EisnerAmper

Qualified Opportunity Funds

Guide for Real Estate Investors

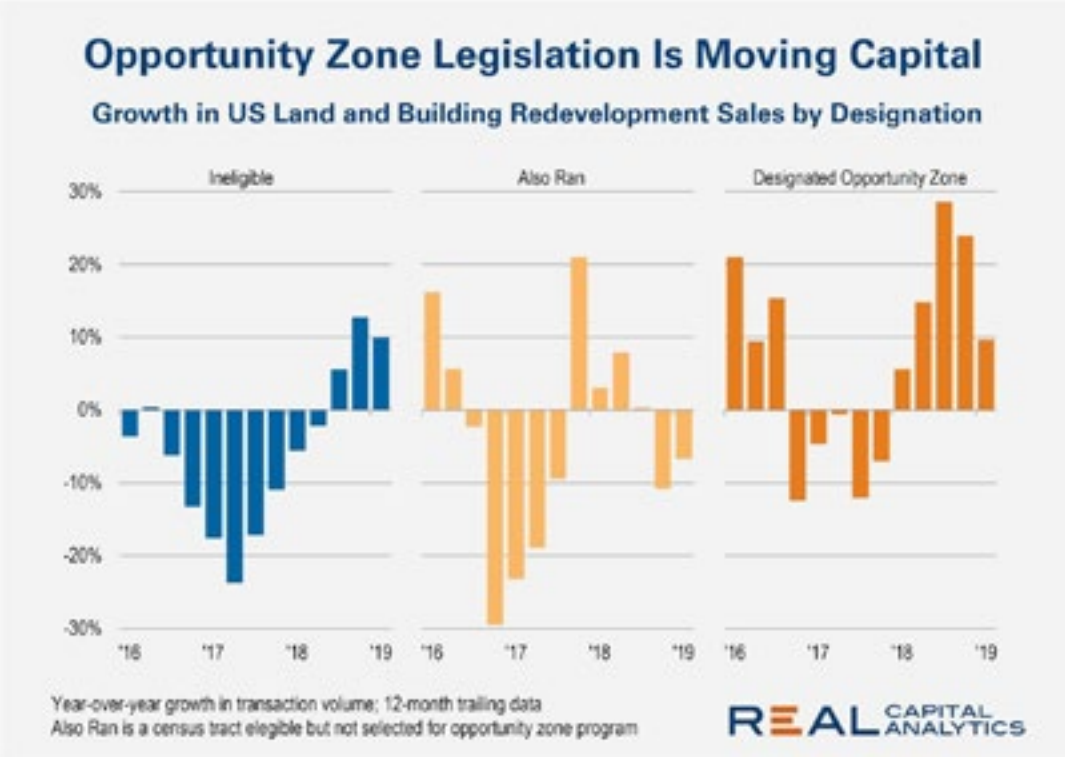
A tax resource to help investors navigate prospective opportunities

Contents

Editors' Notes

The Tax Cuts and Jobs Act of 2017 (TCJA) has provided significant tax and economic benefits for investors, real estate developers and fund sponsors through the Opportunity Zone Program. Qualified Opportunity Zones (QOZs) are designed to spur long-term growth and economic development in economically distressed neighborhoods through tax incentives. As a result of additional guidance issued on April 17, 2019 by the Treasury Department and IRS, we have updated this publication to provide further insight into this highly publicized and promoted tax benefit. This second set of proposed regulations has afforded additional investor-friendly guidance which has answered many uncertainties and addressed many open issues which needed to be resolved for projects to move forward in opportunity zones. Qualified Opportunity Funds (QOFs) are a very hot topic of interest. Investors should recognize that there are inherent risks with these funds. Investors should seek investments that make economic sense independent of the potential tax benefits.

Real Capital Analytics has been tracking development sites and monitoring the growth in QOZs. The chart below represents three categories of potential development sites — parcels ineligible for the QOZ benefits, parcels termed "Also Ran" that are in areas meeting the criteria to be designated as QOZs but which were not selected as QOZs, and parcels eligible for the QOZ benefits. Both the "Also Rans" and QOZ tracts are ripe for development, and both should have seen a surge in activity. If they both showed growth, then consensus would be that the legislation was not needed. However, there is indeed a large discrepancy in the activity of the two since the legislation was enacted, thus showing the impact the program has had since inception in the QOZs.



As the chart suggests, we have continued to see a strong interest in development activity in QOZs. Investors and developers are looking at investment opportunities and wanting to make sure that they understand the implications of the guidance issued to date. According to the preamble to the second set of proposed regulations, taxpayers and QOZs may generally rely on the proposed regulations as long as they consistently apply the rules in their entirety. However, pre-finalization reliance does not apply to the proposed regulations relating to investments held for at least ten years.

The White House Opportunity and Revitalization Council published its implementation plan on administrative reforms and initiatives to target, coordinate and optimize federal resources in QOZs. The Council identified more than 160 federal programs where QOFs could be targeted through additional benefits. The Council will develop an opportunityzones.gov website. The Securities and Exchange Commission (SEC) has also released a Staff Statement on the implications of federal and state securities laws as they relate to the QOZ program. To review its guidance, visit the SEC website here: https://www.sec.gov/page/staff-statement-opportunity-zones-federal-and-state-securities-laws-considerations

We are currently addressing numerous questions and inquiries regarding QOFs. Thus, we created this booklet to help real estate managers and investors navigate through the capital gain deferral, reduction and elimination of gain process, fund formation and operation of QOFs. We will continue to monitor new developments and update this publication accordingly.

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Overview of Potential Tax Benefits

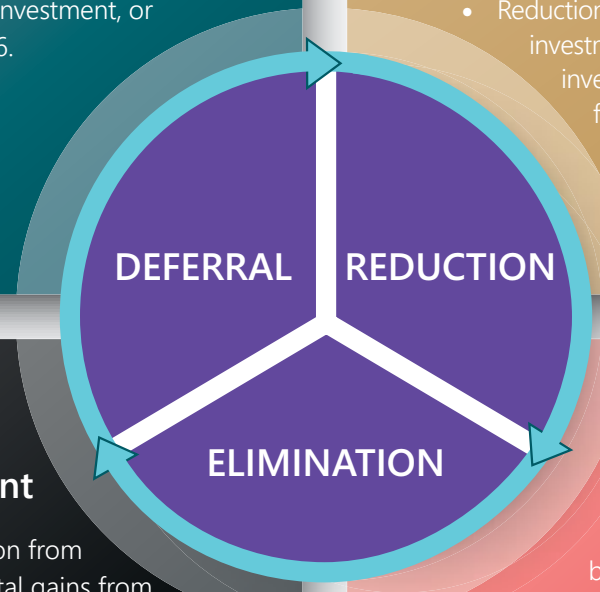
Investors with taxable capital gains (to be discussed in Section 8) have the ability to take advantage of the following benefits while reinvesting their capital gains into a QOF. Below are potential benefits that may be realized over the course of the investment.

Temporary **DEFERRAL** of Capital Gain

- If a taxpayer invests capital gains in a QOF within the appropriate time frame, the investor can elect to defer the gain to the earlier of the sale or the disposition of the investment, or December 31, 2026.

Partial **REDUCTION** of Capital Gain

- Reduction of 10% of the gain for investments held five years –investments held in the QOF for at least five years will receive a basis increase equal to 10%
- Reduction of 15% of the gain for investments held seven years – investments held in the QOF for at least seven years will receive an additional basis increase of 5%, for a total increase of 15%.



ELIMINATION of Gain on the QOF Investment

A permanent exclusion from gross income of capital gains from the sale or exchange of an investment in a QOF, if the investment is held for at least ten years. This exclusion applies to the gains accrued from an investment in a QOF, and not the original gains invested into a QOF.

Other Incentives

- Both federal and state incentives and credits may be available to enhance the benefits available to investments in Qualified Opportunity Zones.

Formation of Qualified Opportunity Funds

General

A Qualified Opportunity Fund must elect to be treated as a QOF at any time after December 31, 2017 and must be formed as a corporation or partnership for the purpose of investing in QOZ property or businesses.

Pre-existing entities may be eligible if they otherwise meet the 90% asset testing requirements discussed in "90% Asset Test." See Section 4c below.

Choice of Entity

QOF entities are limited to the following entity types:

- Partnerships (GP, LP)
- Real Estate Investment Trusts (REITs)
- Corporations
- S Corporations
- LLCs

An individual, trust, estate, or single-member LLC cannot be a QOF.

Other Requirements

The QOF must be created or organized within the 50 states, the District of Columbia, or a U.S. possession.

U.S. Possession: If the QOF is created or organized within a U.S. possession, the QOF must be organized for the purpose of investing in QOZ property that relates to a trade or business operated within that possession.

Certification

The QOF must self-certify by completing and attaching Form 8996, "Qualified Opportunity Fund," to its timely filed federal tax return (including extensions).

Decertification

Treasury is currently working on additional guidance which may cause a QOF to lose its certification in certain situations.

QOZ Designation

One of the key requirements to obtain the tax benefits of investing in QOFs is that qualifying property must be acquired by the QOF in one of the designated QOZs. Fund sponsors should pay attention to the specific boundaries of the areas that are designated to avoid acquiring properties outside the zones (e.g., across the street) which may not qualify.

QOZ Locations

QOZs are economically distressed population census tracts where job growth and income have lagged behind national averages. The locations were determined by each state/possession, and the final round of QOZ designations were announced on June 14, 2018 by the Treasury and IRS (and updated with two new zones added in Puerto Rico on June 25, 2019).

There are a total of 8,766 different zones, and they can be found in all 50 states, the District of Columbia, and five U.S. possessions.

A detailed map can be located at the following website: https://esrimedia.maps.arcgis.com/apps/View/index

Real Property Straddling a QOZ

Where real property straddles a QOZ and one or more census tracts not designated as a QOZ, and the real property outside of the QOZ is contiguous to part or all of the real property located in the QOZ, then all of the property will be deemed to be located within a QOZ.

QOZ Designation Period

The QOZ designations will remain in effect until December 31, 2028.

Qualified Opportunity Zone Property

One of the requirements for a QOF is that at least 90% of its assets must be QOZ Property. The following are QOZ Property: QOZ Business Property, QOZ Stock and QOZ Partnership Interests. QOFs will need to consider the business plan (i.e., into what assets to deploy capital) as well as how to apply the testing requirements.

Qualified Opportunity Zone Stock And Partnership Interests

QOZ Stock

- Stock acquired by the QOF after December 31, 2017, at its original issue from the corporation solely in exchange for cash;
- At the time such stock was issued, the corporation was a QOZ Business (or, in the case of a new corporation, the corporation was organized for purposes of being a QOZ Business); and
- During substantially all of the QOF's holding period for such stock, the corporation qualified as a QOZ Business.

QOZ Partnership Interest

- Partnership interest acquired by the QOF after December 31, 2017, from the partnership solely in exchange for cash;
- At the time the interest was acquired, the partnership was a QOZ Business (or, in the case of a new partnership, the partnership was organized for purposes of being a QOZ Business); and
- During substantially all of the QOF's holding period for such interest, the partnership qualified as a QOZ Business.

A QOZ Business requires that (1) "substantially all" of the tangible property owned or leased is located in a QOZ and (2) at least 50% of the business' gross income is derived from the active conduct of a trade or business in a QOZ.

"**Substantially all**" for this purpose means at least 70% of the tangible business property owned or leased must be QOZ Business Property.

General tax rules for determining the existence of a trade or business (as provided under IRC Sec. 162 – "Trade or Business Expenses") apply in the context of these QOF/QOZ rules.

50% Gross Income Test

The April 2019 proposed regulations provide **three safe harbors and a facts and circumstances test** for determining whether sufficient income is derived from a trade or business in a QOZ for purposes of the 50% test.

Businesses only need to meet **one** of these safe harbors to satisfy that test.

1

The first safe harbor requires that at least 50% of the services performed (based on hours) for a business by its employees and independent contractors (and employees of independent contractors) are performed within the QOZ.

2

The second safe harbor requires that at least 50% of the services performed (based on amounts paid) for a business by its employees and independent contractors (and employees of independent contractors) are performed within the QOZ.

3

The third safe harbor is a conjunctive test concerning tangible property and management or operational functions performed in a QOZ. It requires that (1) the tangible property of the business that is in a QOZ and (2) the management or operational functions performed for the business in the QOZ are each necessary to generate 50% of the gross income of the trade or business.

If a trade or business only has a post office box or other delivery address located in the QOZ, the presence of the post office box or other delivery address does not constitute a factor necessary to generate gross income by such business.

Taxpayers not meeting any of the other safe harbor tests may meet the 50% requirement based on a facts and circumstances test if, based on all the facts and circumstances, at least 50% of the gross income of a trade or business is derived from the active conduct of a trade or business in the QOZ.

Other requirements and qualifications also exist for a QOZ Business, which include the requirement that a QOZ Business not be a "sin business," defined as a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or other facilities used for gambling, or any store where the principal business is the sale of alcoholic beverages for consumption off premises.

Other QOZ Business Requirements

Less than 5% of the average of the aggregate unadjusted bases of property can be attributable to "nonqualified financial property." Nonqualified financial property means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts or annuities, but does not include cash, cash equivalents, or debt instruments with a term of 18 months or less.

In addition, during substantially all of the QOF's holding period for such QOF Stock/Partnership Interest, the corporation/partnership must qualify as a QOZ Business. The April 2019 proposed regulations provide that substantially all for this purpose is 90%.

Triple Net Leases

For purposes of the 50% gross income test, the ownership and operation (including leasing) of real property is treated as the active conduct of a trade or business. However, merely entering into a triple net lease with respect to real property owned by a taxpayer is not considered the active conduct of a trade or business and, therefore, does not satisfy the asset test.

Qualified Opportunity Zone Business Property

QOZ Business Property

- Tangible property used in a trade or business acquired by purchase after December 31, 2017 from an unrelated party;
- Acquired in a QOZ;
- Qualifying either through original use or "substantial improvement," as discussed below; and
- During substantially all of the QOF's holding period for such property, substantially all of the use of such property is in a QOZ.
  - **Substantially all** for purposes of the holding period requirement means at least 90%.
  - **Substantially all** for purposes of the use of tangible property means at least 70%.

Original Use

Property qualifying as original use is one option for QOFs to consider.

The original use of qualified property in a QOZ must commence with a QOF or a QOZ Business. Original use begins on the date when that person or a prior person first places the property in service in the QOZ for purposes of depreciation or amortization (or first uses the property in the QOZ in a manner that would allow depreciation or amortization if that person were the property's owner). Thus, tangible property located in the QOZ that is depreciated or amortized by a taxpayer other than the QOF or QOZ Business would not satisfy the original use requirement.

A revenue ruling (Revenue Ruling 2018-29) provides guidance for building/land acquisitions.

The ruling provides in part:

- Land can never have its original use in a QOZ commencing with a QOF because of the permanent nature of land.
- Pre-existing buildings cannot satisfy the original use test.
- QOFs that acquire real property in a QOZ will most likely need to consider only the substantial improvement test because the original use test may not be available for real property other than newly constructed buildings or buildings which have been vacant for at least five years (see below).

Vacant Buildings

Where a building or other structure has been vacant for at least five years prior to being purchased by a QOF or QOZ Business, the purchased building or structure will satisfy the original use requirement.

Substantial Improvement

In order to be a substantial improvement, during any 30-month period beginning after the date of acquisition of qualifying property, improvements with respect to the property must exceed an amount equal to the adjusted basis of such property at the beginning of the 30-month period.

For example, if a building is acquired for $1 million, improvements totaling an amount more than $1 million would need to be made within such 30-month period in order for the property to be treated as QOZ Business Property.

There is a special rule for building/land acquisitions:

- If a QOF purchases a building located on land wholly within a QOZ, the substantial improvement test focuses on improvements only to the building.
- A QOF does not need to substantially improve the land as well.

For example, if a building and the underlying land are acquired for $2 million, with 20% of the acquisition allocable to land ($400,000) and 80% to the building ($1.6 million), the QOF would need to incur improvements exceeding $1.6 million within a 30-month period to qualify under the substantial improvement test.

There is currently no relief available for extensions of the 30-month period where extraordinary circumstances arise while renovations/construction take place.

Banking Land

Unimproved or minimally improved land (other than real property straddling a QOZ, discussed above) that is purchased with an expectation, intention or view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase will not qualify as QOZ Business Property.

Leased Tangible Property

See discussion of Leased Tangible Property at Section 5 below.

90% Asset Test

Testing Dates

The 90% testing is performed on the last day of the first six-month period of a QOF's taxable year as well as on the last day of a QOF's taxable year. The entity may specify the first month in which it wants to be a QOF, which may help with compliance.

If an eligible entity becomes a QOF in the seventh month or later, the 90% test will apply on the last day of the first taxable year. The QOF does not need to meet the 90% test on each such testing date; the QOF uses the average of the annual percentages to determine whether the 90% requirement has been met.

QOF Start Date	First Testing Date	Second Testing Date
January	June 31	December 31
February	July 31	
March	August 31	
April	September 30	
May	October 31	
June	November 30	
July	December 31	June 30 Year #2
August		
September		
October		
November		
December		

Other Requirements

The value of each asset is based on the value reported on an "applicable financial statement," defined as:

- An audited financial statement, or
- A financial statement filed with the SEC, or
- A financial statement filed with a federal agency other than the IRS.

If a QOF does not have an applicable financial statement, the cost basis of assets is used for the testing.

New Equity Investments

A QOF may apply the 90% asset test without taking into account any investments received in the preceding six months if those new assets/investments are being held in cash, cash equivalents, or debt investments with a term of 18 months or less.

Implications of Failing Asset Test

Failure to maintain the 90% asset test will result in penalties that need to be considered by funds. Although failure to maintain the required amount of qualified assets will not prevent the fund from achieving the tax benefits provided to QOFs, significant penalties may apply that will damage investor returns.

Although the 90% test is performed semiannually, the failure to comply penalty is charged for each month that the test fails.

The amount of the monthly penalty is calculated as follows:

- The excess of 90% of total QOF assets over the aggregate amount of QOZ qualifying property, multiplied by
- The IRS underpayment rate for the month defined, in IRC Sec. 6621(a)(2).

No penalty is imposed with respect to any failure if it is shown that the failure is due to reasonable cause.

Relief Provision

See discussion of "Multi-Assets-Considerations," at Section 7, below.

Future Guidance Needed

The preamble to the proposed regulations indicates that the Treasury Department will address the penalties imposed if a QOF fails to maintain the required 90% investment standard, as well as information reporting requirements in separate regulations, forms or publications.

Leased Tangible Property

The April 2019 proposed regulations provide several rules for the qualification of leased tangible property as QOZ Business Property of a QOF or QOZ Business.

Treatment as QOZ Business Property

In order to qualify as QOZ Business Property, leased property must meet the following two general criteria:

1. Must be acquired under a lease entered into after December 31, 2017, and

2. Substantially all of the use of the leased tangible property must be in a QOZ during substantially all of the period for which the business leases the property. Substantially all for the purposes of the use of leased property means at least 70%.

The proposed regulations do not impose an original use requirement for leased tangible property. Furthermore, there is no requirement for a lessee to substantially improve leased tangible property.

The terms of a lease must be market-rate at the time the lease is entered into in order for the underlying tangible property to be considered QOZ Business Property.

Improvements made by a lessee to leased property in a QOZ are considered as having their original use in a QOZ, as purchased property for the amount of the unadjusted cost basis.

Valuation of Leased Property

For purposes of the 90% asset test and the substantially all (70%) requirement for QOZ Business Property, leased tangible property may be valued using either an applicable financial statement valuation method or an alternative valuation method.

Under the applicable financial statement valuation method, the value of leased tangible property of a QOF or QOZ Business is the value of that property as reported on the applicable financial statement for the relevant reporting period.

Under the alternative valuation method, the value of tangible property that is leased by a QOF or QOZ Business is determined based on a calculation of the present value of the leased tangible property. Specifically, the value of such leased tangible property is equal to the sum of the present values of the payments to be made under the lease for such tangible property.

Once a QOF or QOZ Business selects one of those valuation methods for the taxable year, it must apply such method consistently to all leased tangible property valued with respect to the taxable year.

Rules for Related Parties

Unlike tangible property that is purchased by a QOF or QOZ Business, the proposed regulations do not require leased tangible property to be acquired from a lessor that is unrelated. However, there are specific requirements that must be met in order for the leased tangible property to qualify as QOZ Business Property.

For property leased from a related party (defined as 20% under the QOF provisions, as discussed below), two additional requirements must be satisfied.

1. There cannot be prepayments on a lease that exceeds 12 months.
2. If the original use of leased tangible personal property in a QOZ does not commence with the lessee, then the property is not QOZ Business Property unless the lessee becomes the owner of tangible property that is QOZ Business Property having a value not less than the value of the leased personal property. There must be substantial overlap of the zone(s) in which the owner of the property so acquired uses it and the zone(s) in which that person uses the leased property. This acquisition of property must occur during a period that begins on the date that the lessee receives possession of the property under the lease and ends on the earlier of the last day of the lease or the end of the 30-month period beginning on the date that the lessee receives possession of the property under the lease.

Anti-Abuse Rule

An anti-abuse rule prevents the use of a lease to circumvent the substantial improvement requirement for the purchase of real property (other than unimproved land). If at the time the lease is entered into there is a plan, intent or expectation for the real property (other than unimproved land) to be purchased by the QOF for an amount other than the fair market value of the real property without regard to prior lease payments, then the leased real property is not QOZ Business Property at any time.

Direct vs. Indirect Investments

The proposed regulations provide specific provisions that require a taxpayer to carefully compare the single-tier, or direct investment structure, versus the indirect, or two-tier investment structure. The charts on the following pages are examples of formations of one- and two-tier structures.

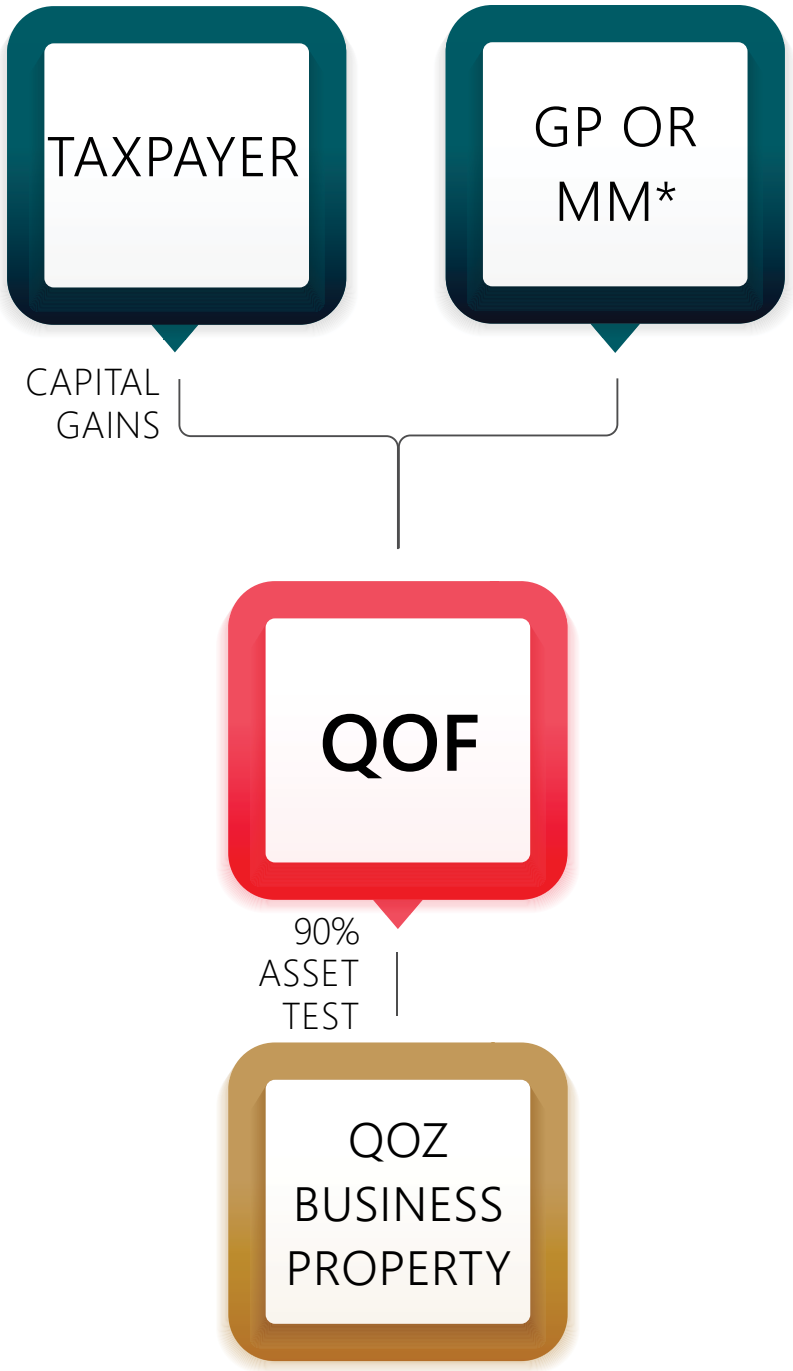
The asset test requirements, working capital safe harbor, and investor gain exclusion election are three key items that must be analyzed in each structure.

In an indirect investment configuration, the overall structure can have as little as 63% of QOZ Business Property in order to pass the 90% asset test as opposed to a single-tier structure which requires 90% of its assets to be QOZ Business Property. The asset test at the QOF level is 90%, whereas it is only 70% at the QOZ Business level. Furthermore, it should be noted that the 90% test at the QOF level uses a fraction, the denominator of which is all assets of the QOF. At the QOZ Business level, however, the 70% test uses a fraction, the denominator of which is all tangible property owned by the QOZ Business. Therefore, complying with the test is less onerous at the QOZ Business level.

The working capital safe harbor which allows a QOZ Business to maintain working capital for up to 31 months without failing the asset test is not allowed at the QOF level. It is only available for a QOZ Business and therefore only allowed for the two-tier structure.

The proposed regulations provide that where a taxpayer has held a qualifying investment in a QOF for at least ten years and the QOF disposes of QOZ property, the taxpayer may make an election to exclude from gross income some or all of the capital gain from such disposition which is reported on the Schedule K-1 that the taxpayer receives. This election is only available for gains generated at the QOF level. Gains incurred at the QOZ Business level in a two-tier structure may not be eligible for the election in accordance with the current proposed regulations.

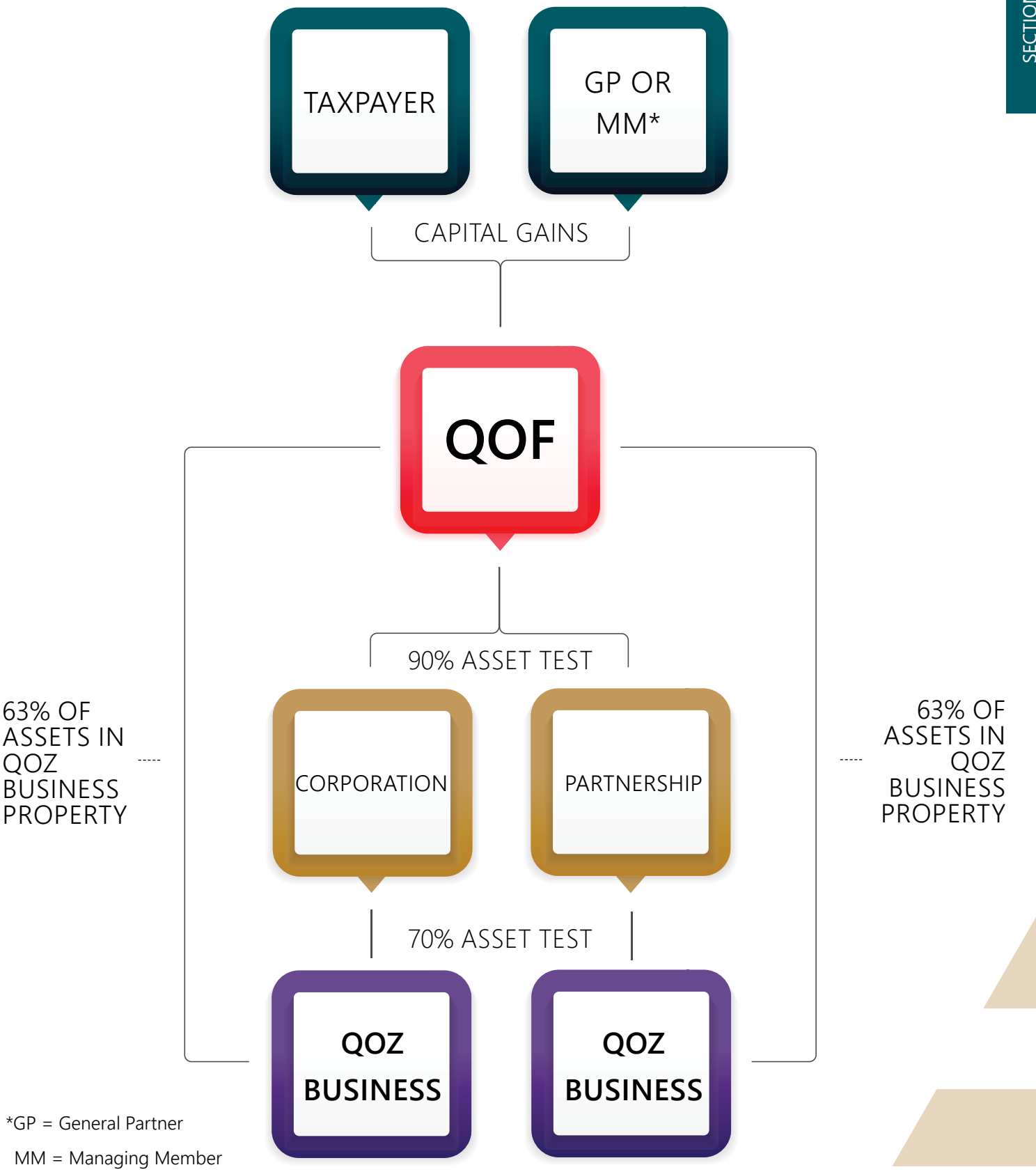
Direct Investment



*GP = General Partner

MM = Managing Member

Indirect Investment



*GP = General Partner

MM = Managing Member

Working Capital Safe Harbor

A "working capital safe harbor" allows a QOZ Business to hold cash, cash equivalents or debt instruments with a term of 18 months or less for up to 31 months prior to investing in qualifying assets. Working capital to support tangible property that will ultimately satisfy planned expenditures will be allowed provided that the following occurs:

1

There is a **written plan** identifying the working capital assets as property held for development of a trade or business in the QOZ as well as the acquisition, construction and/or substantial improvement of the tangible property,

2

There is a **written schedule** consistent with the ordinary business operations of the business providing that the working capital assets will be used in 31 months, AND

3

The business substantially **complies** with the plan and schedule.

The safe harbor affords QOZ Businesses and the respective upper-tier QOFs with undeployed/newly called capital to comply with the 90% asset test during the start-up phase.

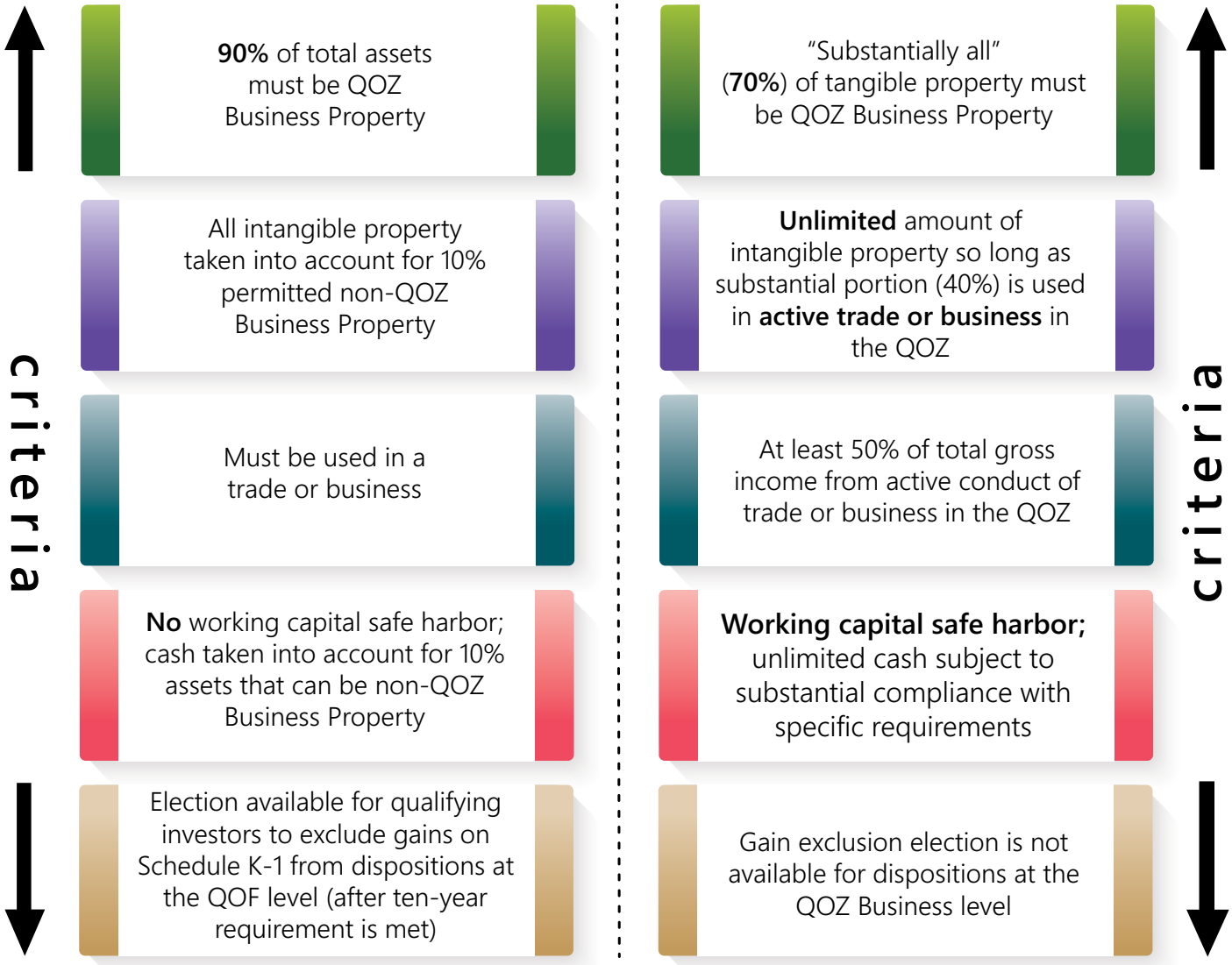
The working capital safe harbor now includes the development of a trade or business in the QOZ as well as the acquisition, construction and/or substantial improvement of tangible property.

A QOZ Business can have multiple overlapping or sequential working capital safe harbors where additional capital is invested into the QOF.

Exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action, the application for which is completed during the 31-month period.

Qualified Opportunity Funds: One-Tier (Direct) vs. Two-Tier (Indirect) Investments

Qualified Opportunity Fund



Multi-Asset Considerations

When developing a new QOF structure, consideration must be made for whether the ultimate investment will consist of a single asset or whether multiple assets will be acquired. While this is generally a business decision, the tax impacts must also be considered given the compliance requirements that the QOZ statute and proposed regulations impose.

Asset Testing

For the 90% test at the QOF level as well as the 70% test at the QOZ Business level, additional assets within a QOF structure will result in additional complexity in compliance where the substantial improvement test is utilized. This result occurs because the substantial improvement test is performed on an asset-by-asset basis.

On the other hand, having multiple assets within a structure does provide some flexibility for real estate investors in regard to meeting the 90% and 70% tests. With a single asset fund, should such asset fail to qualify to be considered QOZ qualifying property, there is a risk that the QOF benefits may be lost for investors. With a portfolio of many assets, it may still be possible to qualify even if a single property fails the asset test where the other assets in the portfolio qualify, and they comprise enough value to meet the overall asset test.

Asset Sales and Reinvestments

Funds that choose to invest in multiple assets will more likely have business reasons to sell particular properties during the investment period as various investments do better than others. The concerns raised by such sales are compliance with the asset tests as well as any interim gains that are recognized.

The proposed regulations provide that proceeds received by a QOF from the sale or disposition of 1) QOZ Business Property, 2) QOZ Stock and 3) QOZ Partnership Interests are treated as QOZ Property for purposes of the 90% test, so long as the QOF reinvests the proceeds received from the disposition of such property during the 12-month period beginning on the date of such disposition.

This rule allows QOFs adequate time to reinvest proceeds without failing the semiannual asset tests.

If reinvestment of the proceeds is delayed by waiting for governmental action the application for which is complete, that delay will not cause a failure of this 12-month requirement.

In regard to interim gains recognized from the disposition of assets, it should be noted that no guidance currently exists to exclude such gains from general tax principles of gain inclusion. Therefore, any gains recognized on such a disposition would be passed through as taxable income to investors in a partnership structure or recognized at the corporate level in a corporate structure.

Ten-Year Fair Market Value (FMV) Step-Up

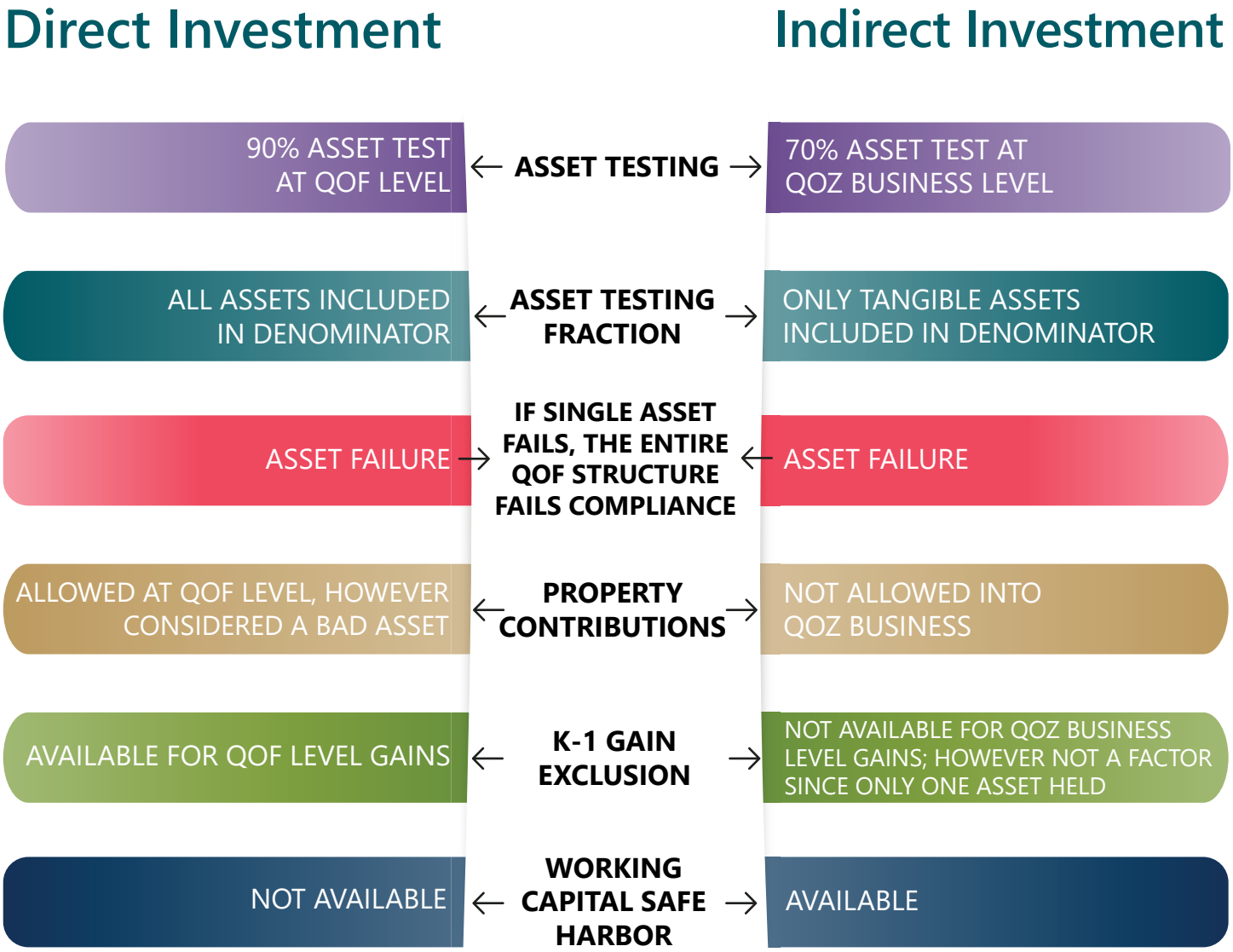
If a taxpayer has held QOZ Property in a QOF for at least ten years and the QOF disposes of the qualifying investment, the taxpayer may make an election to exclude from gross income some or all of the capital gain from such disposition which is reported on the Schedule K-1 that the taxpayer receives.

To the extent that the Schedule K-1 separately states capital gains from various QOZ qualifying investments, the election can be made with respect to each separately stated item.

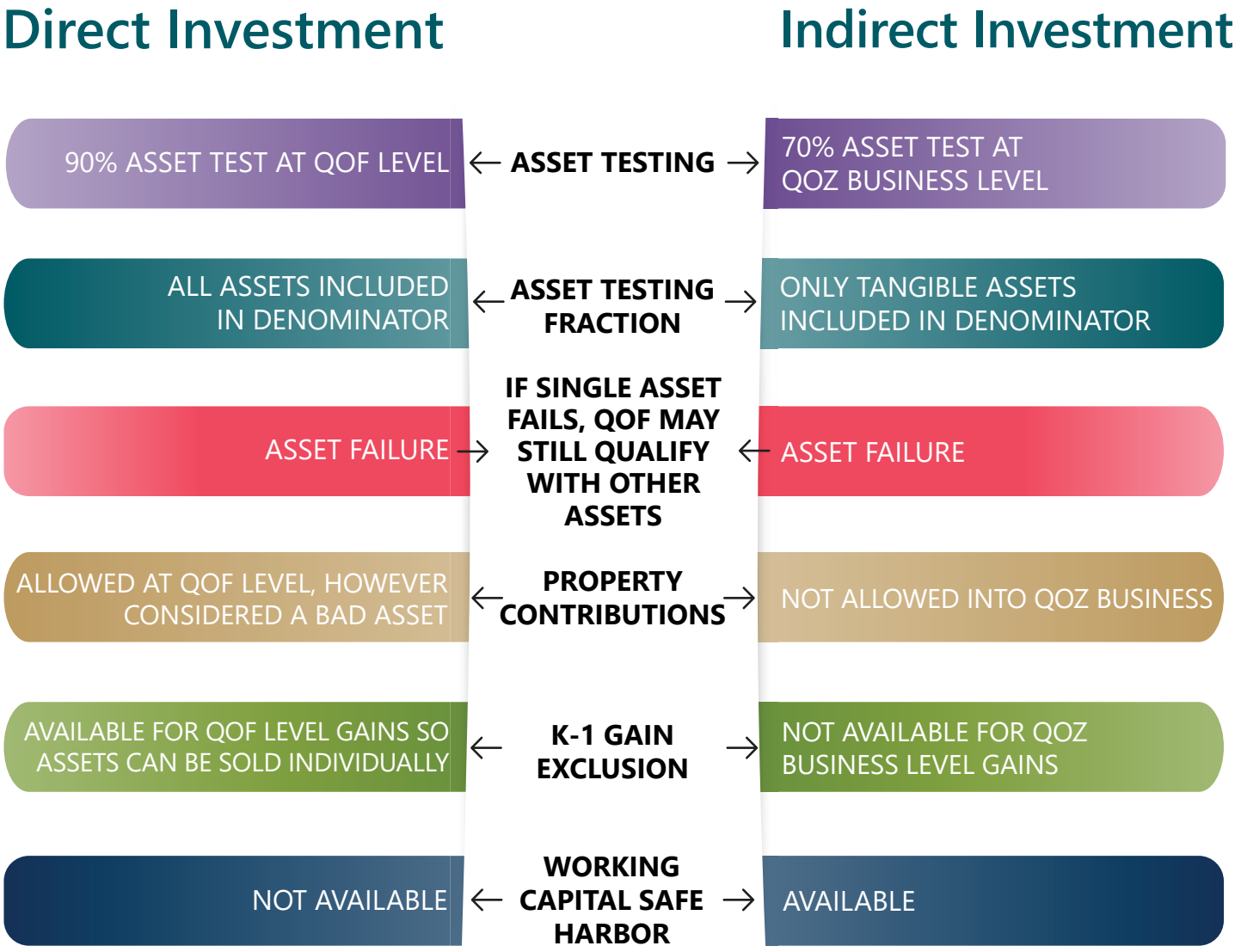
If a QOF holds all of the multiple assets, taxpayers are able to make the election as the QOF sells each qualifying investment. However, if a QOF owns other QOZ Businesses (investments in QOF Stock and QOF Partnership Interests) which sell individual assets, the proposed regulations do not currently allow a taxpayer to make the election for those gains.

It is important for investors looking to create a multi-asset QOF to consider whether the direct or indirect structure should be used. If the QOF were to sell all or a portion of a QOZ Business as opposed to the QOZ Business selling its assets, investors in the QOF could elect to exclude that gain, but sales of entity interests in QOZ Businesses may entail discounts or holdbacks not generally associated with direct asset sales.

Single Asset QOFs



Multi-Asset QOFs



Investor Benefits and Requirements

Summary

Any capital gain from the sale or exchange of property by a taxpayer to an "unrelated" party (as defined on page 29) that is invested in a QOF within 180 days of the sale of such property is excluded from gross income until the **earlier** of the date the investment in the QOF is sold or disposed, or December 31, 2026.

Eligible Investors

Proposed regulations confirm that the following investors can defer gain under the QOZ statute:

- Individuals
- Corporations (including RICs and REITs)
- Partnerships
- S corporations
- Common trust funds under IRC Sec. 584
- Qualified settlement funds
- Disputed ownership funds
- Designated settlement funds
- Trusts
- Estates

This also includes tax-exempt entities that realize a capital gain from activities that generate UBTI.

Temporary Gain Deferral Election

If a taxpayer invests capital gains from the sale or exchange of property with an unrelated person in a QOF within the 180-day period beginning on the date of the sale or exchange, and ending on December 31, 2026, the investor can elect to defer the gain from the sale or exchange.

Proposed regulations provide that the QOZ incentive applies to **capital gains only**.

Capital Gains

The law provides that only the **gain** can be reinvested into the QOF and be entitled to the QOF benefits, **not the total proceeds**, which is different than the tax deferral rules for like-kind exchanges under IRC Sec. 1031. The gain deferred can be any capital gain, including:

- Short-term capital gains
- Long-term capital gains
- Unrecaptured IRC Sec. 1250 gains
- Collectibles gains
- Net IRC Sec. 1231 gains
- Capital gain net income from IRC Sec. 1256 contracts
- Gains from sales of securities other than by dealers in those securities

Net IRC Sec. 1231 Gain

IRC Sec. 1231 property is depreciable property used in a taxpayer's trade or business and held for more than one year and real property used in the trade or business for more than one year, other than property includible in inventory, property held primarily for sale to customers and certain other property. Net IRC Sec. 1231 gain is treated as long-term capital gain; net IRC Sec. 1231 loss is treated as ordinary loss. Because the capital gain from IRC Sec. 1231 property is determinable only as of the last day of the taxable year, the proposed regulations provide that the 180-day period for investing the capital gain from IRC Sec. 1231 property in a QOF begins on the last day of the taxable year.

Exception: A taxpayer invests IRC Sec. 1231 gain in a QOF in its tax year ending prior to May 1, 2019 and during the 180-day period beginning with the realization of an IRC Sec. 1231 gain. The deferral election based on the QOF investment made in an amount less than the taxpayer's net IRC Sec. 1231 gain for the tax year is valid, notwithstanding that the investment was made before the specified 180-day investment window.

Capital Gain Net Income From IRC Sec. 1256 Contracts

As in the case of net IRC Sec. 1231 gain, because the capital gain net income from IRC Sec. 1256 contracts for a taxable year is determined only as of the last day of the taxable year, the proposed regulations provide that the 180-day period for investing capital gain net income from IRC Sec. 1256 contracts in a QOF begins on the last day of the taxable year. However, no deferral of gain from any IRC Sec. 1256 contract in a taxable year is permitted if, at any time during the taxable year, one or more IRC Sec. 1256 contracts were part of an "offsetting positions" transaction in which any of the other positions were not also an IRC Sec. 1256 contract. An offsetting positions transaction is a transaction in which a taxpayer has substantially diminished its risk of loss through a tax straddle or similar transaction.

Mixed-Funds Investments

If a taxpayer contributes money or property to a QOF that exceeds eligible gain for deferral, the taxpayer is treated as having a mixed-funds investment in the QOF. Only the portion of the investment in a QOF to which a valid QOF election is in effect is treated as a qualifying investment.

Under the proposed regulations, solely for purposes of the QOF statute, a mixed-funds partner is treated as holding two interests, and all partnership items, such as income and debt allocations and property distributions, affect qualifying and non-qualifying investments proportionately, based on the relative allocation percentages of each interest. Allocation percentages are generally based on relative capital contributions for qualifying investments and other investments.

Furthermore, the non-qualifying investment is not eligible for the various benefits afforded qualified investments under the QOF statute.

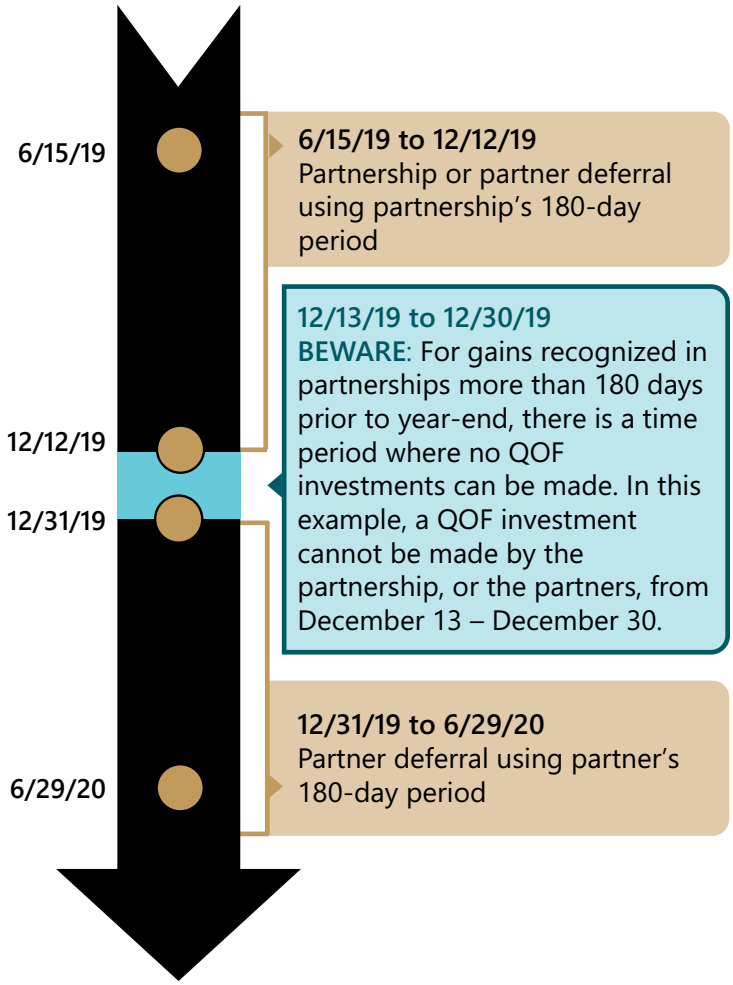
Gains from Partnerships

The proposed regulations include special rules for partnerships and other pass-through entities as well as for the investors to whom these entities pass through income and other tax items.

A partnership may elect to defer all (or part) of a capital gain. If an election is made, the elected deferred gain is not included in the share of distributable income to the partners.

If the partnership does not elect to defer gain, a partner may elect its own deferral with respect to the partner's distributive share of gain not deferred by the partnership. The partner's 180-day period generally begins on the last day of the partnership's taxable year, or the partner may choose to begin its own 180-day period on the same date as the start of the partnership's 180-day period.

For example, if a calendar year-end partnership realizes a $1 million capital gain on June 15, it can elect to defer the gain by investing in a QOF within 180 days (December 12). The income will not be reported to the partners. If the partnership does not elect to defer the gain, each partner can elect to defer its share of the gain within 180 days of June 15 or within 180 days of the partnership's tax year-end.



NOTE: If an election is made to defer gain at the entity level, there is a question as to whether subsequently admitted partners will receive the deferral benefits.

Tracing of Funds

Tracing of funds is not required. Therefore, an investor is not required to show **how** the capital gain proceeds were used to invest, but rather that the **amount** of capital gain proceeds was subsequently invested into a QOF within the 180-day period.

Basis in the Investment

An investor's basis in the QOF is initially zero but will be increased by: (a) **10%** of the deferred gain if the investment is held for **five years** by December 31, 2026,(b) an additional **5%** of the deferred gain if the investment is held for **seven years** by December 31, 2026; and (c) **any deferred gain** recognized at the end of the deferral period (December 31, 2026).

Therefore, if a gain on the sale of property is reinvested in a QOF within the required time frame, investors may be able to decrease the taxable portion of the originally deferred gain by 15% (an overall basis step-up of 15%) if the investment is held for seven years or more by December 31, 2026.

NOTE: Investors should consider the impact of allocated partnership losses on their return in a QOF as an investor's initial income tax basis is zero, and the related partnership losses may be limited.

Recognition of Deferred Gain

The investor defers the gain until the earlier of the date on which the investment in the QOF is sold or exchanged, or December 31, 2026. **Certain other dispositions and distributions for tax purposes (inclusion events) also cause the amount of deferred gain to be included in an investor's income.** See discussion of inclusion events in Section 8a below. At that time, the investor includes the **excess** of (1) the lesser of the amount of deferred gain or the fair market value of the investment in the QOF as determined on that date over (2) the investor's basis in the investment.

When the gain deferral ends, all of the deferred gain's tax attributes, preserved through the deferral period, are taken into account when the gain is included in income. For example, if the investor defers short-term capital gain, the investor will recognize short-term capital gain at the earlier of the date the investment in the QOF is sold or exchanged, or December 31, 2026.

Assuming the investor holds the investment in the QOF until December 31, 2026, the amount subject to tax is the **lesser** of the fair market value of the property at the time of the event or the original deferred gain, taking basis increases, if any, into account.

10 **Ten Years**
No federal taxable gain on appreciation of the investment

7 **Seven Years by December 31, 2026**
Additional 5% reduction of deferred gain (15% total)

5 **Five Years by December 31, 2026**
10% reduction of deferred gain

Disposition of QOF Partial Interests

If an investor disposes of less than all of the interest in the QOF, the proposed regulations provide that the QOF interest disposed must be identified using a first-in, first-out method.

Permanent Gain Exclusion Election

At the investor's election, an investor can exclude any **post-acquisition** capital gains on an investment in a QOF if the investment in the QOF has been held for ten or more years.

When an investor invests both the capital gain amount and additional amounts into a QOF, the investment will be treated as two separate investments, of which only the capital gain portion will be eligible for the ten-year capital gain exclusion (and related five-year/seven-year basis increases).

Unrelated Party Explained

An unrelated party, for the purposes of the QOF and QOZ Internal Revenue Code (IRC) sections, is a party that is not a related party under IRC Sec. 267(b) or IRC Sec. 707(b)(1), which includes, but is not limited to, the following relationships:

- Brothers and sisters (including whole and half-blood), spouses, ancestors, and lineal descendants;
- An individual or fiduciary of a trust and a corporation more than 20% in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual or trust;
- Two corporations which are members of the same controlled group;
- A grantor and a fiduciary of any trust;
- A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- A fiduciary of a trust and a beneficiary of such trust;
- A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- A person and an organization to which IRC Sec. 501 (relating to certain tax-exempt entities) applies and which is controlled directly or indirectly by such person (or by members of such person's family);
- Any pair (two related entities) of C corporation(s), S corporation(s) and/or partnership(s) if the same persons own more than 20% in value of the outstanding stock of such corporation(s), and/or more than 20% of the capital interests, or the profits interests, in the partnership(s);
- A partnership and a person owning, directly or indirectly, more than 20% of the capital interests, or the profits interests, in such partnership;
- Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate; and
- Any constructive ownership identified in IRC Sec. 267 and IRC Sec. 707.

Inclusion Events

The proposed regulations provide a nonexclusive list of 11 inclusion events for a taxpayer's qualifying investment to be included in the taxpayer's income. Some examples of these events, which cause all or part of the deferred gain to be taxable, are included below:

Transfers by GIFT will generally be considered inclusion events with the exception of gifts to grantor trusts, since grantor trusts are taxed to the grantor as long as they are alive. See Note 1, below.

Transfers of eligible interests by reason of DEATH are NOT inclusion events and the holding period is tacked, BUT dispositions by a beneficiary or heir who received interest by taxpayer's death ARE inclusion events.

Distributions in excess of basis will trigger gain recognition.

If the QOF is a C corporation, then the following are inclusion events:

1. Distributions only to extent treated as a sale or exchange.
2. Redemptions unless the stock is held by a single shareholder or single consolidated group and the distribution would be a dividend.
3. Transfers of stock or an interest in a QOF partnership in an IRC Sec. 351 exchange.

NOTE 1: Contrary to the gift rule, most transfers to an estate caused by death and then subsequently to individual beneficiaries or to trusts are not considered inclusion events. When the deferred gain of property received upon death prior to December 31, 2026 is included in income on the earlier of a disposition or December 31, 2026, the income will be treated under IRC Sec. 691 as income in respect of a decedent. Also, when a grantor dies and the trust distributes its assets, or automatically converts to a non-grantor trust, it will not be considered an inclusion event.

Investor Basis

The basis of an asset is the amount used for computing the gain or loss when the asset is sold; it is generally the asset's cost with adjustments for various tax modifications.

For Partnerships

There are **adjustments to an investor's basis** specific to the QOF provisions:

- The initial qualifying investment (i.e., the contribution of the amount of the capital gain) into the QOF will have **a basis of zero** since tax was deferred on the gain proceeds.
- The initial qualifying investment can also be made by acquiring an eligible interest in the QOF from a person other than the QOF.
- If an investor funds its interest in the QOF partnership with amounts in excess of a realized capital gain, the portion of the interest attributable to the deferred gain and the portion in excess of the gain will each be **tracked separately** so that only the deferred gain portion will be eligible for the QOF tax advantages.
- **Basis is increased** for any amount recognized by the investor as gain, from the initial deferral or other gains, during the term of the investment. This includes the recognition of the initially deferred gain on or before December 31, 2026. See discussion above.
- If the investment in a QOF is held for **five years** by December 31, 2026, the **basis is increased by 10%** of the original deferred gain so that if the investor were to sell its interest in the QOF, the recognized gain would only take into account 90% of the originally deferred amount.
- If the investment in a QOF is held for **seven years** by December 31, 2026, the **basis is increased by an additional 5%**. Therefore, a 15% total of the original deferred gain would be the basis increase so that if the investor were to sell its interest in the QOF for his or her original investment, the recognized gain would only take into account 85% of the originally deferred amount.
- If the investment in a QOF is held for a total of **ten years or more**, the investor can make an election to increase the basis of the investment (which is in this case a partnership interest, as stated above) in that QOF equal to the fair market value at the time the investment is liquidated or sold (FMV basis election). The result is that there is no federal tax on any appreciation in the investment.

If the investment in the QOF were to go down in value such that it was less than the investor's basis, the FMV basis election would not be made upon the sale of the interest, thereby preserving a tax loss.

The last day to make the FMV basis election is December 31, 2047. Therefore, investors would have to dispose of their QOF investments by December 31, 2047.

For Corporations

For a QOF organized as a corporation for federal income tax purposes, the tax basis of an investment in the QOF stock starts at zero, similar to a partnership interest. The investor's stock receives the same basis increases listed above, but taxable income/loss and distributions are treated differently.

A corporation's taxable income or loss does not flow through to the shareholders, and therefore there is no impact to the shareholders' basis in their stock. A distribution to shareholders is either treated as a taxable dividend, a return of capital, or a capital gain when a shareholder no longer has basis in the stock. Only a return of capital results in changes to a shareholder's basis. A taxable dividend does not affect a shareholder's basis, and a capital gain, because of distributions in excess of basis, inherently occurs because of zero basis.

Therefore, the key adjustments to an investor's basis in a QOF that is classified as a corporation are the following:

- Basis adjustments relating to the five-year and seven-year gain reductions,
- Basis adjustments upon inclusion of deferred gain recognized on December 31, 2026,
- FMV basis election, and
- Adjustments resulting from distributions treated as return of capital.

Property Contributions to a Qualified Opportunity Fund

The proposed regulations allow a taxpayer to make a QOF investment by transferring property other than cash to a QOF. In order to determine the amount of a taxpayer's QOF investment from a property contribution, a taxpayer must first identify whether the contribution is a taxable event. In all cases, the QOF qualifying investment must be identified as an investment of a recognized capital gain.

Non-Taxable Contributions

In the instance of a nonrecognition transaction (i.e., a non-taxable event), the amount of a taxpayer's investment with a property contribution is the lesser of the taxpayer's adjusted basis in the eligible interest received in the transaction, calculated as if the QOF rules did not apply, or the FMV of the eligible interest received in the transaction, both as determined immediately after the contribution. Generally, this means that the amount of QOF investment is equal to the lesser of the adjusted basis or FMV of the property contributed. This property contribution calculation applies separately to each item of property contributed to a QOF.

If the FMV of the property contributed is greater than the adjusted basis (i.e., there is unrealized gain), the taxpayer's QOF investment is an investment with mixed funds. The adjusted basis component qualifies for QOF benefits, whereas the unrealized gain component does not.

Taxable Contributions

If the contribution of property results in a taxable transaction to the taxpayer, the amount of the QOF investment is the FMV of the transferred property, as determined immediately before the transfer. This rule applies separately to each item of property transferred to a QOF.

Considerations for Property Contributions

1. Although property can be contributed to a QOF, the property will generally not be considered QOZ Business Property. Contributed property would not have been purchased by the QOF, which is one of the requirements for QOZ Business Property. Furthermore, the related party rules might apply. Therefore, contributed property would need to be considered under the 10% "bad asset" bucket of the 90% asset test.
2. Contributed property can only be held by a QOF in a one-tier structure. In a two-tier structure where a QOZ Business holds property, contributed property would cause the entire lower-tier entity to be disqualified. This result occurs because the statute requires that a QOZ Business be acquired solely for cash by a QOF. If contributed property is further contributed by a QOF to a QOZ Business, part of the QOZ Business would have been acquired for property rather than cash. Therefore, the lower-tier entity would not be considered a QOZ Business.

Acquisition of a QOF from Another Existing QOF Investor

Secondary Market Purchases

An investor can acquire an interest in a QOF from an existing QOF investor (as opposed to acquiring directly from a QOF). In this case, the investor is treated as having made an investment in a QOF equal to the amount paid or exchanged for the QOF interest. The investor's holding period begins as of the date of purchase (i.e., the holding period of the existing QOF investor does not tack). This provision would apply even where the existing QOF investment is a non-qualifying interest (i.e., not eligible for QOF benefits).

Additionally, a QOF interest can be purchased on a secondary market. For instance, a developer can fund a qualifying real estate project or qualifying business within a QOF without eligible gains and then sell its interest in the real estate project or business to investors that have eligible capital gains. Additionally, there is no related party restriction. This allows for greater flexibility with regard to QOF timing requirements.

Income Allocations

For Partnerships

While questions remain with regard to the tax treatment of distributions, taxable income/loss and refinance proceeds for QOFs that are organized as partnerships, the general rules of partnership taxation are expected to apply:

- Distributions are generally tax-free if they do not exceed the investor's basis.
- Taxable income will generally be allocated in accordance with the partnership agreement.
- Taxable loss will generally be allocated in accordance with the partnership agreement. However, care should be given to allocations that cause an investor's basis to go negative at the end of a taxable year.
- Refinance proceeds are generally treated as a regular distribution and are generally tax-free if they do not exceed the investor's basis. However, the proceeds/distributions may be subject to interest-tracing rules. Refinance proceeds made within two years of contributions to the QOF may trigger gain to the QOF investor under a disguised sale rule.

In these situations, a tax advisor should be consulted so that the tax ramifications of these transactions are clear to the investor and the GP.

Profits/Carried Interest

The proposed regulations indicate that a QOF formed as a partnership is allowed to have special allocations, which presumably includes carried interests. However, a profits interest where only services are contributed does not constitute an "amount invested by a taxpayer."

For Corporations

Generally, corporations, other than S corporations, would treat operating distributions, taxable income/loss and refinancing proceeds differently from partnerships:

- Operating distributions can either be a taxable dividend or a return of capital depending on the earnings and profits of the corporation. Distributions in excess of basis will result in a capital gain.
- Taxable income/loss is calculated by the corporation, which would pay any tax due. The investors would not be allocated a portion of the income or loss.
- Refinance proceeds are generally treated similarly to operating distributions as a taxable dividend, return of capital, or capital gain.

Operating Distributions and Debt-Financed Distributions

Debt is frequently used to acquire real estate due to the increased purchasing power that leverage provides. Sponsors of QOFs may be inclined to seek out debt financing for investments in QOZs to increase overall returns to investors. Those doing so should pay attention to the impact that debt may have, both generally as well as specifically, for QOFs.

The proposed regulations for QOFs provide guidance for acquisitions with debt (i.e., mortgages).

Debt-financed acquisitions generally by partnerships provide taxpayers with basis for 1) tax depreciation and 2) tax-free distributions.

The initial basis of a QOF investment made with deferred gains is zero, and, therefore, no immediate tax depreciation deduction is available. However, tax depreciation is available from the portion of investments financed by debt, as normally is the case.

Basis from debt is available for investors in partnerships to receive distributions. However, fund sponsors and investors need to be careful that distributions (especially within the two-year period following all contributions of capital) are not considered early sales of their QOF investments, which would accelerate recognition of deferred gain as well as eliminate the ten year step-up benefit. Since a qualifying investment of cash has an initial basis of zero, it is similar to a property contribution in that a cash distribution from the partnership within the first two years of investment could be deemed to be a disguised sale under IRC Sec. 707.

Reinvestments, Dispositions and Exits

There are specific tax implications of transactions involving sales of assets by QOFs, QOF investors disposing of their interests in QOFs, and recognition of interim gains resulting from reinvestments by QOFs and QOF investors.

1 Sale of Assets

The proposed regulations state that a QOF has 12 months from the time of the sale or disposition of QOZ Property or the return of capital from investments in QOZ Stock or QOZ Partnership Interests to reinvest the proceeds in other QOZ Property before the proceeds would not be considered QOZ Property with regard to the 90% asset test. The proceeds must be held in cash, cash equivalents, or debt instruments with a term of 18 months or less in order to qualify.

This clarification is necessary because a sale of property by a QOF close to a testing date could otherwise cause the 90% test to fail. For example, a sale of assets on December 28 might cause the 90% test to fail on December 31. The proposed regulations also state that any gain realized in the sale must be recognized by the QOF. This gain recognition requirement could lead to possible phantom income to the QOF and/or its investors where there is no correlating distribution. The gain may be invested in a QOZ Business (see discussion below).

The reinvestment by a QOF within the 12-month period does not affect a QOF investor's holding period in regard to the five-year and/or seven-year basis increases or the ten-year FMV basis step-up. The preamble to the proposed regulations specifically states that the Treasury and IRS do not have the authority to prescribe rules which depart from the otherwise normal gain recognition provisions of the tax law. Therefore, any interim gains recognized would be reported on the K-1s which are distributed to QOF investors.

It should be noted that this interim gain recognized by a QOF could be eligible for a new QOF deferral election by the QOF investors or by the QOF itself under the standard QOF operating rules.

Depreciation Recapture

In the case of recapture of depreciation benefits from real property, individuals generally should not have to recognize ordinary income. Depreciation recapture on the sale of real property only applies when depreciation previously taken exceeds the amount of straight-line depreciation which would have been taken. Since real property is generally depreciated under the straight-line method, no income would be subjected to ordinary tax rates.

In the case of depreciation recapture from non-real property assets (e.g., solar energy property, or other personal property associated with the real property), individual taxpayers may have to recognize income at ordinary tax rates. Depreciation taken on such assets is generally subject to recapture as ordinary income under IRC Sec. 1245.

2 Transfer or Sale of Partnership Interest of Stock in the QOF

Where partners/stockholders transfer or sell their partnership interest/stock in a QOF prior to December 31, 2026, the deferral provisions require the partners/stockholders to recognize their deferred gain at the time of such transfer or sale since such disposition is considered an inclusion event. Furthermore, if prior to the ten-year anniversary, the FMV basis election is not available and any gain or loss on the sale of the partnership interest/stock must be recognized as well.

However, such partners/stockholders have the opportunity to continue to defer the gain by making a qualifying new investment in a QOF. The proposed regulations provide that a taxpayer is eligible to make a new deferral election to defer the inclusion of the previously deferred gain.

Deferring an inclusion otherwise mandated in this situation is permitted only if the taxpayer has disposed of the entire initial investment without which the taxpayer could not have made the previous deferral election. The general 180-day rule determines when this second investment must be made to support the second deferral election. Under that rule, the first day of the 180-day period for the new investment in a QOF is the date of inclusion of the previously deferred gain, which would be the date that the original interest was disposed of.

There are two considerations for QOF investors contemplating a reinvestment: a) the requisite complete disposition and b) holding periods.

a) Deferring an inclusion in this situation is permitted only if the QOF investor has disposed of the entire initial investment. The complete disposition is necessary because the statute expressly prohibits the making of a deferral election with respect to a sale or exchange if an election previously made with respect to the same sale or exchange remains in effect. Therefore, a QOF investor would need to sell or exchange the entire initial investment.

b) If a QOF investor disposes of its entire qualifying investment in QOF #1 and reinvests in QOF #2 within 180 days, the investor's holding period for its qualifying investment in QOF #2 begins on the date of its qualifying Investment in QOF #2, not on the date of its qualifying investment In QOF #1. There are two implications that result from this treatment. First, the QOF investor may no longer be eligible for the five-year and/or seven-year basis increases depending on when the reinvestment from QOF #1 to QOF #2 takes place. Second, the FMV basis step-up will take longer to achieve since the ten-year clock restarts upon the reinvestment into QOF #2.

3 Other Exit Strategies

Other strategies for exit include, but are not limited to, the following:

- Conversion to a REIT followed, by the sale of interests in the REIT (for further discussion, see Section 9, "Advantage of REITs in Exit Strategies")
- Merge with or be acquired by a public REIT or any other publicly traded company in exchange for cash or publicly traded securities, and
- To the extent allowable by future guidance, the QOF can engage in an UPREIT transaction in which all of the interests in the QOF are contributed to an UPREIT partnership in exchange for interests in the UPREIT partnership that are convertible into cash or publicly traded REIT shares.

4 Interim Gains

The contrasting treatment of interim gains by QOFs and QOF investors must be noted.

As discussed above, if a QOF disposes of QOZ Business Property, QOZ Stock, and/or QOZ Partnership Interests, the QOF investors are subject to taxation on any interim gain triggered by such disposition.

If a QOF investor disposes of a QOF interest and reinvests such proceeds into a new QOF within the required 180-day period, not only is the taxpayer eligible to continue the deferral of the originally deferred gain, but such taxpayer can also defer any new interim gain through a new QOF deferral election. However, in contrast to a QOF's reinvestment where the QOF investor's holding period is not affected, there is a restart of the holding period if a QOF investor reinvests into a new QOF.

Special Considerations for REITS

Use of REITs

In certain situations, a REIT can be a favorable entity choice for a QOF. Generally, a REIT provides more flexibility if fund sponsors are looking to develop through multi-asset or blind pool real estate funds. Please refer to Section 7 for further clarification.

While it is clear that a QOF can be organized as a REIT or a REIT can be utilized as a QOF subsidiary, care should be taken in understanding how the REIT rules in some cases compliment and in other cases conflict with the QOF rules. The use of a REIT can give QOF investors the same benefits that are afforded any real estate fund that utilizes a REIT, which acts as a blocker for unrelated business taxable income (UBTI) for tax-exempt investors, blocks state and local income tax filings, provides tax efficiency for foreign investors (elimination of FIRPTA on the sale of a domestically controlled REIT) and provides for an up to 20% qualified business income (QBI) deduction for REIT dividends not subject to wage and tangible property limitations.

Advantages of REITs in Exit Strategies

There may be advantages to using REITs for the future liquidation of a QOF structure. A REIT can sell its assets in liquidation over a two-year period without triggering a gain at the REIT level which would flow through to the shareholders. Rather, the shareholders are treated as selling their interests in the REIT in exchange for the cash proceeds received. Another benefit of REITs may also apply at the end of a QOF's life where a QOF was not originally structured as a REIT. With proper planning and structuring, a QOF partnership may be able to convert into a REIT after the ten-year mark.

While outside the scope of this booklet, it should be noted that if a liquidation extends beyond the two-year period previously mentioned or if other negative attributes of a REIT exist, significant negative tax consequences may be triggered to the REIT shareholders.

Capital Gain Dividends Paid by a QOF REIT

A REIT is treated similarly to a C corporation where taxable income, including gains on the sale of real estate, is recognized at the entity level. However, a REIT is entitled to a deduction for dividends paid to shareholders, which is the main mechanism by which a REIT avoids double taxation.

By default, QOF investors in a REIT structure would need to sell their REIT shares to obtain the benefit of the FMV basis election after ten years of ownership. However, the proposed regulations provide a mechanism to avoid this, which is similar to the rule for partnership investors where partners can elect to exclude gains reported on K-1s.

The proposed regulations authorize QOF REITs to designate special capital gain dividends, not to exceed the QOF REIT's long-term gains on sales of QOZ property. If QOF REIT shares are qualified investments in the hands of shareholders, those special capital gain dividends are tax-free to shareholders who could have otherwise elected a basis increase in the case of a sale of the QOF REIT shares.

Distributions by REITs

A potential negative consequence of forming a QOF using the REIT structure is the tax treatment of distributions such as those from refinancing proceeds. Partners in a partnership obtain basis for their share of debt, and therefore, distributions are not taxable, or treated as inclusion events, so long as partners have basis to cover distributions. Shareholders in REITs do not obtain basis from entity-level debt. Since a shareholder's initial basis in a QOF investment is zero, distributions from REITs that are not considered dividends may cause an early inclusion of deferred gain.

1031 Exchange vs. QOFs

IRC Sec. 1031, as amended by the TCJA, now allows for the deferral of tax arising from gains **solely** on the sale of real property. This limitation to real property was a significant change from rules that applied prior to 2018. On the other hand, QOFs allow for the deferral of tax due on capital gains from any source that generates eligible gains.

Although further regulations are needed to fully implement QOFs, taxpayers who have recently realized capital gains, or plan to do so imminently, need to carefully analyze the requirements, benefits, and limitations of both IRC Sec. 1031 like-kind exchanges and QOFs. The following table provides a comparison of the various attributes of each alternative.

Relinquished Property and Replacement Property Requirements

	IRC Sec. 1031 Exchange	Qualified Opportunity Fund
Property Type Eligible	Effective 1/1/18, only real property.	Any property that generates capital gain.
Location Requirements	Replacement property can be located anywhere in the U.S.	Property must be located in a Qualified Opportunity Zone.
Required Reinvestment	Entire proceeds from sale (i.e., net equity plus debt replacement).	Only capital gain may be reinvested and obtain Qualified Opportunity Fund treatment.
Replacement Property Usage Restrictions	Cannot be held primarily for sale. Must be held for productive use in a trade or business or held for investment.	In the case of two-tier (indirect) investments, cannot be used for golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, gambling facility, or certain stores with a principal business of selling alcoholic beverages for off-premises consumption.

Ownership and Timing Requirements

	IRC Sec. 1031 Exchange	Qualified Opportunity Fund
Ownership	Owner of new property must be same as owner of sold property.	Owner of new property must be Qualified Opportunity Fund.
Deadline to Identify Replacement Property	45 days after sale.	Not applicable.
Deadline to Acquire Replacement Property	180 days after sale.	Capital gain must be invested into Qualified Opportunity Fund within 180 days of recognition of capital gain.
Reverse Reinvestments	Replacement property can be acquired first, after which relinquished property is sold.	Capital gain event must occur prior to investment into Qualified Opportunity Fund.
Applicability to Partnerships	Partnership itself must enter into IRC Sec. 1031 exchange. Partners cannot separately defer gain.	Either partnership itself, or the partners individually, are able to defer gain into Qualified Opportunity Fund.
* Special rule for gains generated by partnerships	Not applicable.	For 180-day test, partners that defer gain individually use December 31 (calendar-year partnerships) of the taxable year as the start date for the test or elect to use the partnership's actual gain recognition date.

*** Special planning note:** If a partnership attempts and fails an IRC Sec. 1031 exchange due to the 180-day replacement period, individual partners still have additional time after December 31 (calendar-year partnerships) to defer gain by investing into Qualified Opportunity Funds.

Tax Benefits and Reporting Requirements

	IRC Sec. 1031 Exchange	Qualified Opportunity Fund
Deferral Period	Gain deferred until new property sold. However, permanent deferral is possible if owner of new property dies, and owner's estate receives basis step-up.	Gain deferred until earlier of the date on which the investment in a Qualified Opportunity Fund is sold or exchanged, or December 31, 2026. If taxpayer dies before December 31, 2026, the gain must be recognized. There is no step-up at death.
Tax Reporting	Form 8824	Form 8996 for fund self-certification and Form 8949 for deferral reporting. Awaiting other reporting guidance.
State Conformity	Most states conform, but certain states have clawback provisions.	Some states have acknowledged conformity or non-conformity; awaiting guidance from other states.

FIRPTA Considerations

What is FIRPTA?

Nonresidents of the U.S. are generally only taxed in the U.S. on effectively connected income (ECI), U.S.-source income that is fixed and determinable (for example: interest, dividends and royalties) and sales of a U.S. real property interest (USRPI).

Congress enacted the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) to impose a tax on foreign persons when they sell a USRPI. A "foreign person" includes a nonresident alien, foreign partnerships, trusts, estates and corporations which have not elected to be treated as a domestic corporation under IRC Sec. 897(i).

In general, a USRPI is any interest in real property, such as land, buildings, improvements, leaseholds and natural deposits, located in the U.S. or the U.S. Virgin Islands. It also includes, with certain exceptions, any interest (other than solely as a creditor) in a "U.S. real property holding corporation" (a corporation in which, at any time during the shorter of the foreign person's holding period of the stock or five years prior to the sale of the corporation's stock, the value of the corporation's USRPI is equal to at least 50% of the value of its assets).

For U.S. real property dispositions subject to FIRPTA, the transferee (purchaser) is required to withhold and remit to the IRS 15% of the gross sales price to ensure that any taxable gain realized by the seller is actually paid.

Issues to Be Addressed Regarding the Interplay of FIRPTA and QOFs

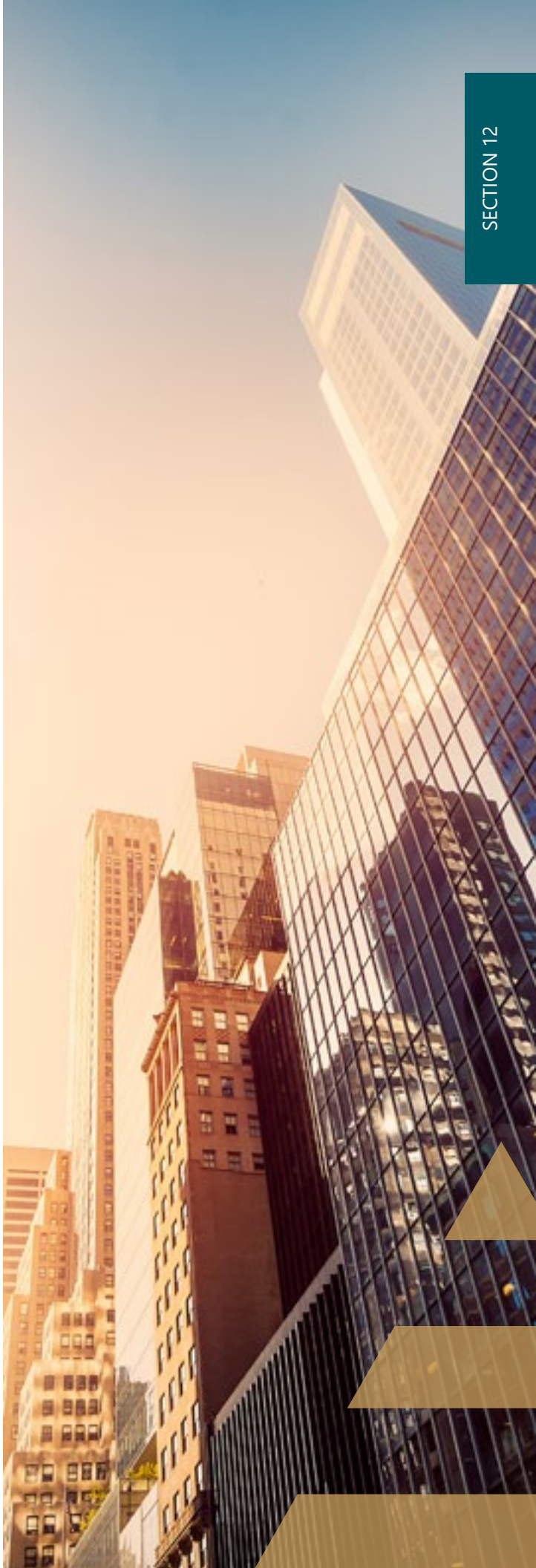
In order for gain to be eligible for the QOZ regime, the IRS should clarify that gain recognized by a nonresident is considered eligible gain for purposes of the QOZ regime whether or not the gain would be subject to U.S. taxation. There is nothing in the legislative history of the QOZ regime that would appear to deny the ability of nonresidents to benefit from the QOZ regime.

When a nonresident sells a USRPI, it may be possible to obtain a withholding certificate from the IRS to reduce the amount of withholding. It can take the IRS several months to issue a certificate. During this period, funds are usually held in escrow until the IRS issues a withholding certificate. The TCJA requires that a taxpayer invest gain into a QOF within 180 days of the sale or exchange that generated the gain. Will a withholding certificate be obtained in a timely fashion? The IRS has been asked to issue guidance that allows taxpayers to elect to treat the 180-day period from the date of sale or exchange or the date they receive a FIRPTA withholding certificate.

Anti-Abuse Provisions

The proposed regulations contain a general anti-abuse rule – if a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of the QOF statute, the IRS can recast a transaction (or series of transactions) for federal tax purposes as appropriate to achieve tax results that are consistent with such purposes. Whether a tax result is inconsistent with the purposes of the statute must be determined based on all facts and circumstances.

The preamble to the proposed regulations provides as an example a QOF's acquisition of a parcel of land currently utilized entirely by a business for the production of an agricultural crop (whether active or fallowed at that time) that could potentially be treated as QOZ Business Property without the QOF investing any new capital in, or increasing any economic activity or output of, that parcel. In that case, the purposes of the statute would not be realized and the QOZ/QOF tax incentives should not be available.



Other Credits

The QOF provisions do not limit the ability to use other tax credits. The following are a few credits more commonly utilized within QOZs:

Research & Development (R&D) Credits

The federal R&D tax credit is an incentive for business investment in research.

The credit is dollar-for-dollar of a company's qualified expenses for performing qualified research activities. Startup businesses with no federal tax liability and gross receipts of less than $5 million are able to take the R&D tax credit against their payroll taxes. The Protecting Americans from Tax Hikes (PATH) Act of 2015 permanently extended the R&D tax credit and expanded its provisions. Many states have also implemented R&D credits.

Solar Investment Tax Credit (ITC)

The ITC is a dollar-for-dollar federal tax credit for investments in solar property. The credit is equal to 30% of basis invested in eligible property through 2019, and 26% and 22% for projects that begin construction in 2020 and 2021, respectively. Many states have ITC credit incentives as well.

New Markets Tax Credit (NMTC)

The NMTC is a federal tax credit provided in exchange for investing in Community Development Entities (financial intermediaries that make loans and investments to businesses operating in low-income communities). The total credit is equal to 39% of the investment and is claimed over seven years. The credit expired at the end of 2014 but was extended by Congress through 2019.

Low-Income Housing Tax Credit (LIHTC)

LIHTC is a federal tax credit for creating affordable housing investments in low-income communities. The credit is either approximately 4% (rehabilitation projects and new construction financed with tax-exempt bonds) or 9% (generally available for new construction) per year for ten years, incurred for the development of low-income units in a housing project. Developers typically sell the tax credits to investors.

State and Local Taxation

State and Local Tax Conformity with Internal Revenue Code

State and local tax conformity with the federal QOZ provisions should be examined by investors in determining the state taxation of gains invested in QOZs. Investors in states conforming with the federal QOF provisions may receive state and local tax incentives similar to those available at the federal level, whereas investors residing in nonconforming states and localities may be unable to defer and reduce state and local taxation on the initial gains invested in QOZs. Investors in nonconforming states and localities may also be required to recognize gain for state and/or local tax purposes on their eventual sale of the QOF investment.

The chart on page 48 outlining state conformity with Qualified Opportunity Zone taxes. Local tax conformity would need to be further analyzed.

Many states have drafted legislation that provides incentives in lieu of or in addition to the QOZ benefits in order to enhance investments in local QOZs. Below are some examples of either enacted or pending legislation to date.

Alabama

Alabama H.B. 540 was introduced to grant the state authority to issue up to $50 million in tax credits to impact Alabama QOFs meeting certain criteria. The legislation includes a range of incentives to attract and expand businesses in rural Alabama and would allow various state funds to invest in opportunity zones.

California

Included in the governor's proposed budget summary for the 2019-2020 fiscal year is a provision whereby California will partially conform to the federal QOZ provisions, allowing for deferred and reduced taxes on capital gains for investments in California opportunity zones held for ten years or longer. This provision limits the definition of California qualified opportunity zone business property to property located in a California QOZ that is a qualified low-to-moderate income housing project or is a business whose purpose is to generate and distribute green energy. Additionally, California A.B. 791, introduced on February 20, 2019, would provide a new tax credit incentive for the creation of affordable housing in qualified opportunity zones for the tax years beginning after January 1, 2020 and before January 1, 2025.

Maryland

The governor of Maryland signed legislation expanding Maryland tax incentives to Maryland opportunity zones and extending the state historic tax credit program. The enacted legislation allows qualifying business and property in Maryland opportunity zones to be eligible for the More Jobs for Marylanders program, as well as certain tax credits. The bill also allows local jurisdictions to offer property tax credits for vacant opportunity zone properties that are revitalized and makes other credits available through the Maryland Department of Commerce.

New Jersey

New Jersey has not passed legislation to adopt the QOZ tax benefits; however, the Division of Taxation has provided notice that for both individual and corporate income tax purposes, New Jersey will follow the federal QOZ rules.

New York

New York State is participating in the federal QOZ program. Under the New York opportunity zone rules, investors who meet the federal QOZ criteria and are able to defer and exclude capital gains for federal income tax purposes will also be able to defer and exclude capital gains for New York state income tax purposes.

Ohio

Ohio Senate Bill 8, introduced on February 12, 2019, generally follows the provisions under Ohio General Assembly House Bill 727 (HB 727). HB 727, introduced on August 29, 2018, seeks to capitalize on the federal opportunity zone program by adding a state tax incentive component.

HB 727, if passed, would create a non-

refundable state income tax credit of up to 10%, against the aggregate tax liability of a taxpayer that invests $250,000 or more during the taxable year in an Ohio QOF.

A QOF, in order to qualify under HB 727, would need to hold 100% of its assets in a QOZ property designated in the state of Ohio. This is a noteworthy departure from the federal definition for a QOF in that 100% of the assets must be invested in QOZ property in a designated Ohio geographic location, whereas the federal definition requires that 90% of the QOF must be held in QOZ property, but in any geographic location.

Rhode Island

Rhode Island SB 668, introduced on March 21, 2019, includes a non-refundable state income tax credit of up to 20% against the aggregate tax liability of a taxpayer that invests $250,000 or more during the taxable year in a Rhode Island QOF.

South Carolina

South Carolina General Assembly House Bill 3186 (H.3186), introduced on December 18, 2018, if adopted, would create a 25% tax credit for companies that invest in qualified opportunity zones. The tax credit would be available beginning in 2019 and would be capped at $50,000 per taxpayer. The credit would be allowed to carry over for up to five years.

Texas

Introduced in February 2019, Texas H.B. 1000 provides a 25% tax credit for investments in Texas opportunity zones and rural areas. The legislation, currently before the Texas Senate, would further allow up to $35 million annually in insurance tax credits to qualified opportunity funds registered as rural opportunity funds. To be registered, the funds must have invested at least $100 million in non-public companies located in either QOZs or rural cities and counties that have created or retained a certain number of jobs.

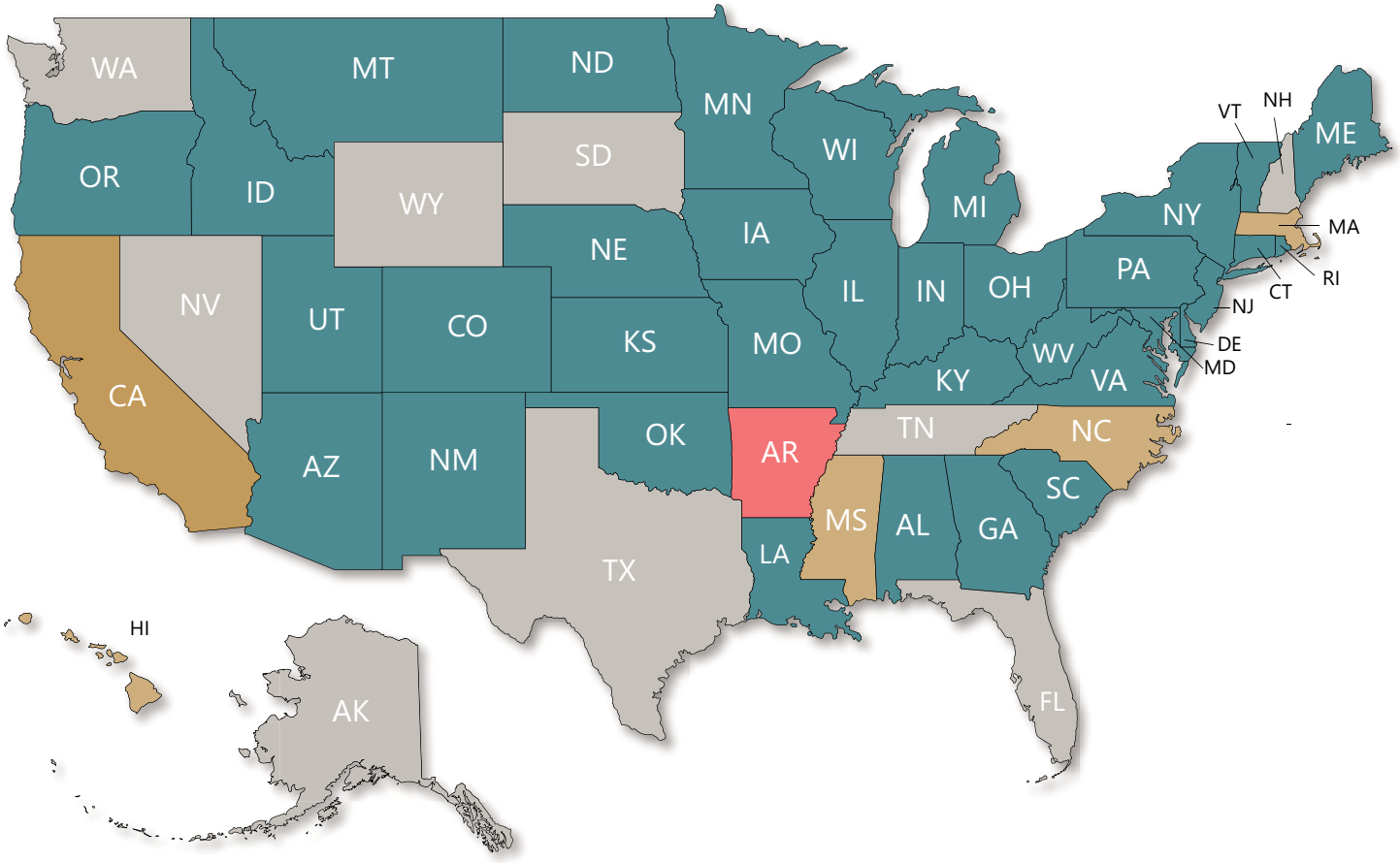
Washington

Washington H.B. 1324 created a state incentive for investment in Washington opportunity zones and rural developments. Once signed by the Governor, the bill would create a tax credit against business tax or insurance premium tax equal to the amount of the contribution to a rural development and opportunity zone account.

Puerto Rico

The Opportunity Zones Development Act, enacted May 14, 2019, provides incentives to areas designated as disadvantaged or low-income communities. In addition to the federally designated opportunity zones, all low-income communities are automatically designated as a Puerto Rico opportunity zone, making approximately 95% of the island eligible. This legislation provides a fixed tax rate on net income from opportunity zones, tax-free dividend distributions, a 15% transferable investment credit and various tax exemptions on property tax, residential priority projects and accrued interest on loans to tax-exempt businesses.

State Conformity - Individual Income Tax



Legend:

- Opportunity Zone Conformity
- Opportunity Zone Non-Conformity
- State with No Individual Income Tax Including Capital Gains
- Limited Opportunity Zone Conformity

Remaining Areas of Uncertainty

There are several key areas of uncertainty that should be considered by investors and fund managers alike. It is expected that Treasury will address many of these issues in subsequent guidance.

Ten Year Step-Up Adjustment

If a QOF partner's basis in a qualifying QOF partnership interest is adjusted under the FMV basis election, then the basis of the partnership interest is adjusted to an amount equal to the FMV of the interest, including debt.

Immediately prior to the sale, the basis of the QOF partnership's assets are also adjusted. The adjustment to the partnership's assets is calculated in a manner similar to an IRC Sec. 743(b) adjustment had the transferor partner purchased its interest in the QOF partnership for cash equal to FMV immediately prior to the sale, assuming that a valid IRC Sec. 754 election had been in place.

However, there is no discussion regarding an adjustment to the basis of the assets of a QOZ Business. In a two-tier structure, it is unclear, therefore, how a partner's FMV basis election will impact the assets of underlying QOZ Businesses.

Investor Gain Exclusion

The proposed regulations provide that where a taxpayer has held a qualifying investment in a QOF for at least ten years and the QOF disposes of QOZ Property, the taxpayer may make an election to exclude from gross income some or all of the capital gain from such disposition which is reported on the Schedule K-1 that the taxpayer receives. However, this election is only available for gains generated at the QOF level. Gains incurred at the QOZ Business level in a two-tier structure are not eligible for the election.

It is unclear whether this was a drafting oversight in the proposed regulations or whether this was the intended result. At this point in time, the guidance provided only allows the election where a disposition of property occurs at the QOF level.

Substantial Improvement Requirement

Under the proposed regulations, the determination of whether the substantial improvement requirement is satisfied is made on an asset-by-asset basis. This results in substantial complexity for businesses that have a large amount of assets.

Treasury is considering, and requesting comments, for an aggregate approach for compliance with the substantial improvement test. It is expected that future guidance will address such an alternative option.

Carried Interest

The proposed regulations provide that a share of gain attributable to the services component of an interest in a QOF partnership (i.e., carried interest for services rendered) is not eligible for the various benefits afforded qualifying investments.

However, there is no guidance on whether a carried interest for non-service related reasons would be allowed. For example, a general partner may agree to subordinate his or her return to the return of limited partners. It is unclear if an allocation based on the risk premium for such subordination would be afforded the benefits of QOF investments. Furthermore, a taxpayer would need to consider whether obtaining a valuation to determine the breakdown of carried interest between services and non-service reasons would therefore be warranted.

IRC Sec. 1231 Gains

Because the capital gain income from IRC Sec. 1231 property is determinable only as of the last day of a taxable year, the proposed regulations provide that the 180-day period for investing such capital gain income from IRC Sec. 1231 property in a QOF begins on the last day of the taxable year.

Therefore, an investor that recognizes an IRC Sec. 1231 gain on January 5 of a tax year needs to wait until the end of the year to have the opportunity to make a qualifying QOF investment. The Treasury Department and the IRS have requested comments on this proposed treatment of IRC Sec. 1231 gains. Also, taxpayers who invested IRC Sec. 1231 gains from 2019 transactions before the April 2019 proposed regulations were issued may have non-qualified QOZ investments even though they made the contributions to the QOF prior to the guidance delaying the allowable timing.

Generally, capital gains and IRC Sec. 1231 gains are netted on an individual's tax return to determine whether the gains are short/long-term or capital/ordinary, respectively. The proposed regulations do not address whether: (1) individuals must determine their net capital gains or IRC Sec. 1231 gain/loss for the taxable year to determine the character and eligibility of the investment in a QOF, or (2) whether a partnership making a QOF election must determine the character and eligibility of its investment in a QOF by first verifying on a partner-by-partner basis.

Rolling Over a QOF Investment/Interim Gains

QOF

The proposed regulations do not provide guidance regarding gains recognized by a QOF on interim sales of QOZ property. The preamble to the proposed regulations does however state that the statutory language regarding QOF investments does not specifically authorize the Treasury Department to prescribe rules for QOFs departing from the normal gain recognition rules. Therefore, it appears any interim gains would be recognized by the investors in QOFs.

INVESTOR

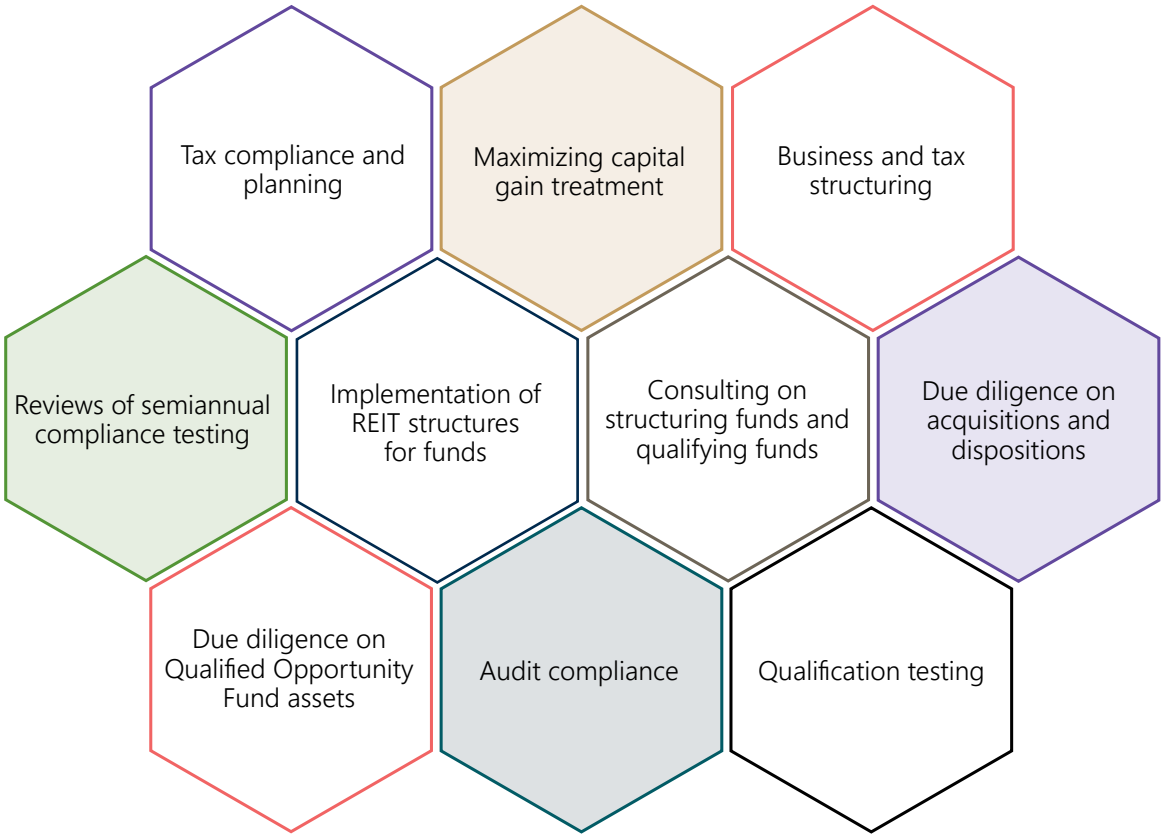
If a partner or partnership sells its **entire** interest in a QOF prior to December 31, 2026, the proposed regulations allow the investor to reinvest the funds into another QOF within 180 days of that secondary sale. However, the proposed regulations do not address whether: (1) any gain in excess of the originally deferred gain resulting from the sale must be recognized in the year of sale or is deferred until December 31, 2026 (at the latest), or (2) whether the holding period resets or is tacked on from the original QOF investment for purposes of the ten-year FMV basis election.

Determining a Fair Market Value

As discussed earlier, the amount subject to tax on the sale or exchange of a QOF interest or December 31, 2026 is the lesser of the fair market value of the property at the time of the event or the original deferred gain, taking basis increases, if any, into account. It is unclear whether normal valuation rules are applicable, such as discounts for lack of control and lack of marketability.

EisnerAmper's Qualified Opportunity Fund Resources

EisnerAmper has a team of specialists dedicated to assisting Qualified Opportunity Fund investors with a wide array of services. Tax compliance and planning are critical elements in a fund's financial strategy. Beyond preparing returns, we work closely with clients on business and tax structuring designed to minimize federal, state, and local income tax; withholdings; UBTI; ECI; FIRPTA and other taxes. Another facet of our tax planning focuses on maximizing capital gain treatment and the implementation of REIT structures for funds in order to offer investors tax-efficient returns. We also review semiannual compliance testing, assist with federal and state examinations, and analyze sales tax on shared services agreements and purchases. Our professionals can also offer clients assistance with consulting on structuring and qualifying funds, due diligence on acquisitions and dispositions, due diligence on a Qualified Opportunity Fund's assets, audit and tax compliance including qualification testing, and outsourced fund administration services.



With EisnerAmper's deep bench of professionals and access to robust fund resources, we can provide comprehensive support for Qualified Opportunity Funds. And as a leading service provider for financial services companies, private equity funds, and family offices, EisnerAmper is uniquely positioned to help create synergies that help you grow. We approach each engagement with a big-picture perspective, working across our many specialties to provide a comprehensive service solution that works best for you.

For more information, visit EisnerAmper.com/QOF or contact us at realestate@eisneramper.com

We hope you have found this guide to be a helpful resource.
If you have any further questions or comments, email
realestate@eisneramper.com

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