Session 407 | What (Not So) Crazy Rich Asian Americans Need to Know about Qualified Opportunity Zones

Do you or someone you know have capital gains and don’t know what to do? Do you see a low income neighborhood like Flushing, New York and wish to help revitalize it? Then consider the newly created qualified opportunity zone (QOZ) program, which provides certain tax benefits for qualified opportunity fund (QOF) investments in designated low-income census tracts. QOZs have generated a huge amount of public attention for a tax code provision, due to the potential to deploy possibly trillions of dollars to the affected communities through 2026. Even after several sets of IRS regulations, a large number of questions remain about how individuals, property owners, and other constituencies may benefit from the program.

The panel consists of veteran tax practitioners with representative experience in all aspects of the QOZ program, ranging from retail and institutional investors to fund organizers, property developers, startup entrepreneurs, and other groups. Discussion topics will include (i) the major areas of tax and regulatory uncertainties for the QOZ program, (ii) the important tax and business considerations in selecting a QOF investment, and (iii) creative strategies for property owners and business owners to obtain the tax benefits.

Moderator:
Edward Kim, Senior Counsel, Wells Fargo

Speakers:
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Agenda

• Overview
• Qualified Opportunity Funds
• Assets
• Foreign Investors
• Questions
What is it?

• Investments in a qualified opportunity zone are entitled to preferential tax treatment

• Designed to spur long-term economic development and job creation in distressed communities

• Added to the Internal Revenue Code by the Tax Cuts and Jobs Act on December 22, 2017
What are the Tax Benefits?

• Capital gains tax deferral
  – Earlier of sale or December 31, 2026 (e.g., 8 years)

• Reduction in capital gains
  – Basis increased by 10% (5 year hold)
  – Basis increased by 15% (7 year hold)

• Eliminate future gain
  – No tax due upon sale (10 year hold)
Where are the Opportunity Zones in New York City?
Where are the Opportunity Zones in New York State?

• See https://esd.ny.gov/opportunity-zones
• Low Income Community
• Based on 2010 population census tracts
• In New York City, this includes Flushing
Sample Steps

1. Invest Capital Gains

2. Timely (e.g., within 180 days)

3. Qualified Opportunity Fund

4. Qualified Opportunity Zone Property
Sample Timeline

2020
investor sells asset with $100 capital gain

2025
tax basis in fund increased to $10 (10% of investment)

2030
if fund interest sold after 10 years of investment, no tax on additional gain

2020
invest $100 in qualified opportunity fund within 180 days; defer tax on gain; but tax basis in fund set to zero

2026
mandatory tax payment on deferred gain (less tax basis increase)
Qualified Opportunity Funds
Sample Fund Structure

- General Partner
- Investors
- Qualified Opportunity Fund
- Qualified Opportunity Zone Business
- Qualified Opportunity Zone Business Property
Fund Compliance Considerations

- Investment vehicle organized as a corporation or partnership
- QOF election made by fund
- Feeder structures generally do not qualify
- 90% of assets in:
  - Qualified opportunity zone business property
  - Qualified opportunity zone partnership interest
  - Qualified opportunity zone stock
- Greater qualification flexibility with indirect interests
- 90% asset test satisfied every 6 months
- Annual certification by fund
- Potentially complicated book keeping required, tracking eligible and non-eligible gains separately
Fund Commercial Considerations

- Timing, frequency, and method of capital calls
- Certain distributions may trigger deferred gain
- Tax distribution to cover tax bills in 2026?
- Subsequent closings/later investors
- Exit considerations – sale of QOZB or QOF?
- Carry is not entitled to QOZ benefits
ASSETS
QOF’s or Lower-Tier Entity’s Owned Property

- Purchased in 2018 or later from a ≤20%-related party
- Used in the active conduct of a trade or business (not a triple net lease)
- Generally at least 70% of the use of the property is in the QOZ
- Except for land, meet either original use or substantial improvement test
  - Original use – placed in service for depreciation purposes
  - Substantial improvement – more than double the adjusted basis of the property within 30 months
  - Vague anti-abuse rule for land banking
QOF’s or Lower-Tier Entity’s Leased Property

- Leased in 2018 or later from a ≤20%-related party
- Used in the active conduct of a trade or business (not a triple net lease)
- Generally at least 70% of the use of the property is in the QOZ
- Except for land, meet either original use or substantial improvement test
  - Original use – placed in service for depreciation purposes
  - Substantial improvement – more than double the adjusted basis of the property within 30 months
  - Vague anti-abuse rule for land-banking
- Market rate lease under section 482 transfer pricing rules
- For property other than unimproved land, only fmv purchase options
- For related party leases, no >12 month rent prepayment and a special rule for leased personal property
Operating Business

- Investors
- Opportunity Fund partnership
  - Opportunity Zone stock in lower-tier corporation A
  - Opportunity Zone stock in lower-tier corporation B
  - Opportunity Zone partnership interest
Operating Businesses

• Interest in lower-tier entity must be equity issued in primary for cash
• Interest can be preferred or common, but not debt or issued for services
• Potential to use new QOF “recycling” rule, which helps with 90% asset test but not for lower-tier entities, and does not exempt the gain from tax
• In a two-tier structure, at least 50% of the lower-tier entity’s gross income is derived from the active conduct of a trade or business in the QOZ

• Safe harbors 1 and 2 apply if at least 50% of the business’s services (based on either hours or employee compensation) is performed by employees and independent contractors (including the employees of independent contractors) within a QOZ

• Safe harbor 3 requires that (i) the business’s tangible property in a QOZ and (ii) the business’s management or operational functions in the QOZ are each necessary to generate at least 50% of the business’s gross income

• Can an operating business have activities in more than one QOZ?
Intangible Property Test

• In a two-tier structure, at least 40% of the lower-tier entity’s intangible property must be used in a business in a QOZ

• No guidance on how to actually apply this test
  – Patents, copyrights, trademarks
  – Goodwill
  – Software
  – Leasing costs
Excluded Businesses

• Lower-tier entity cannot own a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises
  – A QOF may own such businesses directly
  – No clarity on definitions:
    • Health spa?
    • Minigolf?
  – Still unclear whether a tenant can be an excluded business
# QOZ vs. Section 1031

<table>
<thead>
<tr>
<th>Qualified Opportunity Zone</th>
<th>Like-Kind Exchange (Section 1031)</th>
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<tbody>
<tr>
<td><strong>Relinquished Property</strong></td>
<td>Any asset that gives rise to capital gain and sold to ≤20%-related party</td>
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<tr>
<td><strong>Replacement Property</strong></td>
<td>QOF can own indirectly at least 63% personal property and real property in QOZs in the United States (incl. Puerto Rico), with original use or substantial improvement, purchase from ≤20%-related party, and other tests. QOF can also own indirectly some cash and intangible property.</td>
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<td><strong>Acquisition Period</strong></td>
<td>Around 179 days to acquire QOF interest (beginning from year-end for section 1231 gain, some issues with partnerships), up to another 3 years to acquire and develop property</td>
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<td><strong>Investment</strong></td>
<td>Gain amount (net gain for section 1231 gain)</td>
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<td><strong>Benefit of Initial Tax Deferral</strong></td>
<td>Gain deferred until 2026, up to 15% exempt, no basis step-up for deferred gain at death</td>
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<td><strong>Post-Investment Gain</strong></td>
<td>Permanent tax exemption after 10 years</td>
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Foreign Investors
General Considerations

• Foreign persons generally are not subject to US taxation on capital gains

• Exceptions
  – Dispositions of US real property interests (USRPIs)
  – Interests in partnerships engaged in business in the United States (operating partnerships)

• Are non-taxable capital gains of a foreign person eligible for QOZ benefits?

• What about capital gains from the sale of USRPIs/operating partnerships?
Pass-Through Entity Considerations

- Tax considerations for foreign investors in a QOZ Fund structured as a pass-through entity
  - Investor taxed on share of Fund’s operating income at normal rates applicable to US persons
  - Fund obligated to withhold US tax from income allocated/distributed to foreign investors
  - Investor must file annual US tax returns
  - Fund interests potentially subject to estate tax
  - Foreign person may invest through a blocker corporation to preserve anonymity with IRS and avoid estate tax (in the case of a foreign blocker)
Alternatives

• Alternatives for deferral/elimination of US tax on capital gains from dispositions of USRPIs

  – 1031 exchange
  – Domestically controlled REIT
QUESTIONS?