

Ozone 201

What We Know...And
What We Don't Know

Fund Formation, Deal
Structuring, Timing, Exit, etc.

March 6, 2019



FUND FORMATION – GENERAL SEQUENCE

The following outlines the general sequence for the deferral of CG and the consummation of an investment of such gain in an Opportunity Zone:

Step 1: A Qualified Opportunity Fund (a “QO Fund”) is formed by the investor or a third party and self certifies its status as an QO Fund. (Set up Qualified Opportunity Zone Business as well in order to achieve safe harbor?)

Step 2: An investor with a recently realized CG elects to invest this gain into the QO fund within 180 days from the date of the underlying sale or exchange of the asset, taking stock or a partnership interest in the QO Fund (the “OZ Fund Interest”) in return. By so doing, the investor is able to defer including the CG in income.

Step 3: The QO Fund uses the investment to acquire “qualified opportunity zone property.” This investment represents the QO Fund’s interest in the underlying business in the low-income community.

Step 4: The investor holds the OZ Fund Interest for as long as he desires or for some period of time as may be stipulated in the organizational documents of the QO Fund. Unless adjusted as described in Step 5, the basis of the investor in the OZ Fund Interest is zero.

FUND FORMATION– GENERAL SEQUENCE

Step 5: If the investor sells or exchanges his OZ Fund Interest before December 31, 2026, he will recognize all or a portion of the deferred CG. If the holding period of the OZ Fund Interest on the date of sale is at least 5 years, the investor receives a 10% basis increase for such investment to offset a portion of the CG. If the holding period of the OZ Fund Interest on the date of sale is at least 7 years, the investor receives an additional 5% basis increase above the 10% increase for the 5 year hold.

Step 6: In any event, the investor's CG deferral period ends on December 31, 2026. If the investor still owns the OZ Fund Interest, the deferred CG must be recognized as of that date, subject to the basis adjustments noted in Step 5 above. The amount of gain recognized will not exceed the excess of (i) the lesser of the fair market value of the OZ Fund Interest or the deferred gain over (ii) the basis of the OZ Fund Interest on such date

Step 7: If the investor holds his interest in the QO Fund for at least 10 years, he is entitled to fair market value basis increase at the time of disposition of the interest (upon taxpayer's election), which results in any appreciation in the value of his interest being excluded from income.

Summary: The QO Zone Program incentivizes QO Fund investments by allowing for (a) temporary deferral and limited elimination of CG, (b) possible step-up basis of such OZ Fund Interest, and (c) possible permanent exclusion of CG from the appreciation of such QO Fund investments.

OZ PROGRAM – INVESTMENT BENEFITS EXAMPLES

EXAMPLES

Assume A sells stock with a basis of 5mm for 10mm, realizing a 5mm gain on June 1, 2018. On July 1, 2018, A invests 5mm in P, a certified QO Fund taxed as a partnership with a December 31 year end, in exchange for interest in P, an OZ Fund Interest. On August 31, 2018, P acquires Qualified Opportunity Zone Partnership Interest, as described below (a “QOZPI”) which constitutes its only asset. A sells the OZ Fund Interest for 15mm on July 2, 2028. At all times, A’s interest is an OZ Fund Interest and P’s interest is a QOZPI. Assume that on December 31, 2026, the value of A’s OZ Fund Interest is 5mm. We would expect the following results: (i) A pays no tax on the CG in 2018; (ii) P constitutes a QO Fund; (iii) on December 31, 2026, A recognizes eighty-five percent of the deferred 2018 CG or \$4,250,000; and (iv) A recognizes no gain as a result of the sale of the OZ Fund Interest on July 2, 2028.

FUND FORMATION– THE INVESTOR

The OZ statute addresses CG from the “sale to, or exchange with, an unrelated person of any property held by the **taxpayer**” and makes the available deferment of CG under the OZ program “at the election of the **taxpayer**.”

- “Taxpayer” is defined in the proposed OZ regulations to be a person that may recognize gains for purposes of Federal income tax accounting.
- Thus, “eligible taxpayers” include individuals; C corporations, including regulated investment companies (RICs) and real estate investment trusts (REITs); partnerships; S corporations; trusts and estates.
- Taxpayer Types: Family offices, insurance companies, corporations with investible assets, high net worth individuals, foreign investors?, developers.
- Likely not interested: Non-profits, Banks, 401k Groups.

FUND FORMATION – GAIN ELIGIBLE FOR OZ INVESTMENT

The proposed OZ regulations provide that gain entitled for OZ treatment is “**eligible gain**” if:

- The gain is treated as capital gain for Federal income tax purposes;
- The gain would be recognized (and invested) for Federal income tax purposes prior to January 1, 2027 in the absence of an OZ investment; and
- The gain does not arise from the sale or exchange with a person who is related to the taxpayer.
- “Eligible gain” does not include any portion of gain that has already been elected to be deferred under the OZ program.
- For 1256 contracts (mark to market), eligible gain is only capital gain net income for a taxable year.
- Gain from offsetting positions transactions is not eligible gain.

FUND FORMATION – CORPORATION OR PARTNERSHIP?

The Qualified Opportunity Zone Fund is required to be a corporation or partnership for tax purposes.

- Corporation straight forward but valid partnership formation can involve tricky questions when it comes to diversifying ownership in self-directed funds and businesses.
- Who will be the minority partner, will that partner's contribution also be considered "eligible gain" for deferral or will it be a "mixed fund."
- Qualified Opportunity Zone Business has to also be a corporation or partnership for tax purposes as well. How do we distinguish the QOZB from OOZF for ownership purposes if pass through partnership? How much ownership diversity is enough?
- What proactive measures can a new business take to optimize investment? Location, assets, ownership structure?

FUND FORMATION – THE QO FUND

The OZ statute defines a “**Qualified Opportunity Fund**” to be:

- An investment vehicle which is organized as a corporation or a partnership for the purpose of investing in **qualified opportunity zone property** (other than another qualified opportunity fund); and
- Such vehicle holds at least 90 percent of its assets in qualified opportunity zone property, determined by the **average** of the percentage of qualified opportunity zone property held in the fund as measured:
 - On the **last day of the first 6-month** period of the taxable year of the fund, and
 - On the last day of the taxable year of the fund
- Form 8996 – Testing Periods.

FUND FORMATION – THE QO FUND

- The eligible entity self certifies as an OZ Fund on forms released by the IRS.
- The entity may designate the first month of its certification or absent such designation the certification is effective on the first month of the entity's initial taxable year.
- Any investment made in an OZ Fund prior to certification is not eligible for OZ deferral.
- Preexisting entities are eligible for OZ Fund certification as long as they satisfy all of the OZ statutory and regulatory requirements.
- The entity must be organized in one of the 50 states, Washington D.C., or a U.S. territory.
- Additional limitations if organized within a U.S. territory.

FUND FORMATION – THE QO FUND: THE ASSETS TEST

90% ASSETS TEST

- “**Assets**” - QO Fund is required to hold at least 90% of its average assets in QO Zone Property.
- For entities with financial statements, the value of the asset is the same as reported on the statement. For entities without applicable financial statements, the asset is valued on a cost basis.
- **Testing Period** – The 90% test is measured:
 - on the last day of the first 6-month period of the taxable year of the fund and in which the OZ certification is effective, and
 - on the last day of the taxable year of the fund
- **Penalty** – If the QO Fund fails to meet the assets test, QO Fund must pay a penalty for each month that it does not meet the test. The amount of the penalty is equal to the excess of 90% of the aggregate assets over the aggregate amount of QO Zone Property held by the QO Fund, multiplied by the underpayment rate established in Section 6621(A)(2).

TIMING– THE 180 DAY INVESTMENT PERIOD

To be eligible for OZ gain deferral, the taxpayer's eligible gain must be invested in a Qualified OZ Fund within "the 180-day period beginning on the date of such sale or exchange" giving rise to the eligible gain.

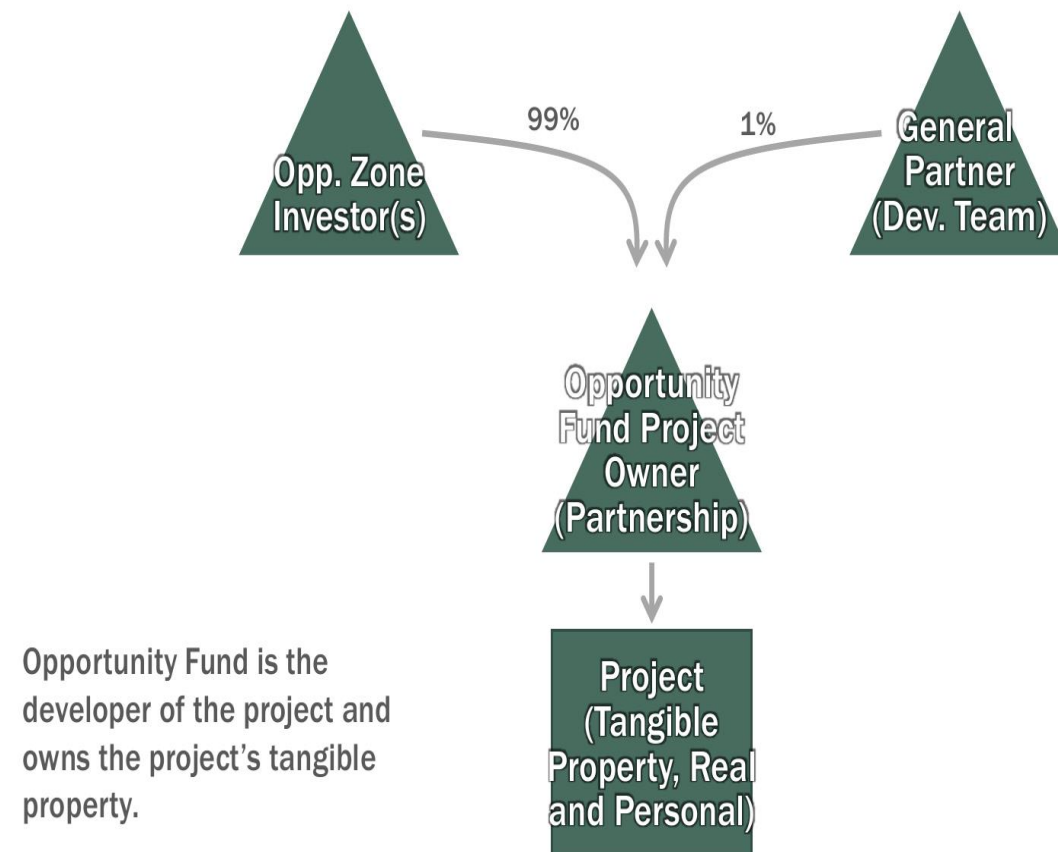
- The proposed OZ regulations clarify that the 180 day period begins on the day on which the gain would be recognized for Federal income tax purposes.
- For stock, the 180 day period begins on the day the stock is traded.
- For RIC or REIT shareholders, the 180 day period begins on the day of receipt of the dividend.
- For previously deferred gain that is eligible for reinvestment in an OZ Fund, the 180 day period begins on the date on which the entire original OZ investment is disposed of.

TIMING– THE 180 DAY INVESTMENT PERIOD

- For partnerships, if the partnership itself elects to defer the gain then the 180 day period begins on the date of the sale or exchange.
- Absent a partnership level deferral, for the individual partners, the 180 day period begins on the last day of the partnership taxable year.
- Partners may elect to have their 180 day period coincide with the partnership's 180 day period.
- For other pass through entities like S-Corporations, trusts, or a decedent's estate, the rules analogous to partnerships and partners apply to shareholders or beneficiaries, as the case may be.
- Taxpayers are entitled to rely on the proposed OZ regulations for the 180 day period issue.

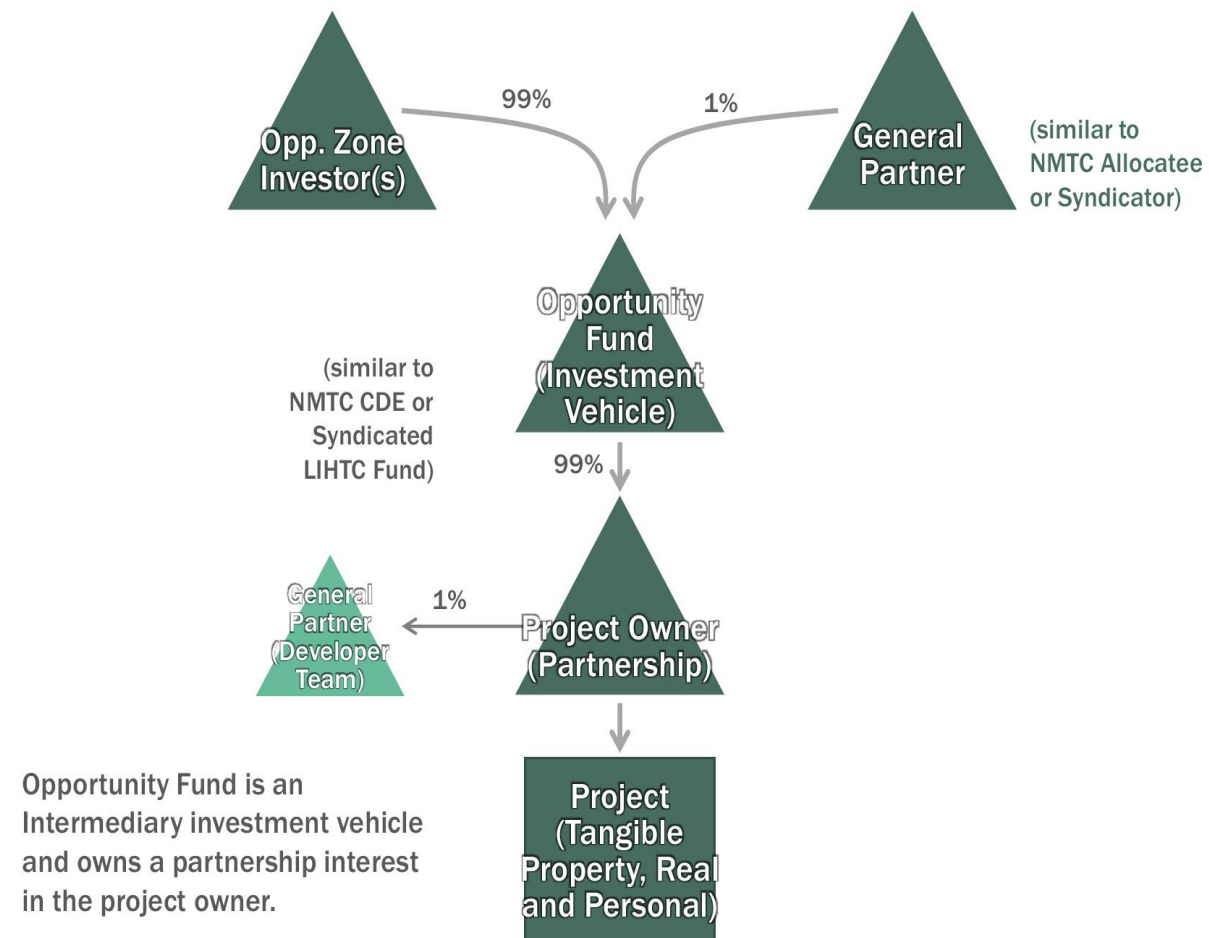
STRUCTURE - DIRECT

Direct Approach



STRUCTURE - INDIRECT

Indirect Approach



STRUCTURES – DIRECT V. INDIRECT

Requirement	Direct Investment	Indirect Investment
% of OFund assets invested in Ozone Property	90%	N/A
% of OFund assets invested in stock or partnership interests	N/A	90%
% of OFund assets that may be held in cash or liquid	10% (including intangibles)	5% plus reasonable working capital
% of OFund assets that may be held in intangible property	10% (together with cash)	Unlimited, but intangible property must be used in trade or business
% of OFund assets that must be invested in tangible property	90%	No minimum
% of gross income must be derived from within the Ozone	None	50%
Ineligible Business	None	“Sin” Business

STRUCTURES – THE QO FUND: QO ZONE PROPERTY

QUALIFIED OPPORTUNITY ZONE STOCK

- QO Zone Stock is stock in a domestic corporation, including an S corporation, acquired by the QO Fund from the corporation after December 31, 2017, at its original issue directly from the issuer, solely in exchange for cash.
- When the QO Zone Stock is issued, the corporation must be a **QO Zone Business** and must remain a QO Zone Business for substantially all of the QO Fund's holding period of such stock. (Decertification?)
- If it is a new corporation, it must be organized for the purpose of being a QO Zone Business.
- A redemption of QO Zone Stock is subject to I.R.C. § 1203(c)(3), which prohibits the issuing corporation from purchasing such stock from the purchaser or a party related to the purchaser for a 4 year period beginning on the date that is two years prior to the issuance of the stock.
- Investments in corporate debt instruments are not permitted
- The taxpayer may collateralize the stock.
- What about 1202 Corporations (Qualified Small Business Stock Corporations)? Does it help? Other unique tax advantage structures for M&A or exits?

STRUCTURES– THE QO FUND: QO ZONE PROPERTY

QUALIFIED OPPORTUNITY ZONE PARTNERSHIP INTEREST

- QO Zone Partnership Interest is a domestic partnership interest acquired by the QO Fund from the partnership after December 31, 2017, solely in exchange for cash. An interest acquired from a partner, rather than the partnership or an interest acquired in exchange for property other than cash will not qualify
- As is the case with QO Zone Stock, when the QO Zone Partnership Interest is issued, the partnership must be a QO Zone Business and must remain a QO Zone Business for substantially all of the QO Fund's holding period of such interest.
- If it is a new partnership, it must be organized for the purpose of being QO Zone Business.
- Investments in partnership debt instruments are not permitted, and the taxpayer may collateralize its OZ partnership interest.

STRUCTURES – THE QO FUND: QO ZONE PROPERTY

QUALIFIED OPPORTUNITY ZONE BUSINESS PROPERTY

- QO Zone Business Property is tangible property used in a trade or business of a QO Fund if such property:
 - Was acquired by purchase after December 31, 2017,
 - The original use of such property in the QO Zone commences with the QO Fund or the QO Fund substantially improves the property, and
 - substantially all (at least 70%) of the use of such property was in a QO Zone during substantially all of the QO Fund's holding period for the property
- **Substantial Improvement** – QO Zone Business Property is deemed substantially improved if during the 30 month period beginning after the date of acquisition, the additions to the basis of such property in the hands of the QO Fund exceed the adjusted basis of such property at the beginning of the 30 month period. For property consisting of land and improvements, the substantial improvement requirement only applies to the improvements, not the land.

STRUCTURES : QO ZONE BUSINESS

A “**QO Zone Business**” is a trade or business:

- In which substantially all of the tangible property owned or leased by the taxpayer is QO Zone Business Property;
- At least 50% of the total gross income of such business is derived from the active conduct of such business;
- A substantial portion of the intangible property of such entity is used in the active conduct of any such business;
- Less than 5% of the average of the aggregate unadjusted bases of the property of such business is attributable to nonqualified financial property, with allowances for reasonable amounts of working capital that meets certain requirements; and
- Is not a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

QO ZONE: QO ZONE BUSINESS

- **Safe Harbor** – If the QO Zone Business Property of the QO Zone Business ceases to be QO Zone Business Property, it will continue to be treated as such for the earlier of (i) 5 years after the date it ceases to be qualified, or (ii) the date on which it is no longer held by the QO Zone Business.
- **Working Capital Safe Harbor for QO Zone Business:**
 - Amounts designated in writing for the acquisition, construction and/or substantial improvement of tangible property in a QOZ.
 - There is written schedule consistent with the ordinary start-up of a business for the expenditure of the working capital assets within 31 months of the receipt of the assets.
 - The working capital assets are actually used in a manner consistent with the designation and the schedule.
 - Gross income earned on working capital during reasonable working capital period counted toward satisfaction of 50% active conduct test,

WHAT WE DON'T KNOW

- **O Zone Fund Safe Harbor:** O Zone Fund needs more time. No safe harbor at the fund level at this time. Second round of regulations?
- **Exits:** Sale of Assets v. Interests Re: 10 Year Hold. What are other uncertainties in exits?
- **What happens if an O Zone Fund Sells Property During the 10 Year Hold?** Reinvestment and related issues. How long will an O Zone Fund have to reinvest proceeds from the sale of property to keep the clock ticking?
- **What about debt financed distributions?** Those that don't exceed a partners basis...would they be considered return of capital or continue deferral?
- **Feeder partnership structures.** Can numerous taxpayers create a partnership that, in turn, invests into an O Zone Fund?
- **What about vacant land?** Vacant buildings that have not been in use for some time period?
- **Residential rental property in QOZB? What is active conduct standard? What about leased property for QOZB?**



Questions?



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