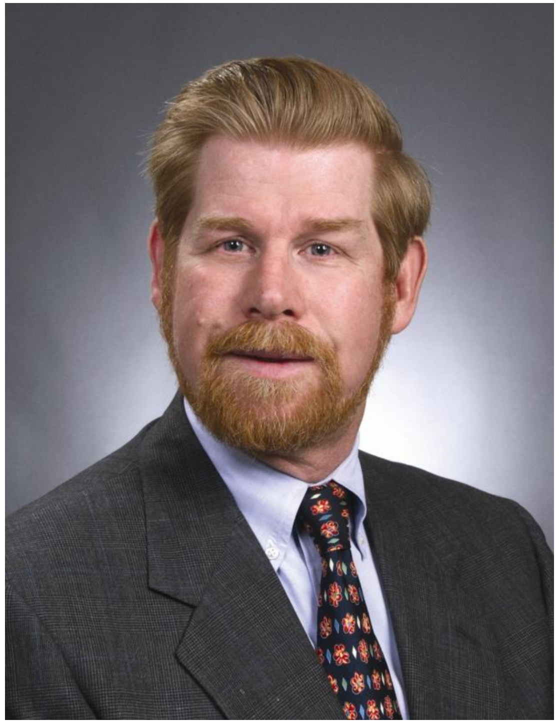

A. Introduction

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- Qualified Opportunity Zones were added to the Internal Revenue Code by the 2017 Tax Cuts and Jobs Act (The "2017 Tax Act")– and almost immediately thereafter became part of the American tax vernacular.
- The relevant provisions of law are found is in the very peculiarly numbered Internal Revenue Code ("Code") §§ 1400Z-1 and 1400Z-2.
- These new provisions are a BIG DEAL.
- What they create, for the first time since 1986, is an entirely legal (in fact, actively encouraged) form of tax-favored investment (also known in common parlance as a "tax shelter") that is both legal and wholly accessible by all U.S. taxpayers. Literally *everyone* can take advantage of this new opportunity.

A. Introduction

- The basic concept underlying Opportunity Zones is that US taxpayers with built-in gain in capital investments in other sectors of the economy will be encouraged to redeploy these capital investments into designated low-income areas by offering tax incentives.
- Curiously, the tax benefits are only extended to a reinvestment of "gain recognized from the sale to, or exchange with, an unrelated person of any property held by the taxpayer…".
- A taxpayer can also invest other (non-gain) funds but these will not enjoy the tax benefits accorded to "gain." Eligible gain means only "capital gain" (as suggested by the title to Code § 1400Z-2) and confirmed by recent IRS guidance.

A. Introduction

- A taxpayer who timely reinvests capital gain from a sale of property into a "Qualified Opportunity Fund" ("Fund") can enjoy the following tax benefits:
  - Deferral: Gain on a property sale that is invested in a Fund is deferred until the earlier of the date that the taxpayer sells its interest in the Fund or December 31, 2026.
  - Basis Adjustment: If the taxpayer maintains investment in the Fund for at least 5 years, 10% of the original gain is added to outside tax basis; if the investment lasts for at least 7 years, an additional 5% (for a total of 15%) of the original gain is added to outside tax basis in the Fund.
  - Appreciation Exclusion: Best of all, if the taxpayer maintains investment in the Qualified Opportunity Fund for at least 10 years, all appreciation in the investment will be tax-free on sale of the taxpayer's interest in the Fund.

A. Introduction

- Who can potentially benefit from this new tax incentive? Literally any US taxpayer. Potential beneficiaries include:
  - Individuals or corporations looking to reinvest gains from sales of property in order to defer and reduce taxes and/or to enjoy tax-free investment returns;
  - Real estate developers and start-up companies located in an Opportunity Zone who are looking for equity investment; and
  - Real estate sponsors, syndicators and/or private equity funds looking to create Opportunity Funds and then make investments in Qualified Opportunity Zone Property, including investments in corporations, partnerships or direct investments in property.

B. What Is an Opportunity Zone?

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- The rules defining the "designation" of Opportunity Zones are set forth in Code § 1400Z-1.
- An Opportunity Zone is a United States population census tract that qualifies as a "low-income community" under specified income criteria and that is nominated for designation as a "qualified opportunity zone" by the by the governor of each state (or by the mayor of Washington DC) and then certified by the US Treasury.
- In early 2018, eligible census tracts were nominated by the "chief executive officer" of each state, which means the governor of a state or the mayor of the District of Columbia. It appears that the IRS certified all census tracts nominated.

B. What Is an Opportunity Zone?

- Census tracts are not a familiar geographic region to anyone – except maybe a census taker. Fortunately, a map of the Opportunity Zones is now available on line.
- This link is to the information page. The 4th bullet is for the map of all designated QOZs. https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx
- This is the link to the map. On the very right side of the page you need to select the **layers** tab and **then make sure the only boxes checked are the opportunity zone tract and state**. Next to the opportunity zone tract it should also say “designated”. When you zoom into the map anything highlighted in blue has been designated and approved by Treasury. https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml

C. What Is an Opportunity Fund?

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- In order to enjoy the tax benefits available under the Opportunity Zone legislation, a taxpayer must invest the applicable “gain” into a “Qualified Opportunity Fund” (herein a “Fund” or a “QOF”) during the 180-day period beginning on the date the gain is recognized.
- If a successful investment is made, the taxpayer’s gross income for the taxable year shall not include so much of such gain as does not exceed the aggregate amount invested by the taxpayer.
- In addition, the taxpayer can potentially enjoy the full set of tax benefits, including deferral of gain, favorable adjustments to tax basis at five and seven years, and a permanent exclusion of gain recognized on the sale of the investment in the QOF at ten years.

C. What Is a Qualified Opportunity Fund?

- A QOF can be either a corporation or partnership that is organized for the purpose of investing in ’qualified opportunity zone property” (but specifically excluding another QOF) and that holds at least 90% of its assets in such qualified property, as determined by averaging the ownership percentages at the mid-point and last day of the QOF’s taxable year.
- An LLC can qualify as a QOF so long as it is characterized as either a corporation or partnership for federal income tax purposes.
- QOFs that fail to achieve the required minimum investment objectives are subject to penalty, but apparently are not disqualified from QOF status.

C. What Is an Opportunity Fund?

- A QOF can invest in a wide variety of eligible investments, so long as the investment is in "Qualified Opportunity Zone Property."
- Eligible investments include property which is:
  - Qualified Opportunity Zone Stock
  - Qualified Opportunity Zone Partnership Interest
  - Qualified Opportunity Zone Business Property
- These investment requirements are highly technical and are reviewed in greater detail, below.

C. What Is an Opportunity Fund?

- However, as an initial introduction, we will find that eligible QOF investments can include:
  - Direct investment in property, such as real estate, that is used in a trade or business operated by the QOF in an Opportunity Zone (e.g., residential, commercial, or mixed use real estate developments); or
  - Investment in a start-up business (which can be either a corporation or a partnership) where substantially all (at least 70%) of the tangible assets of such business are used in the Opportunity Zone.
- Again, the specific requirements for eligible investments are reviewed in careful and technical detail, below.

D. How Do the Tax Benefits Work?

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- The three tax benefits that can be enjoyed from investing in a QOF include the following:
  - 1. Temporary Deferral of Gain. The new law allows taxpayers to exclude capital gains from sales of property to the extent such gains are invested in a QOF within 180 days from the date the applicable gain is realized. The taxation of the reinvested gain is deferred until the earlier of (i) the date the investment (QOF) is sold or (ii) December 31, 2026.
  - 2. Adjustments to Tax Basis. If the QOF investment is held for 5 years, the tax basis in the investment is increased by an amount equal to 10% of the deferred gain amount. If the investment in the QOF is held for 7 years, the tax basis is increased by an additional 5% (a total of 15%) of the deferred gain amount.

D. How Do the Tax Benefits Work?

- 3. Permanent Exclusion of Investment Gain. Third, and best of all, if the taxpayer holds the QOF investment for at least 10 years, taxpayer can make an election to adjust tax basis in the QOF investment to fair market value, with the result that no gain will be recognized when the investment is sold or exchanged.
- Note that this non-recognition rule applies to all appreciation in the QOF investment following investment but does not apply to the original deferred gain, which deferred gain will be recognized no later than December 31, 2026 under the first rule noted above.
- Because the tax basis adjustment is elective, a taxpayer selling at a loss can simply not make an election and can claim the loss under the usual rules.

D. How Do the Tax Benefits Work?

- The following highly simplified examples illustrate the tax benefits of investing in a QOF. Deferred gain is $100 and appreciation in the QOF investment is also $100 – it is NOT the same $100.
- Example 1. *Investment in Fund is Held for 10 Years and Sold in 2028*

Opportunity Zone Investment Held for at Least 10 Years			Ordinary Investment		Difference	
Deferred Gain (taxed in 2026)	$100.00		Gain (taxed in 2018)	$100.00		
Basis Step-Up	$15.00		Basis Step-Up	$0.00		
Taxable Gain	$85.00		Taxable Gain	$100.00		
Tax (at 23.8%)	$20.23		Tax (at 23.8%)	$23.80	$3.57	
Gain on Disposition of Investment in Fund	$100.00		Gain on Investment	$100.00		
Basis Step-Up	$100.00		Basis Step-Up	$0.00		
Taxable Gain on Disposition of Investment in Fund	$0.00		Taxable Gain	$100.00		
Tax (at 23.8%)	$0.00		Tax (at 23.8%)	$23.80	$23.80	
					$27.37	**TOTAL**

D. How Do the Tax Benefits Work?

- As a result of holding an investment in a QOF for 10 years, and assuming the investment in the Opportunity Fund doubles (i.e., enjoys 100% appreciation) over the 10-year period, a taxpayer in this hypothetical situation would save a total $27.37 in tax, and would also enjoy the benefit of deferral of tax on the gain that is invested in the Opportunity Fund until 2026.
- The deferral of tax to 2026 is valuable but needs a larger chart with a present value computation to calculate.
- The tax basis adjustments of 10% and 5% can be more complicated than a simple $15 adjustment – the added tax basis may free up losses or allow tax-free distributions of cash.

D. How Do the Tax Benefits Work?

- Example 2. *Investment in Fund is Held for 7 Years and Sold in 2025*

Opportunity Zone Investment Held for at Least 7 Years			Ordinary Investment		Difference
Deferred Capital Gain (taxed in 2025)	$100.00		Capital Gain (taxed in 2018)	$100.00	
Basis Step-Up	$15.00		Basis Step-Up	$0.00	
Taxable Capital Gain	$85.00		Taxable Capital Gain	$100.00	
Tax (at 23.8%)	$20.23		Tax (at 23.8%)	$23.80	**$3.57**

D. How Do the Tax Benefits Work?

- As a result of holding an investment in a QOF for 7 years, a taxpayer in this hypothetical situation would save $3.57 in tax, and would also enjoy the benefit of deferral of tax on the gain that is invested in the QOF until the investment is sold in 2025.

D. How Do the Tax Benefits Work?

- Example 3. *Investment in Fund is Held for 5 Years and Sold in 2023*

Opportunity Zone Investment Held for at Least 5 Years			Ordinary Investment		Difference
Deferred Capital Gain (taxed in 2023)	$100.00		Capital Gain (taxed in 2018)	$100.00	
Basis Step-Up	$10.00		Basis Step-Up	$0.00	
Taxable Capital Gain	$90.00		Taxable Capital Gain	$100.00	
Tax (at 23.8%)	$21.42		Tax (at 23.8%)	$23.80	**$2.38**

D. How Do the Tax Benefits Work?

- As a result of holding an investment in a QOF for 5 years, a taxpayer in this hypothetical situation would save $2.38 in tax, and would also enjoy the benefit of deferral of tax on the gain that is invested in the QOF until the investment in the QOF is sold in 2023.

E. Requirements of a Qualified Opportunity Fund

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- The next concept to examine closely is the definition of a QOF.
- The term "Qualified Opportunity Fund" means any investment vehicle which is organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held in the fund as measured—
  - on the last day of the first 6-month period of the taxable year of the fund, and
  - on the last day of the taxable year of the fund.

E. Requirements of a Qualified Opportunity Fund

- At the outset, it is important to note that there is a time limitation placed on acquiring the necessary asset mix of a QOF.
- The QOF must hold at least 90% of its assets in “Qualified Opportunity Zone Property” and this percentage test (the “90-Percent Asset Test”) is measured by determining the average of the percentage of Qualified Opportunity Zone Property held in the Fund
  - (a) on the last day of the first six-month period of the taxable year of the Fund, and
  - (b) on the last day of the taxable year of the Fund.

E. Requirements of a Qualified Opportunity Fund

- In effect, there are two measuring dates, the first at the mid-point of the Fund's taxable year and the second at the end of the taxable year, assuming the tax year is a full calendar year.
- It appears that these two percentages are then "averaged" together, and that the average has to meet at least a 90% threshold in order to avoid full the potential penalty.
- For example, if the Fund is 88% invested in qualifying property on June 30 of the applicable tax year, and then 94% invested on the last day of the tax year, the "average" would appear to be 91%.
- NOTE: It is not clear whether this "average" could be interpreted as a "weighted average," but that might make sense, especially if there is only a small amount invested in the Fund during the first six months and a much larger amount invested during the second six months.

E. Requirements of a Qualified Opportunity Fund

- These two measuring dates lead to several immediate observations.
- Obviously, an investment in a QOF will be directly affected by the time limitations placed on taxpayers, because the taxpayers only have 180 days following a gain realization event in which to reinvest the gain amount into a QOF.
- On the other hand, a QOF does not want to take in money that it cannot immediately turn around and invest successfully under the 90 Percent Asset Test.
- It appears that the QOF can accept as much investment money as it wants (or as little as it wants) whenever it wants, but the money so received must then has to be invested by the QOF in Qualified Opportunity Zone Property (up to the required 90% averaged level) at the six-month point and twelve-month point of the Fund's taxable year.

E. Requirements of a Qualified Opportunity Fund

- In light of the foregoing, it seems very likely that a QOF will have "windows" when the QOF will identify a desired investment opportunity, will open the window to take in money, and will almost immediately put the money into the desired investment and then close the window.
- Managing the timing of money flowing into, and then almost immediately thereafter out of, the QOF will be a central issue in structuring and operating a QOF successfully.
- As a practical matter, it will be difficult to operate a QOF as a general investment fund where additional partners are added and additional investments are made over time.
- At the moment, the more likely scenario will be to set up a QOF as a "single purpose" or "single investment" fund that takes in investor funds for the specific purpose of investing in a specific qualifying investment.

E. Requirements of a Qualified Opportunity Fund

- An interesting issue to evaluate is whether a QOF should be a corporation or a partnership.
- Thanks to the dramatic reduction in corporate tax rates in 2018, an interesting tax strategy might be to establish a QOF as a C corporation, and pay taxes at a lower tax rate than would be paid by the partners in a partnership (21% versus approximately 29.6% (if the QBI deduction is applicable) or 37% (if QBI is not applicable).
- The C corporation QOF could accumulate funds and reinvest this tax savings into other eligible investments, and, at the end of ten years, the taxpayer could sell the QOF investment and all gain on the sale should be excluded. This assumes the IRS would not attempt to apply the Accumulated Earnings Tax to the C corporation accumulations.

E. Requirements of a Qualified Opportunity Fund

- On the other hand, a QOF structured as a partnership would be eligible to enjoy stepped up tax basis in the QOF assets as a result of a Code Section 754 election and adjustments under Code Section 743(b).
- This analysis also assumes a partnership would be eligible for the Qualified Business Income Deduction under Code Section 199A, which seems highly likely since any Qualified Opportunity Zone Business will necessarily be operating a business.
- However, note that a QOF structured as a partnership but owning Qualified Opportunity Zone Stock might not have any QBI.
- An LLC can be either a corporation or a partnership and qualify as a QOF. However, a single member LLC DOES NOT QUALIFY. An LLC set up as a QOF must be used with great care. A limited partnership with a corporate general partner will never become a disregarded entity and may be a prudent structuring choice for a QOF.

F. Qualified Opportunity Zone Property

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- The next important concept is the types of property into which a QOF can invest. The eligible investment property is defined as "Qualified Opportunity Zone Property." This, in turn, is broken down into three specific sub-categories:
    - *Qualified Opportunity Zone Stock* (meaning equity (i.e., stock) in an eligible corporation),
    - *Qualified Opportunity Zone Partnership Interest* (meaning equity (i.e., a partnership interest) in a partnership), and
    - *Qualified Opportunity Zone Business Property* (meaning a direct investment by the Fund in applicable property used in a trade or business in the applicable zone).

F. Qualified Opportunity Zone Property

- Qualified Opportunity Zone Stock means a domestic corporation, that satisfies three criteria:
  - The stock must be acquired after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation, solely in exchange for cash.
  - At the time the stock is issued, the corporation must be a Qualified Opportunity Zone Business (or, in the case of a new corporation, must be organized for the purpose of being a Qualified Opportunity Zone Business).
  - During substantially all of the QOF's holding period for such stock, the corporation qualified as a Qualified Opportunity Zone Business.

F. Qualified Opportunity Zone Property

- A Qualified Opportunity Zone Partnership closely mirrors the requirements of a Qualified Opportunity Zone Corporation, except that it is a business operated through a partnership. In particular, it must be a domestic partnership, and must meet the same three requirements as set forth above for a corporation, namely:
  - The partnership interest must be acquired after December 31, 2017, from the partnership, solely in exchange for cash.
  - As of the time the partnership interest is acquired, the partnership must be a Qualified Opportunity Zone Business (or, in the case of a new partnership, must be organized for the purpose of being a Qualified Opportunity Zone Business).
  - During substantially all of the Qualified Opportunity Fund's holding period for such partnership interest, the partnership qualifies as a Qualified Opportunity Zone Business.

F. Qualified Opportunity Zone Property

- The third category of eligible investment property, Qualified Opportunity Zone Business Property, is different from the first two, and involves an investment in property owned directly by the OZ Fund.
- "Qualified Opportunity Zone Business Property" means tangible property used in a trade or business of the QOF.
- Note, first of all, that this requirement assumes the QOF is engaged in a trade or business, and uses the tangible property in that business.
- An open question is whether triple-net leasing of a single parcel of real property qualifies as a "trade or business" for this purpose.
- US Tax Court case law tends to be favorable, but the IRS needs to provide specific guidance on a number of "leasing" issues, including this one.

F. Qualified Opportunity Zone Property

- Such tangible property must then meet the following three additional requirements:
  - The property must be acquired by the Fund by purchase from an unrelated party (as defined in Code Section 179(d)(2), but modified by Code Section 1400Z-2(e)(2) to a 20% relationship test) after December 31, 2017.
  - The original use of the property in the Qualified Opportunity Zone commences with the QOF or the QOF substantially improves the property.
  - During substantially all of the Qualified Opportunity Fund's holding period for such property, substantially all of the use of such property must be in a Qualified Opportunity Zone.

F. Qualified Opportunity Zone Property

- Under the second requirement, above, one of the alternatives choices is to "substantially improves" the property. "Substantial improvement" is defined as follows:
- "For purposes of subparagraph (A)(ii), property shall be treated as substantially improved by the Qualified Opportunity Fund only if, during any 30–month period beginning after the date of acquisition of such property, additions to basis with respect to such property in the hands of the Qualified Opportunity Fund exceed an amount equal to the adjusted basis of such property at the beginning of such 30–month period in the hands of the Qualified Opportunity Fund." [Capitalized words added]

F. Qualified Opportunity Zone Property

- This requirement specifies that, in order to be "substantial," the capitalized expenditures over *any* 30-month period following the acquisition date of the property must exceed the "adjusted tax basis" of the taxpayer in the property at the beginning of the 30-month period (i.e., the acquisition purchase price).
- Note that this requirement approximately maps to or corresponds to the requirement, under the Historic Rehabilitation Tax Credit, in order for a building rehabilitation project to qualify as "substantially rehabilitated."
- Rev. Rul. 2018-29, issued by the IRS, provides that upon a purchase of improved real property in an Opportunity Zone the cost of land is not taken into account (only the purchase amount attributed to existing improvements) for purposes of determining whether rehab costs exceed "adjusted tax basis" and this constitutes "substantial improvement."

F. Qualified Opportunity Zone Property

- The foregoing rules provide a very notable dichotomy between OZ Funds that seek to operate their own businesses directly, versus OZ Funds that seek to invest in one or more eligible corporations or partnerships that then qualify as a "Qualified Opportunity Zone Business" (an "OZ Business").
- For example, the direct investment by an OZ Fund requires that 90% of the funds must be invested in tangible property, while indirect investments (through an OZ Business) have no minimum stated requirement for tangible property.
- A direct OZ Fund investment does not have an "active" business requirement, meaning that triple-net leasing activities may qualify, while an OZ Business must derive at least 50% of gross income from the "active conduct" of the business.
- There is an extensive and highly intricate list of additional differences.

G. Qualified Opportunity Zone Business

G. Qualified Opportunity Zone Business

– The term "Qualified Opportunity Zone Business" means a trade or business

- in which substantially all of the tangible property owned or leased by the taxpayer is Qualified Opportunity Zone Business Property (determined by substituting "Qualified Opportunity Zone Business" for Qualified Opportunity Fund" in each place it appears in paragraph (2)(D));
- which satisfies the requirements of paragraph (2), (4), (8) of Code Section 1397C(b); and
- which is not described in Code Section 144(c)(6)(B).

G. Qualified Opportunity Zone Business

- Basically, to be a Qualified Opportunity Zone Business "substantially all' (defined in the Proposed Regulations as meaning at least 70%) of the tangible property owned or leased must be QOZBP. In turn, QOZBP is tangible property used in the applicable trade or business, and that is
  - property acquired by purchase from an unrelated party after December 31, 2017,
  - the original use of such property commences with the business, or the business substantially improves the property (under the substantial improvement standards described above), and
  - during substantially all of the period that the business holds such property, substantially all the use of the property is in the Qualified Opportunity Zone.

G. Qualified Opportunity Zone Business

- The applicable requirements imported from Code §1397C(b), paragraphs (2), (4) and (8) are, respectively, the following:
  - (2) at least 50% of the gross income of such entity is derived from the active conduct of such business,
  - (4) a substantial portion of the intangible property of such entity is used in the active conduct of such business, and
  - (8) less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to Non-Qualified Financial Property.

G. Qualified Opportunity Zone Business

– The term "Non-Qualified Financial Property", in turn, means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property as specified in regulations; except that such term does not include --
  - reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or
  - accounts receivable of the businesses as described in [Code] §1221(a)(4).
  - Proposed Regulations provide that "working capital" can be held by a QOZ Business for up to 31 months so long as there is a written plan with a reasonable schedule to spend the money and the taxpayer actually spends the funds in a manner "substantially consistent" with the plan.

G. Qualified Opportunity Zone Business

- Code §144(c)(6)(B) defines the "businesses that are not eligible to be considered within the scope of an eligible business". These are generally "sin" businesses and are comprised of the following:
    - "No portion of the proceeds may be used to provide (including the provision of land for) any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises."

G. Qualified Opportunity Zone Business

- The single biggest area of uncertainty is in the definition providing that, or order to be an OZ Business, "substantially all" of the tangible property owned or leased by the taxpayer is [required to be] Qualified Opportunity Zone Business Property (determined by substituting "Qualified Opportunity Zone Business" for Qualified Opportunity Fund" in each place it appears).
- The Proposed Regulations provide that "substantially all" for this purpose means 70% or more of all tangible property.
- An obvious preference of many businesses is to lease the real property it occupies and use its capital for business assets and operations.
- But the definition of Qualified Opportunity Zone Business Property requires that it must be "purchased" so it is hard to reconcile logically how "leased" property can meet the "purchase" requirement.

G. Qualified Opportunity Zone Business

- Interestingly, a QOF engaged in a direct investment in QOZBP seems to permit a lease, e.g., a ground lease of real estate on which a qualifying new building can be built that would potentially meet both the 90% purchase requirement and the original use requirement/substantial improvement requirement.
- This seems to be one of the many situations where there is a substantive difference in the way the legislation is written between a direct QOF investment in Qualified Opportunity Zone Business Property versus an indirect investment through a QOZ Business.

H. Additional Rules

H. Additional Rules

- Code Section §1400Z-2(e) contains a number of definitions and special rules that provide further explanation and detail on the operational aspects of a Qualified Opportunity Fund and an investment in Qualified Opportunity Zone Property.
- Mixed Funds. The law clearly anticipates that a Qualified Opportunity Fund may accept investments that are "mixed funds," i.e., where only a portion of the investments into the Fund are eligible for the election to exclude taxable gain under Subsection (a).
- Thus, for example, a taxpayer might put $1 million into a Fund, $600,000 of which is a rollover of gain from a sale of property that took place within the last 180 days, and the other $400,000 of which is simply additional funds for the investment.
- Under those circumstances, the investment is treated as two separate investments consisting of
  - a. one investment that only includes the amounts to which the election under Subsection (a) applies, and
  - b. a separate investment consisting of the other amounts.

H. Additional Rules

- The three tax benefits contained in Subsections (a), (b), and (c) of Code Section §1400Z-2 (including the special ten-year holding rule that exempts from tax all gain on sale of the Fund investment) apply only to the portion of the Fund that represents the rollover of the gain and the related election under Subsection (a) of Code Section §1400Z-2.
- Thus, a direct investment of money (meaning an investment that is not related to a timely rollover of gain under Subsection (a)) will enjoy none of the tax benefits of a Qualified Opportunity Fund.

H. Additional Rules

- Related Persons. The definition of a "related person" for this Code Section is quite broad, and treats persons as related to each other if they are persons described in the related person rules under Code §267(b) or 707(b)(1), but determined by substituting 20% for 50% each place it occurs in those Code sections.
- Decedents. Code Section 1400Z-2(e)(3) provides a rule on the characterization of gain under this Code Section where the gain is recognized with respect to a decedent. The rule states that if gain under this Code Section is not included in the gross income of the decedent, then it will be characterized as income in respect of a decedent or "IRD" under Code Section 691(c).

H. Additional Rules

- Code Section 1400Z-2(f)(1) deals generally with the penalties that will be imposed upon the failure of a QOF to meet the 90% Asset Test requirement in Subsection (c)(1).
- The provision proposes a penalty "for each month" that the Fund fails to meet the minimum investment threshold in an amount equal to the product of
  - a. the excess of 90% of the assets over the aggregate amount of eligible assets in the Fund, multiplied by
  - b. the underpayment rate under Code §6621, which is the general interest rate charged by the government on underpayments of tax.

H. Additional Rules

- One very curious aspect of this penalty formula is that the principal amount on which the penalty is assessed is the amount of non-invested gain below the threshold amount, while Code Section 6621 is normally interest applied to deferred payment of actual tax amounts owed.
- Note that the “gain” invested in a Fund, if taxed, would produce a federal income tax liability equal to 20% of the gain amount (23.8% if the Net Investment Income Tax (“NIIT”) is included) but the interest charge is assessed based on the full amount of the gain rather than on the actual amount of deferred tax liability.
- The calculation is very different, for example, than the interest charge on deferred taxes under the installment sale rules imposed by Code Section 453B.

H. Additional Rules

- The following illustrates the proposed calculation and the curious nature of how it is measured:
  - Assume that a taxpayer has $10 million of gain and, instead of paying federal income tax on it at a 23.8% tax rate, invests it in a Qualified Opportunity Fund. The Fund, in turn, invests $6 million into Qualified Opportunity Zone Property. The excess of 90% of the target amount ($9 million) over the amount of eligible assets held by the Fund ($6 million) is $3 million. This amount would therefore be multiplied by the underpayment rate under Code Section 6621. Again, note that $3 million represents non-invested gain, while the actual amount of deferred federal tax (even at a 23.8% rate) associated with $3 million of gain would be $714,000.

H. Additional Rules

- Reasonable Cause Exception.
- Finally, Code Section 1400Z-2(f)(3) provides that a Fund can avoid under-investment penalties if it can be shown that such failure is due to reasonable cause.
- The Internal Revenue Code is chock full of penalties, and almost all of these can be abated due to a showing of reasonable cause.
- It seems reasonable to anticipate that this reasonable cause exception will be applied in a manner that follows the standard code practices and procedures.

Q&A

We will be happy to take questions at this time.