ECONOMIC
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Qualified Opportunity Zone Investment Considerations

2021

Prepared by Steptoe & Johnson for the EIG Opportunity Zones Coalition

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This memorandum discusses certain key federal income tax considerations[1] of which qualified opportunity fund (QOF) managers should be aware and illustrates them using several simplified examples of QOF structures. The examples generally progress from the simplest structure in terms of issues presented to the most complicated. In addition, this memorandum highlights various differences between a traditional investment fund and a QOF. This memorandum does not contain a comprehensive analysis of the qualified opportunity zone (QOZ) requirements or issues relating to these structures. Fund managers are encouraged to consult with tax advisors. Capitalized terms used herein are defined in the Glossary in Appendix 1 at the end of this memorandum, and a summary of key differences between traditional investment funds and QOFs can be found in Appendix II.

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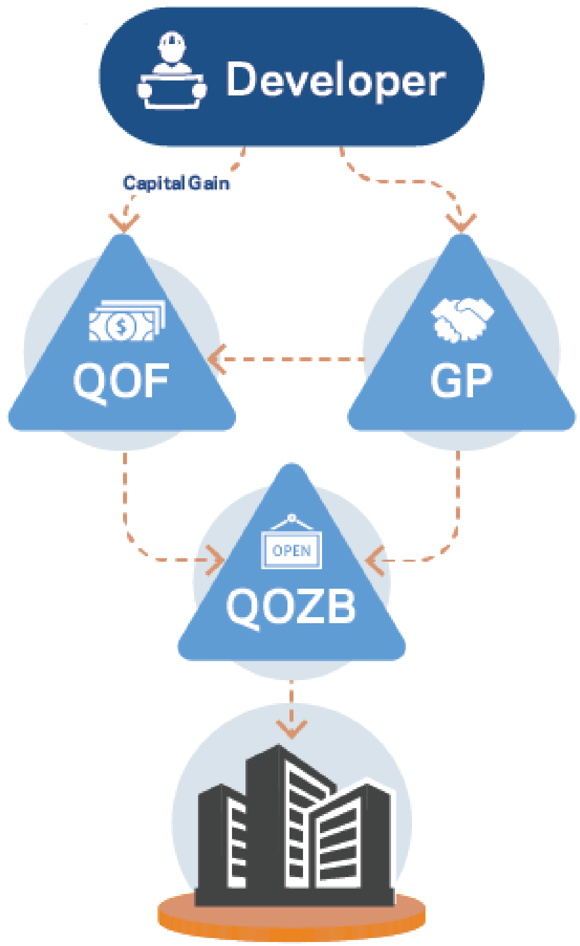
1 This memorandum addresses only the requirements of section 1400Z-2 of the Internal Revenue Code of 1986, as amended, and the final regulations thereunder. See Treas. Reg. §§ 1.1400Z2(a)-1, 1.1400Z2(b)-1, 1.1400Z2(c)-1, 1.1400Z2(d)-1, 1.1400Z2(d)-2, 1.1400Z2(f)-1, 1.1502-14Z, and 1.1504-3.

Scenario 1: Single Investor, Single Asset (Real Estate) QOF



Tax Objectives

The structure illustrated in this scenario generally would be used by a real estate developer who has a significant capital gain that will be recognized and wishes to reinvest the proceeds from this gain into an investment located in a QOZ (such as a real estate project) where the developer will act as the anchor investor (as well as the fund manager).

Timeline/Overview of Scenario

- On March 1, 2019, Developer recognizes a $1 million capital gain.
- On August 1, 2019, Developer invests the proceeds into a newly formed QOF.
- On April 1, 2020, the QOF contributes $1 million to a newly formed qualified opportunity zone business (QOZB), and the QOZB borrows another $1 million.
- On April 30, 2020, the QOZB purchases land in a QOZ from an unrelated person for $50,000.
- The QOZB has a written schedule in place to expend the $1.95 million remaining funds for the ground-up development of a commercial building with an anticipated completion date of March 31, 2022. In the meantime, the QOZB holds the investment in cash, cash equivalents, or short-term debt.

Considerations for Single Investor, Single Asset (Real Estate) QOF

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Exit strategies are considered below in Scenario 4.

A. Eligible Gains

The regulations adopt a "gross approach" to gains from "section 1231 property" (generally consisting of depreciable property held for at least one year for use in a trade or business). In general, net gains from the sale or exchange of section 1231 property are treated as capital gains whereas net losses are treated as ordinary losses.

Under the "gross approach" of the regulations, Eligible Gains for QOZ purposes include the gross amount of eligible section 1231 gains unreduced by section 1231 losses. As a result, section 1231 gains treated as Eligible Gains are deferred and not taken into account for purposes of netting under section 1231(a) or the recapture rules of section 1231(c) until they are triggered. This can affect the character of section 1231 losses in the same year. For example, if Developer realized a $1 million section 1231 gain and a $1 million section 1231 loss, it can treat the $1 million section 1231 gain as Eligible Gain. The $1 million section 1231 loss would be treated as ordinary because Developer has a net section 1231 loss for the taxable year. The $1 million section 1231 gain would be taken into account when triggered.

B. Investment Timeline

Because of the need to satisfy various rules at different testing dates under the QOZ statute and regulations, the timing of investing and deploying capital in a QOF is significantly less flexible than for a traditional investment fund.

Investor Level: The investor must make its contribution to the QOF within 180 days of the date on which its capital gain was recognized for tax purposes, which is generally the date on which the capital asset is sold.[2] In this scenario, the Developer recognized capital gain on March 1, 2019 and invested in the QOF on August 1, 2019, which is less than 180 days after March 1.

If the investor realizes a section 1231 gain, because such gains are taken into account on a gross basis, it is not necessary for the investor to wait until the end of the taxable year to determine whether the section 1231 gain is an Eligible Gain. If the Developer had sold section 1231 property to an unrelated party for a gain on March 1, 2019, the Developer's 180-day period for investment would begin on March 1, similar to capital gain from the sale of a capital asset.[3]

If the capital gain is realized by a partnership in which Developer is a partner, the partnership itself may invest in the QOF, or the partners may elect to invest their distributive share of the partnership's gain. In the latter case, the 180-day period, by default, runs from the last day of the partnership taxable year (December 31, 2019 in the case of a calendar year partnership), but the partner may elect to instead use: (i) the same 180-day period as the partnership (which would start March 1, 2019); or (ii) the due date for the partnership's tax return, without extensions (which would start March 15, 2020). This last option should provide partners with additional time to receive Schedules K-1, which provide partners with necessary information about the amount of their distributive share of Eligible Gain.

If the capital gain is realized in an installment sale, the investor may elect to begin the 180-day investment period on either: (i) the date a payment under the installment sale is received, or (ii) the last day of the year the eligible gain under the installment method would otherwise be recognized. Alternatively, the investor may elect out of installment sale treatment altogether and use the date of the sale to start the 180-day period.

QOF Level: After receiving the capital from the investor, the QOF then has a limited time to invest those funds in QOZ Property to meet the 90% Assets Test (i.e., that at least 90% of the QOF's assets consist of QOZ Property). For this purpose, QOZ Property includes either directly held QOZ Business Property or an interest in an entity,

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2 The IRS extended the investment period in 2020 as a result of the COVID-19 pandemic. If the last day of the 180-day investment period within which a taxpayer must make an investment in a QOF in order to satisfy the 180-day investment requirement falls on or after April 1, 2020, and before December 31, 2020, the last day of that 180-day investment period is postponed to December 31, 2020. Notice 2020-39.

3 Under the proposed regulations, the 180-day period for net section 1231 gain began on the last day of the taxpayer's taxable year in which the gain was recognized. Many investors with section 1231 gains relied on the delayed 180-day period for section 1231 gains that was included in the proposed regulations. Under the final regulations, these investors may find that the 180-day period for these gains has now expired. However, the final regulations provide that the rules contained therein are applicable for tax years beginning 60 days after the date the final regulations are published in the Federal Register, or March 13, 2020. For tax years beginning prior to that time, taxpayers may choose to either rely on the final regulations or each section of the proposed regulations, if applied in a consistent manner for all such taxable years. This means that if the proposed regulations are relied upon for purposes of the 180-day period for section 1231 gains, then none of the final regulations, including the gross approach, may be relied upon. Note, however, that a reasonable interpretation of the statute may be relied upon in lieu of a rule in the proposed regulations.

a QOZB, that holds QOZ Business Property. Measurement dates for the 90% Assets Test generally occur at the middle and end of the QOF's taxable year (i.e., June 30 and December 31 for a calendar-year QOF).[4] Cash, cash equivalents, or short-term debt (with a term of 18 months or less) held by the QOF may be disregarded for six months. This generally means that a QOF has until the next measurement date to satisfy the 90% Assets Test, effectively giving the QOF six to twelve months to invest in QOZ Business Property (which, in this scenario, is the QOF's interest in the QOZB). In this scenario, because the QOF receives money from the Developer in August 2019, the QOF can ignore the cash for six months, until February 2020. Thus, the QOF will be treated as meeting the 90% Assets Test on December 31, 2019, the first measurement date, and would not have to meet the test until its next measurement date of June 30, 2020.[5]

QOZB Level: Once the QOF makes a cash contribution to the QOZB, the QOZB may rely on the Working Capital Safe Harbor in order to make investments in developing a qualifying business (including purchasing or improving a qualifying asset) over a 31-month period. Delays caused by government permitting may extend the safe harbor period. In addition, if the QOZB is located in a QOZ designated as part of a federally declared disaster area, the QOZB may receive up to an additional 24 months to consume its working capital assets.[6]

If additional capital is contributed to the QOZB, the QOZB may have additional 31-month periods to deploy that additional capital.[7] A single business can have multiple sequential or overlapping 31-month safe harbor periods. However, a single unit of tangible property may only benefit from such periods for a total of 62 months[8]. In most cases, however, 62 months should provide a sufficient start-up period.

If the QOF relies on the QOZB to satisfy its 90% Assets Test, it could fail that test if the QOZB fails to meet its requirements (e.g., fails to satisfy the 70% Assets Test after the Working Capital Safe Harbor). The regulations adopt a six-month cure period to bring a QOZB into compliance. During that period, the QOF will be treated as meeting its 90% Assets Test. However, a QOF may apply only once for each QOZB.

4 The IRS provided relief from the penalty for failure to satisfy the 90% Assets Test as a result of the COVID-19 pandemic. In the case of a QOF whose (i) last day of the first 6-month period of the taxable year or (ii) last day of the taxable year falls within the period beginning on April 1, 2020, and ending on December 31, 2020, any failure by that QOF to satisfy the 90% Assets Test for that taxable year of the QOF is deemed to be due to reasonable cause and will be disregarded for purposes of determining whether the QOF or any otherwise qualifying investments in that QOF satisfy the QOZ requirements. Notice 2020-39.

5 There is a technical issue with the computation under this exception if the QOF holds no assets other than the cash, cash equivalents, and short-term debt, because disregarding these assets appears to provide an undefined result (zero divided by zero) for purposes of the 90% Assets Test. Disregarding these assets also means that if the QOF has any nonqualifying property, it will not satisfy the 90% Assets Test until it acquires sufficient qualifying assets and, even then, may not satisfy the requirement that the QOZB qualify for substantially all (for this purpose, 90%) of the QOF's holding period. The final regulations declined to address this issue, but the IRS has indicated informally that it is aware of this issue, so it may not present a problem in practice. To minimize the effects of this issue, a QOF may wish to acquire at least a nominal amount of QOZ Property prior to its first testing date, lease the nonqualifying property or wait to acquire it once it is already invested in sufficient qualifying assets, or report the fraction on Form 8997 as 1.0 instead of an undefined result.

6 Notice 2020-39 clarified that, as a result of the Federally declared disasters resulting from the COVID-19 pandemic, all QOZBs holding working capital assets intended to be covered by the Working Capital Safe Harbor before December 31, 2020 may receive not more than an additional 24 months to expend the working capital assets, as long as the qualified opportunity zone business otherwise meets the requirements of the safe harbor.

7 Note that if the QOZB is relying on Substantial Improvement of the property to satisfy the requirements for QOZ Business Property (as opposed to Original Use), the QOZB has 30 months to substantially improve the property by more than doubling the basis of the asset. This 30-month period runs concurrently with the 31-month Working Capital Safe Harbor period. The IRS extended this 30-month period as a result of the COVID-19 pandemic. Specifically, the period beginning on April 1, 2020, and ending on December 31, 2020, is disregarded in determining any 30-month Substantial Improvement period (that is, the 30-month Substantial Improvement period is tolled during the period beginning on April 1, 2020, and ending on December 31, 2020). Notice 2020-39.

8 In order to benefit from the 62-month safe harbor, certain requirements must be met: (i) each cash infusion must be covered by a 31-month safe harbor; (ii) subsequent cash infusions must form an integral part of the plan covered by the initial working capital safe harbor period; and (iii) each cash infusion must be "substantial," a term that is undefined.

C. Structure

Unlike a traditional investment fund, which can be structured in multiple tiers of entities, QOFs can generally only be structured in one or two tiers. These entities can be either partnerships or corporations for tax purposes, though similar to traditional investment funds, partnerships are frequently being used (and are assumed in Scenarios 1-5; Scenario 6 addresses corporations filing consolidated returns). In addition, with a QOF, only an investment of Eligible Gain qualifies for the QOZ tax benefits. Although additional amounts may be invested, they must be accounted for separately as a Mixed Funds Investment. No such concept exists for traditional investment funds.

One vs. Two-Tier Structure

A QOF must invest at least 90% of its assets in QOZ Property, which can either be directly held QOZ Business Property or an interest in a lower-tier QOZB. Thus, the QOZ rules contemplate either a single-tier structure consisting only of the QOF or a two-tier structure consisting of the QOF and the QOZB. If the two-tier structure is used, the cash must flow from the QOF to the QOZB, and the QOZB, in turn, invests in QOZ Business Property.

However, the rules favor the two-tier structure. First, there is more time to deploy capital. As discussed above in Scenario 1.B, Investment Timeline, a QOF has six to twelve months to invest in QOZ Property, but the QOZB benefits from up to 62 months if it takes advantage of multiple Working Capital Safe Harbors. Second, there is a larger cushion for nonqualified property. The QOF must satisfy the 90% Assets Test, leaving only a 10% cushion, while the QOZB need only satisfy the 70% Assets Test, leaving a 30% cushion. Note, however, that if the QOZB is a disregarded entity, then the QOF will not be able to take advantage of the Working Capital Safe Harbor or the 70% Assets Test, but a QOZB can hold assets through one or more disregarded entities without running afoul of these requirements.

Form of Investment

In the simplest case, an investor will contribute cash to the QOF less than or equal to the investor's amount of Eligible Gain. But the investor can also contribute noncash property to the QOF or purchase an interest in a pre-existing QOF and still qualify for the tax benefits. Services do not qualify; therefore, a carried interest cannot be a qualifying interest.

However, an investor may have a Mixed Funds Investment that partially qualifies for QOZ benefits and partially does not qualify. For example, if an investor contributes more cash to the QOF than the Eligible Gain available, it generally will have a Mixed Funds Investment. An investor also will have a Mixed Funds Investment if it contributes appreciated property to the QOF. In general, the portion of the investor's contribution that corresponds to basis will be a qualifying investment while the built-in gain portion will be nonqualifying.

An investor that receives a carried interest in the QOF in exchange for management services while also making a qualifying investment will have a Mixed Funds Investment. In such a case, the allocation percentage for the investor's carried interest will be determined based on the share of residual profits the mixed-funds partner would receive with respect to that interest, disregarding any allocation of residual profits for which there is not a reasonable likelihood of application. Thus, if the partnership agreement provides for a waterfall where the carried interest is subject to a “catch-up” provision, the allocation percentage will be the highest share that has a reasonable likelihood, even if the partner’s actual share of profits resulting from the waterfall is much lower.

Accounting for Mixed Funds Investments can become complicated, because they must be treated as separate interests for purposes of the applying QOZ rules. As a result, fund managers and investors may wish to avoid having Mixed Funds Investments. This can be accomplished by not making or allowing Mixed Funds Investments or by having investors make nonqualifying investments directly in the QOZB instead of through the QOF.

When the QOF makes an investment in the QOZB, it must do so by directly purchasing an interest from the QOZB in exchange for cash. Unlike the investment by the investor in the QOF, the QOF cannot purchase an interest in the QOZB from another person, and it cannot contribute noncash property to the QOZB.

D. QOZ Business Property Requirements

70% Assets Test

Traditional funds can focus on the fund’s investment strategy and investment objectives in identifying investments. Managers of QOFs will need to consider these objectives while also ensuring that the investments will meet a variety of tests to qualify as QOZ Property or QOZ Business Property.

In order to constitute QOZ Business Property, property must be purchased after December 31, 2017 from someone who is not a Related Person and either Substantially Improved or the Original Use of the property in the zone must commence with the QOF or QOZB.[9] In addition, substantially all (for this purpose, 70%) of the use of the property must be in the QOZ for substantially all (for this purpose, 90%) of the entity’s holding period. The 70% Assets Test is suspended during a valid Working Capital Safe Harbor.

The regulations include special rules for vacant property. If real property, including land and buildings, has been vacant for an uninterrupted period of at least one calendar year beginning on a date prior to the date on which the QOZ in which the property is located is listed in a QOZ designation notice and the property has remained vacant through the date on which the property was purchased by a QOF or QOZB—or if the property has been vacant for an uninterrupted three calendar year period beginning on a date after the date of publication of the QOZ designation notice and the property has remained vacant through the date on which the property was purchased by the QOF or QOZB—then it may be treated as meeting the Original Use requirement and thus need not be Substantially Improved. In addition, unimproved land does not need to meet the Original Use or Substantial Improvement requirement. [10]

The regulations also provide special rules for buildings located on “brownfield sites” under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA). In particular, the regulations

9 In the case of leased property, the Substantial Improvement and Original Use tests do not need to be satisfied, although other requirements, described below, apply.

10 However, this rule will not apply if the land is unimproved or minimally improved and the QOF or QOZB purchased the unimproved land with an intention not to improve the land by more than an insubstantial amount within 30 months after the date of purchase. Grading, clearing, remediation of contaminated land, or acquisition of QOZ Business Property that facilitates the use of the land in a trade or business may all be taken into account in determining whether land is improved by more than an insubstantial amount, but the regulations do not define “insubstantial.”

provide that all real property composing a brownfield site, including land and structures located thereon, will be treated as satisfying the Original Use requirement. To qualify, however, the QOF or QOZB must make investments in the brownfield site to ensure that the site meets basic safety standards for human health and environment.

In this scenario, the land was purchased from an unrelated party after December 31, 2017, and it is contemplated that the QOZB will do a ground-up construction project. Although unimproved land need not meet the Original Use or Substantial Improvement requirement, a ground-up construction would satisfy the Original Use requirement. The regulations clarify that self-constructed property can satisfy the acquired by purchase requirement. However, to qualify as QOZ Business Property, the property must be constructed with the intent to use the property in a trade or business in a QOZ, and the materials and supplies used in construction must be QOZ Business Property.[11]

Even if the land had a pre-existing structure that had been used in the QOZ, the renovation in this scenario should meet the Substantial Improvement requirement, which generally requires improvements that more than double the basis of the property. For purposes of determining whether basis has doubled, land is not counted.

Buildings may be aggregated in certain circumstances in determining whether the Substantial Improvement requirement is satisfied. First, buildings on a single deeded property may be treated as a single property. Second, buildings on contiguous parcels of land may be treated as a single property as long as they are: (i) operated exclusively by the QOF or QOZB; (ii) share business resource elements (e.g., accounting or other back office functions) or employees; and (iii) are operated in coordination with one or more of the trades or businesses (e.g., supply chain interdependencies or mixed-use facilities).

Because the lines of census tracts may not follow natural boundaries, it is possible for a parcel of real property to straddle multiple contiguous census tracts, partly within a QOZ and partly outside a QOZ. The regulations provide that all of the property is deemed to be in the QOZ for purposes of satisfying the gross income safe harbors and the 70% Assets Test if the property is substantially located in a QOZ, and the property located outside the QOZ is contiguous with the property in the QOZ. For purposes of determining whether property is substantially located within a QOZ, at least 50% of either the square footage or the unadjusted cost basis of the property must be located within a QOZ.

An investor may not contribute property, such as land, to a QOF or a QOZB and have that property be treated as QOZ Business Property because this would violate the requirement that QOZ Business Property be acquired by purchase. In addition, if an investor sells the property to a QOF or a QOZB and contributes the sales proceeds to the QOF, this transaction may be recharacterized under general tax principles (such as the step-transaction or circular cash flow doctrine) as a contribution of the property for tax purposes, depending upon the circumstances. If such an investor retains more than a 20% interest in the QOF, then this may also implicate the Related Person limitations.

11 The regulations also provide rules for determining the date on which self-constructed property is treated as purchased, specifically the date physical work of a significant nature begins. Physical work of a significant nature does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The regulations provide a safe harbor under which a QOF or QOZBs may choose the date on which it paid or incurred more than 10 percent of the total cost of the property—excluding the cost of any land and preliminary activities.

In addition, the preamble to the final regulations contained a statement that suggests that improvements made to nonqualified property do not qualify as QOZ Business Property, citing administrative burdens. Because of these limitations, if the Developer already owned the land prior to 2018, then it generally could not sell or contribute that property to a QOF or QOZB and treat the property as QOZ Business Property.[12] Instead, a leasing arrangement should be considered to avoid these issues. The regulations provide that leased property qualifies as QOZ Business Property if it meets certain requirements. Furthermore, leased property does not need to satisfy the Substantial Improvement or Original Use requirements. To qualify, the lease must be entered into after December 31, 2017, must have arm's-length terms, and there cannot be an intention for the lessee to purchase the property for an amount of consideration other than the fair market value determined at the time of the purchase. Leases between unrelated parties are presumed to have arm's-length terms. In addition, leases can be between Related Persons if they meet certain additional requirements, including that the lessee cannot prepay more than 12-months' rent. As a result, in the example where the Developer already owned the land, it could enter into an arm's-length lease with the QOZB, and the lease would be considered a qualifying asset.

Active Business Requirements

QOZ Business Property held by a QOZB must satisfy certain active business requirements, including the 50% Gross Income Test, the Intangibles Test, and the Nonqualified Financial Property Limitation. The regulations clarify that ownership and operation of real property (including leasing) constitutes an active trade or business. However, merely entering into a triple-net lease will not be considered the active conduct of a trade or business. As a result, the QOZB should avoid simply entering into triple-net leases and should take on some substantive role in managing the properties.

Another issue that comes up is *when* the active business requirements must be satisfied. The QOZB has 31 months to deploy capital and develop an active trade or business under the Working Capital Safe Harbor[13]. In addition, for start-up businesses, tangible property may benefit from an additional 31-month period, for a total of 62 months, in the form of multiple overlapping or a sequential application of the Working Capital Safe Harbor. The Working Capital Safe Harbor can be extended to 62 months for the purpose of satisfying all of the active business requirements.

Sin Business Limitation

The QOZB may not operate a so-called Sin Business (including golf courses, gambling facilities, and liquor stores). The regulations also prohibit a QOZB from leasing its property to a Sin Business. However, the regulations also provide a de minimis exception, so that the QOZB will not fun afoul of this limitation if less than five percent of its income is from a Sin Business or less than five percent of property (measured by net rentable square feet of real property or value of tangible property) is leased to a Sin Business.

E. Treatment of Operating Income/Distributions

As with a traditional investment fund, the investor may have to pay income tax on any profits realized by the QOF or QOZB that flow-through to the investor under ordinary tax principles. Although the QOZ tax benefits

12 Note, however, that the QOZB will not be disqualified during a valid Working Capital Safe Harbor for owning nonqualified property, as the QOZB is treated as satisfying the 70% Assets Test.

13 Each application of the 31-month safe harbor period must meet certain requirements. See *supra* note 6.

generally permit deferral of capital gain that is invested into a QOF, the QOZ rules do not turn off these ordinary partnership tax principles. In this scenario, for example, if the QOZB earns a $100 net profit from rents, the Developer generally will have to pay tax on its share of this profit, regardless of whether it actually receives any cash distributions from its investment in the QOF. Under the normal partnership tax rules, losses may be deducted and cash distributions may be received tax-free to the extent of the Developer's basis in its QOF interest.

However, if the investor holds the partnership interest for 10 years, gain or loss from the sale of QOF or QOZB assets (whether ordinary or capital or whether or not it qualifies as QOZ Business Property) may be excluded by the partner. The only exception is for gains or losses from the sale of inventory by the QOF or QOZB in the ordinary course of business.[14]

Where the QOZ rules differ from traditional partnership tax rules is in the amount of the investor's basis in its QOF interest. The investor starts with a zero basis in its interest in the QOF, because basis is the mechanism by which the QOZ rules measure the deferred gain. The basis can be increased by incurring partnership debt that is allocated to the investor. The basis also can be increased if an investor receives a distributive share of taxable income from the QOF. Finally, after holding an investment in the QOF for five years and seven years, the investor will receive a partial step-up in basis to reflect the portion of deferred gain that is made exempt from tax by the QOZ rules.

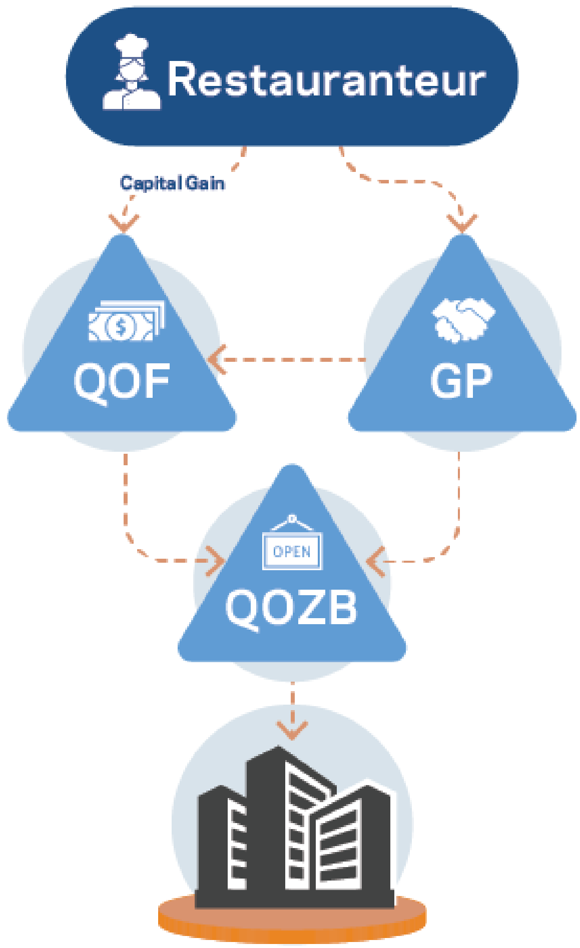
If the investor has an Inclusion Event, it will trigger the deferred Eligible Gain. For example, sales of QOF interests or distributions in excess of a partner's basis in its partnership interest are considered Inclusion Events. Thus, it is important for the fund manager to monitor cash distributions to ensure sufficient basis to avoid Inclusion Events.

In addition, the regulations provide that any distribution of cash or property will disqualify an investor's original transfer to a QOF partnership from beneficial QOZ treatment to the extent the overall transaction would be recharacterized as a "disguised sale." For this purpose, distributions within two years of the contribution are presumed to be disguised sales. In addition, the regulations broaden the definition of disguised sale to treat cash contributed to a QOF partnership as non-cash property, and to ignore the exception from disguised sale treatment for certain debt-financed distributions. Thus, distributions of cash to QOF partners within two years of the contribution typically will trigger deferred gain.

In this scenario, the QOZB borrowed $1 million. The Developer's share of this partnership debt will provide basis that generally can support cash distributions after two years and the deduction of losses.

14 Similar rules apply in the case of a QOF S corporation.

Scenario 2: Single Investor, Single Asset (Operating Business) QOF



Tax Objectives

The structure illustrated in this scenario generally would be used by the owner of an operating business who has a significant capital gain that will be recognized and wishes to reinvest the proceeds from this gain into a new business located in a QOZ (such as a restaurant) where the business owner will act as the anchor investor (as well as the fund manager).

Timeline/Overview of Scenario

- On March 1, 2019, Restaurateur recognizes a $1 million capital gain.
- On August 1, 2019, Restaurateur invests the proceeds into a newly formed QOF.
- On April 1, 2020, the QOF contributes $1 million to a newly formed QOZB, and the QOZB borrows another $1 million.
- The QOZB has a written schedule in place to expend the $2 million for the purchase (or lease) of new space, the build-out for a restaurant, and the purchase of kitchen, dining room, and office equipment with an anticipated opening date of March 31, 2021. In the meantime, the QOZB holds the investment in cash, cash equivalents, or short-term debt.

Considerations for Single Investor, Single Asset (Operating Business) QOF

QOZB Requirements

This Scenario highlights those considerations in addition to Scenario 1 that are relevant to operating businesses.

A. QOZB Requirements

70% Assets Test

A real-estate development project likely will meet the Substantial Improvement test (by making improvements to any buildings it purchases that more than double its basis and because of favorable rules for unimproved land). However, an operating business may find it difficult to meet this test because it generally applies on an asset-by-asset basis.

However, the regulations do permit a QOF or QOZB to aggregate assets to a limited extent in determining whether an asset has been substantially improved. For example, the final regulations set forth an asset aggregation approach for determining whether a non-original use asset (such as a pre-existing building) has been Substantially Improved. Under the approach adopted by the regulations, QOFs and QOZBs can take into account purchased original use assets that otherwise would qualify as QOZ Business Property, if the purchased assets (i) are used in the same trade or business in the QOZ (or a contiguous QOZ) for which the non-original use asset is used, and (ii) improve the functionality of the non-original use assets in the same QOZ (or a contiguous QOZ). For example, if a QOF purchases and intends to substantially improve a building to be operated as a restaurant, the QOF may include "original use" purchased assets in the basis of the purchased building to meet the Substantial Improvement requirement if those purchased assets improve the functionality of the restaurant business. These "original use" purchased assets might include new ovens, stoves, tables, cash registers, or any other new tangible property used in the restaurant business.[15]

Alternatively, the operating business might consider using leases (which do not need to meet the Original Use or Substantial Improvement test), but the lease must be entered into after December 31, 2017, and special limitations apply to leases of tangible personal property, such as equipment, from a Related Person.[16]

Operating businesses may have greater difficulty ensuring that 70% of their assets are used in the QOZ because their business assets are mobile. The regulations provide a couple of safe harbors to provide flexibility for businesses with mobile tangible assets. One safe harbor permits up to 20% of the tangible property of a trade or business to be treated as satisfying the 70% Assets Test if (i) the tangible property is utilized in activities both inside and outside of the QOZ, (ii) the trade or business has an office or other fixed location located within a QOZ, (iii) the tangible property is operated by employees of the trade or business who regularly use the office and are actively managed by one or more employees at the office, and (iv) the tangible property must not be operated exclusively outside of the geographic borders of a QOZ for a period longer than 14 consecutive days. A second safe harbor is provided for short-term leases of tangible property by a trade or business located within the QOZ to a lessee that utilizes the tangible property outside of a QOZ, if (i) the tangible property is parked or otherwise stored at a location within a QOZ when the tangible property is not subject to a lease, and (ii) the lease duration (including any extensions) must not exceed 30 consecutive days.

Another complication that operating businesses have is how to treat inventory for purposes of the various tests. For example, where is inventory used when it is being shipped? Is it considered acquired by purchase? Can it satisfy the Original Use or Substantial Improvement tests? The regulations provide a safe harbor that inventory would not fail to qualify as used in a QOZ simply because the inventory is in transit outside the QOZ (i) from a vendor to a facility of the trade or business that is in a QOZ, or (ii) from a facility of the trade or business that is in a QOZ to customers outside the QOZ. For purposes of the 90% Assets Test and the 70% Assets Test, the regulations also permit QOFs or QOZBs to either: (i) include inventory in both the numerator and denominator; or (ii) exclude inventory entirely from both the numerator and denominator. Furthermore, the regulations provide that inventory is deemed to satisfy the Original Use and Substantial Improvement requirements.

Active Business Requirement

It should generally be easier for an operating business than a real estate business to be considered engaged in an active trade or business. The 31-month (and 62-month) Working Capital Safe Harbor applies to the development of an operating trade or business. As discussed above in scenario 1.D, *Active Business Requirements*, the 62-month safe harbor gives a start-up business 62 months to satisfy all of the requirements for an active trade or business. However, some of the specific requirements may still present challenges for operating businesses.

15 The regulations provide an example of a QOF that purchases an existing, non-original use hotel. The QOF may count the basis of purchased original use items such as mattresses, gym equipment, and furniture as well as renovations of the in-hotel restaurant towards the substantial improvement of the hotel property. However, improvements made to an apartment building that is not used in conjunction with the hotel do not count towards the substantial improvement of the hotel. It is less clear how the functionality test applies if the non-original use asset is not a building.

16 Specifically, in the case of tangible personal property leased from a Related Person the original use of which does not commence with the lessee, the lessee must acquire QOZ Business Property with a value at least equal to the leased property within 30 months. As discussed above in Scenario 1.D, *QOZ Business Property Requirements*, leases with unrelated parties benefit from a presumption that the requirement for arm's-length terms is satisfied.

For one thing, it may be more difficult for operating businesses to satisfy the 50% Gross Income Test because people and assets may be mobile. However, the regulations provide three safe harbors for meeting this requirement: (i) at least 50% of the services (based on hours) are performed by employees or independent contractors in the QOZ; (ii) at least 50% of the services (by amount paid) are performed by employees or independent contractors in the QOZ; or (iii) the tangible property and management or operational functions that are necessary to produce at least 50% of the gross income are in the QOZ. Operating businesses that have customers outside the QOZ but whose products are manufactured or developed in the QOZ should be able to meet the first or second safe harbor, even if a secondary facility or service center is located outside the QOZ. The third safe harbor is intended for operating businesses whose employees are mobile, but the headquarters, including management and maintaining of equipment is located in the QOZ. These safe harbors are helpful, but they will require tracking to ensure they are satisfied. For example, if an operating business uses the services of independent contractors, the service contract should ensure that the independent contractors report the number of hours they spend in the QOZ.[17]

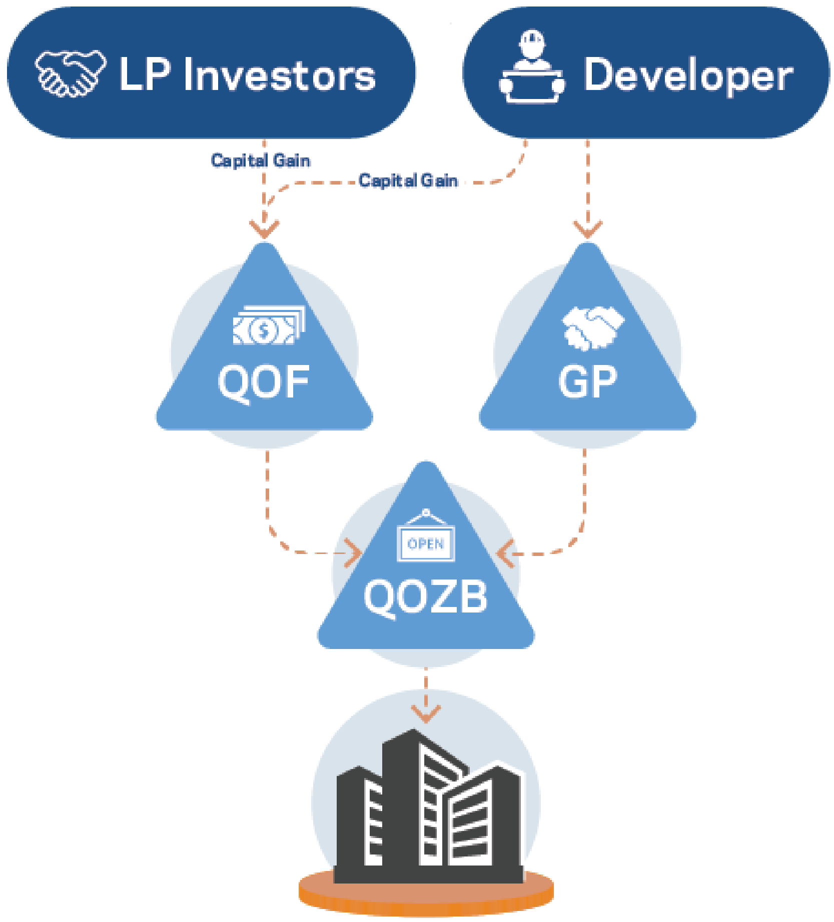
Furthermore, it is not clear how the Intangibles Test will apply if, for example, the operating business is headquartered in the QOZ but certain value-adding activity, such as sales or research, are conducted outside the QOZ. To increase certainty in making such determinations, the regulations provide that intangible property of a QOZB is used in the active conduct of a trade or business in a QOZ if the following two requirements are satisfied: (i) the use of the intangible property must be normal, usual, or customary in the conduct of the trade or business; and (ii) the intangible property must be used in the QOZ in the performance of an activity of the trade or business that contributes to the generation of gross income for the trade or business. It is not entirely clear how this standard will apply in practice. In such a case, the fund manager should make every effort to ensure that the majority of employees and assets that arguably generate and use intangibles such as goodwill, going concern value, customer lists, workforce in place, and know how, are located in the QOZ.

Sin Business Limitation

The Sin Business Limitation is more likely to affect operating businesses than real estate businesses. The restaurant in this scenario should not run afoul of the Sin Business Limitation if it serves alcohol, because it will not be for consumption off premises. There could be an issue, however, if the business involves a microbrewery or microdistillery that sells alcohol for consumption off premises and the income from such business is five percent or more.

17 Consideration should also be given to recent shifts in the workforce (which have been accelerated by the COVID-19 pandemic) resulting in more employees working from home.

Scenario 3: Multi-Investor QOF



Tax Objectives

The structure illustrated in this scenario generally would be used to form a fund to develop real estate or operate a business located in a QOZ where the fund sponsor invests Eligible Gain and will act as the fund manager and the limited partner investors will invest Eligible Gain.

Timeline/Overview of Scenario

- On March 1, 2019, Developer recognizes a $100,000 capital gain.
- On August 1, 2019, Developer invests the proceeds into a newly formed QOF.
- Between August 1, 2019 and April 1, 2020, LP investors invest Eligible Gain amounts totaling $900,000 in QOF.
- On April 1, 2020, the QOF contributes $1 million to a newly formed QOZB, and the QOZB borrows another $1 million.
- On April 30, 2020, the QOZB purchases land in a QOZ from an unrelated person for $50,000.
- The QOZB has a written schedule in place to expend the $1.95 million remaining funds for the ground-up development of a commercial building with an anticipated completion date of March 31, 2022. In the meantime, the QOZB holds the investment in cash, cash equivalents, or short-term debt. The introduction of outside investors brings a number of additional considerations into play, as well as potential federal and state securities law considerations (which are not described in this memo).

Considerations for Multi-Investor QOF

A. Timing of Capital Calls/Investments

Managers of traditional funds often receive capital commitments from LP investors that can be called by the fund manager when needed (e.g., when a new investment has been identified or funds in their bank account are low). Because qualifying investments in a QOF must match the 180-day period of the LP investor, this traditional model may frustrate the tax objectives of QOF investors. However, managers will also not be able to give LP investors complete discretion over when they put in their funds because the QOF will have to be able to initially deploy capital in a timely fashion (typically within six to twelve months) in order to avoid tax penalties. This tension will need to be resolved in the relevant fund documentation.

While traditional investment funds could use feeder funds to manage the timing of capital by collecting investments by the LP investors, the QOZ rules require that Eligible Gains be invested directly into the QOF, so a feeder fund cannot be used. In addition, there cannot be multiple tiers of QOFs, so a lower-tier QOF cannot be formed to manage the QOFs measuring dates.

There may be a couple ways to manage the timing conflict between the investor's and QOF's time limitations. For example, the QOF could set the capital calls in accordance with its need to satisfy the 90% Assets Test, but provide investors with a right to require the QOF to accept a cash investment up to a certain amount within a certain number of days before expiration of the 180-day period. Alternatively, the Developer could form the QOF by making a Mixed Funds Investment with its Eligible Gains and other amounts and then selling the nonqualifying QOF interests to the LP investors as they recognize their Eligible Gains. This structure is possible because the regulations allow investors to acquire eligible interests in a QOF by purchasing an interest in a pre-existing QOF.

B. Carried Interest

In this scenario, Developer receives a carried interest through its ownership of the GP entity depicted in the diagram. Developer also could take a carried interest at the QOF level. However, carried interests cannot be treated as eligible interests for purposes of the QOZ rules because they are received in exchange for services, rather than cash or other property. Accordingly, receipt of a carried interest at the QOF level will result in a Mixed Funds Investment. See discussion of carried interests above in Scenario 1.C, *Form of Investment*.

C. Foreign Investors

Foreign investors generally do not invest directly in partnerships to avoid being subject to U.S. tax on income that is effectively connected with a U.S. trade or business or U.S. real property interests. Instead, they invest through blocker corporations. However, for the same reason that QOFs cannot have feeder funds (i.e., an upper-tier fund that collects contributions to feed into the QOF), they will not be able to have special purpose blocker corporations, so foreign investors may not find partnership QOFs to be desirable investments. A corporate QOF may be more suitable for foreign investors, depending on their circumstances.

Eligible Gains can include only capital gains that would be subject to federal income tax but for the making of a valid deferral election under the QOZ rules. Thus, capital gains that are effectively connected with a U.S. trade or business or gains from the sale of investments in U.S. real property of foreign investors may qualify as Eligible Gains, but most other capital gains of foreign investors who are not present in the United States for at least 183 days in a year will not qualify. Furthermore, to qualify as Eligible Gains, gains of a foreign investor may not be eligible for treaty benefits. To prevent foreign investors from benefitting from inconsistent positions, the regulations provide that a foreign eligible taxpayer cannot make a deferral election under the QOZ rules unless the investor irrevocably waives any treaty benefits that would exempt that gain from U.S. federal income tax.

In addition, foreign investors who recognize gains from the sale or exchange of an investment in U.S. real property may still be subject to withholding requirements under the Foreign Investment in Real Property Tax Act (FIRPTA) even if they make a valid election to defer such gains under the QOZ rules. The Treasury Department and the IRS continue to study this issue but have not yet issued guidance.

D. Other Differences Between Traditional Funds and QOFs Affecting Investors

Compliance Costs

Tracking and monitoring compliance with all of the QOZ requirements is likely to generate significant costs, particularly at the early stages of investment. In addition, if a QOF fails to satisfy the 90% Assets Test, the QOF generally will be subject to penalties, subject to a reasonable cause exception. If the QOF is a partnership, then this penalty will be allocated to all partners at the time the penalty is imposed (and even in a corporate QOF the investors generally will bear the economic burden of penalties as owners of the QOF). Incoming partners may wish to be exempted or indemnified against allocable penalties resulting from past failures, or at a minimum, may wish to have access to information to ensure compliance going forward. However, many fund documents may contain clauses that the fund manager will try to satisfy the 90% Assets Test, but may exercise ordinary business judgment to manage investments, even if it results in a violation of the 90% Assets Test.

Long-Term Investments and Lack of Liquidity

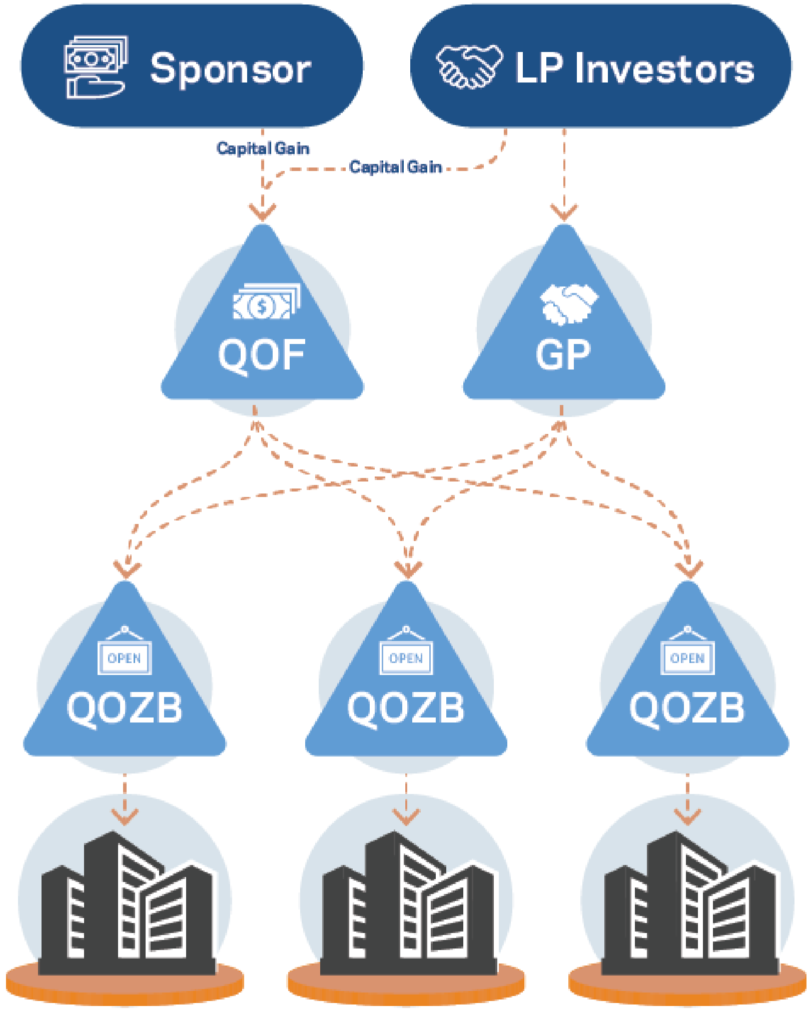
Many traditional funds have a seven-year time horizon. However, to obtain all of the QOZ tax benefits, investors will need to remain invested in a QOF for at least 10 years.

Under the QOZ rules, a substantial portion of the deferred capital gains taxes will become payable at the end of 2026. Investors will need cash in order to make these payments. As discussed above in Scenario 1.E, *Treatment of Operating Income/Distributions*, QOFs can make debt-financed distributions to investors, but such distributions will likely be discretionary on the fund's part. Such discretion may be necessary to protect cash positions and to manage against inadvertent Inclusion Events.

Non-QOZ Parallel Investments

Certain investors may wish to make parallel investments into the underlying businesses and assets that a QOF invests in, even though they do not have Eligible Gains or otherwise are unable to receive the tax benefits associated with investing in a QOF. It has become more common for non-QOZ equity capital to also be invested into QOZ projects. For example, a QOZB that is investing in a renewable energy project may attract investors who are interested in energy tax incentives but do not qualify for QOZ tax benefits. Generally, these kinds of parallel investments can be accomplished more easily by having non-QOZ investors invest either directly in an underlying QOZB or through a non-QOF investment vehicle that invests directly in an underlying QOZB. The QOZ rules generally do not prevent a QOZB from receiving equity capital from other investors in addition to receiving equity capital from a QOF. Moreover, by creating a separate investment vehicle for non-QOZ investors, issues associated with maintaining accounts for Mixed Funds Investments can be avoided.

Scenario 4: Multi-Asset QOF



Tax Objectives

The structure illustrated in this scenario generally would be used by a sponsor who wants to form a fund to facilitate investment in multiple businesses within a particular QOZ or similar types of businesses in multiple QOZs, where the sponsor invests Eligible Gain and will act as the fund manager and the limited partner investors will invest Eligible Gain.

Timeline/Overview of Scenario

- On March 1, 2019, Sponsor recognizes a $500,000 capital gain.
- On August 1, 2019, Sponsor invests the proceeds into a newly formed QOF.
- Between August 1, 2019 and April 1, 2020, LP investors invest Eligible Gain amounts totaling $1 million in QOF.
- On April 1, 2020, the QOF contributes $500,000 each to three newly formed QOZB, and each QOZB borrows another $500,000.
- Each QOZB has a written schedule in place to expend the $1 million in various real estate projects and operating businesses in QOZ X between April 1, 2020 and November 1, 2022. In the meantime, each QOZB holds the investment in cash, cash equivalents, or short-term debt.

Considerations for Multi-Asset QOF

A. Structuring Exits After 10 Years

Traditional funds have significant flexibility in structuring exits from investments to optimize tax efficiency. Often, this is achieved by a sale of an underlying portfolio company (or assets held in a portfolio company), followed by a cash redemption of LP investors. In the case of an investment in a QOF held for at least 10 years, the statute provides that the basis in the investment is equal to its fair market value on the date the investment is sold or exchanged. The language of the statute seems to contemplate that the sponsor will sell the QOF interest at the end of 10 years. While the second round of proposed regulations provided some additional flexibility on exits after 10 years, some gaps still remained.[18] Thankfully, these remaining gaps generally were resolved favorably by the final regulations.

Sale of Assets vs. QOF Interests

The final regulations significantly expanded the proposed rules for gain exclusion for asset sales by QOFs and QOZBs. In particular, the final regulations permit a taxpayer that invests in a QOF partnership or QOF S corporation to make an election for each taxable year to exclude a QOF's gains and losses from all sales or exchanges in the

18 The proposed regulations permitted a QOF investor who has held its investment in a QOF for at least 10 years to make an election to exclude from gross income capital gain from the sale or disposition of QOZ Property by the QOF that is reported on the investor's Schedule K-1 (the "K-1 Rule"). The proposed regulations also mitigated the potential negative consequences of the so-called "hot asset" rules by providing that, if a QOF investor sells a qualifying investment in a QOF partnership after the 10-year holding period, a special deemed adjustment is made to the inside basis of QOF partnership assets immediately before the sale so as to mimic a cash purchase of the investment when a section 754 election is in effect, with the result that ordinary income is not triggered (the "Deemed Section 754 Election"). However, several significant questions remained unanswered, including: (i) how sales of property by QOZB after the 10-year holding period are treated under the K-1 Rule; (ii) whether the Deemed Section 754 Election applies to the sale of a QOF interest if the hot assets are held at the QOZB level; and (iii) whether ordinary income from hot assets sold by the QOF or QOZB could be excluded by the investor under either the K-1 Rule or the Deemed Section 754 Election.

taxable year, both ordinary and capital, whether or not from sales of QOZ Business Property. The only exception is for gains or losses from the sale of inventory by the QOF in the ordinary course of business.

This expanded rule generally should permit investors in a QOF partnership or QOF S corporation to structure exits as asset sales at the QOZB level without reducing the benefit of the 10-year basis step-up. In addition, this expanded rule generally should prevent the hot-asset rules, described immediately below, from reducing the QOZ tax benefits for exits structured in this way. Because of the exception for sales of inventory, taxpayers investing in businesses with substantial inventory may still benefit from structuring an exit as a sale of QOF interests rather than as a sale of assets (unless the QOZB is selling its inventory assets in a bulk sale of a trade or business, which would not be considered ordinary course).

In order to prevent the duplication of the tax benefits provided by the 10-year basis step-up, the final regulations treat—solely for the purposes of determining the amount of an investor's qualifying investment and non-qualifying investment—QOFs and investors electing to take advantage of this rule as making a deemed distribution and recontribution of net proceeds from the asset sales on the last day of the QOF's taxable year.

It is not entirely clear how these rules are intended to apply in the context of a sequence of sales of different businesses across multiple tax years if proceeds from the sale are not distributed to investors. For example, assume QOZB 1 sells substantially all of its assets in 2031 but reinvests the proceeds instead of making a distribution to Sponsor and the LP Investors. Because of the deemed distribution and recontribution rules, this should convert a portion of the Sponsor's and the LP Investors' qualifying investments into non-qualifying investments. If QOZB 2 then sells substantially all of its assets in 2032, it would appear that Sponsor and the LP Investors will lose a portion of the benefit of the 10-year basis step-up because a portion of their investments are now non-qualifying. To avoid this result, fund managers may either wish to ensure that proceeds of any asset sales are distributed to investors within 90 days of the sale or exchange, or may wish to use a parallel fund structure, similar to the one illustrated in Scenario 5, below.

Hot Asset Rules

The Hot Asset rules could cause investors who otherwise would be able to exit from a QOF tax-free after 10 years to recognize ordinary income in the amount of the partner's share of Hot Assets. In order to achieve the correct overall gain or loss on the sale of the partnership interest, the ordinary income is offset by a capital loss. Because capital losses generally can only offset $3,000 of ordinary income each year for individual taxpayers, the offsetting capital loss generally would not be usable by most investors. Property subject to depreciation recapture is a Hot Asset. Because the sale of most kinds of real property typically does not trigger depreciation recapture, real property itself generally will not be a Hot Asset. However, most real estate investments include at least some personal property that will be a Hot Asset because of the depreciation recapture rules. Unrealized receivables and inventory are additional sources of Hot Assets in an operating business.

As did the proposed regulations, the final regulations provide that, when an investor sells a qualifying investment in a QOF partnership after the 10-year holding period, a Deemed Section 754 Election applies to mitigate the Hot Asset issue and prevents ordinary income from being recognized.

The final regulations also clarify that the Deemed Section 754 Election generally applies to the sale of a QOF interest even with respect to hot assets held at the QOZB level. Furthermore, the preamble states that the 10-year basis step-up "is designed to result in no gain or loss to the transferor QOF partner." To ensure this result, the final regulations provide that, to the extent existing rules for basis adjustments operate in a manner that results in recognition of gain or loss on a sale of a QOF partnership interest after 10-years, basis adjustments will be made to the extent necessary to eliminate any such gain or loss.

Amount of Basis Step-Up

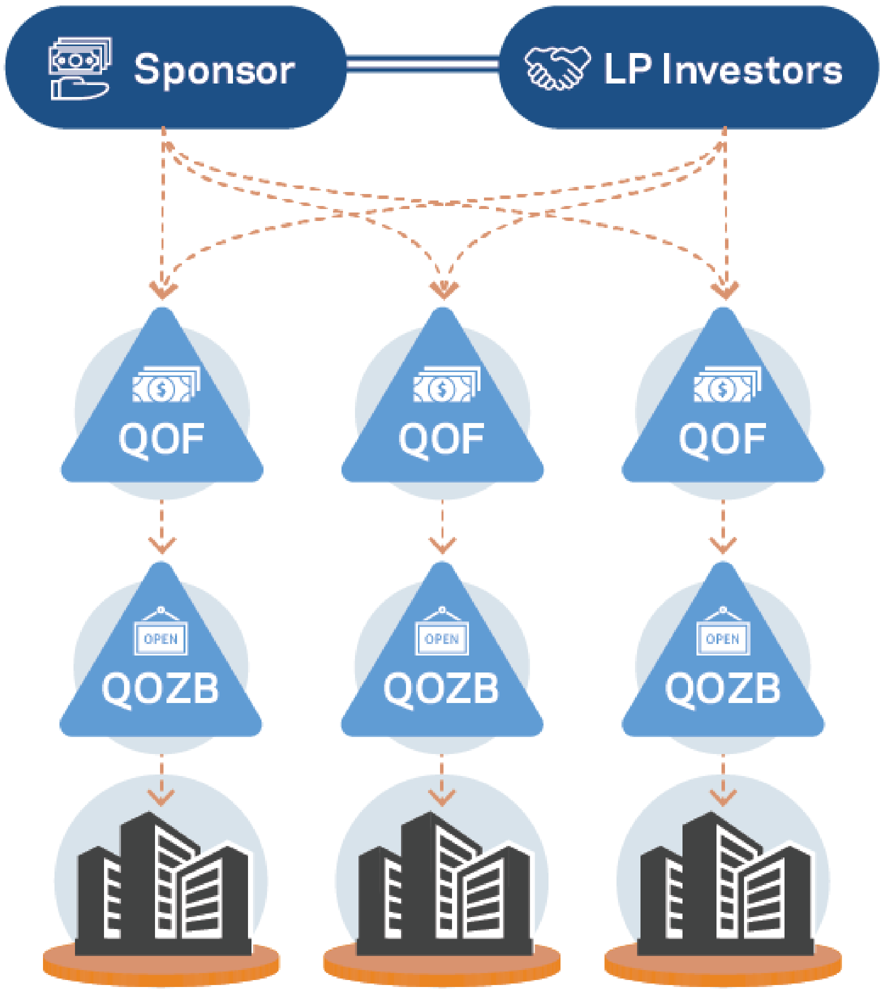
Section 1400Z-2(c) provides that if a taxpayer sells a qualifying investment in a QOF partnership after the 10-year holding period, the basis of such property is equal to the fair market value on the date the investment is sold or exchanged. The regulations provide that, in the context of a QOF partnership interest, the basis will be adjusted to an amount equal to the net fair market value of the interest, plus the partner's share of partnership debt. This clarification should prevent a reduction in an investor's share of partnership debt upon selling a QOF partnership interest from reducing the QOZ tax benefits provided by the 10-year basis step-up.

B. Exits Before 10 Years

If the QOF sells a QOZB before 10 years has passed, not only does the gain flow through to the partners, but the QOF could be subject to a penalty for failure to meet the 90% Assets Test, and the partners could be at risk of triggering their deferred gains. Fortunately, the final regulations provide some relief. If the QOF reinvests the proceeds of the sale within 12 months, and holds the proceeds in cash, cash equivalents, or short-term debt in the interim, the QOF will not be subject to the penalty for failure to meet the 90% Assets Test.[19] In addition, the investors' deferred gains will not be triggered unless there is an Inclusion Event (which could occur, for example, if the QOF distributed the proceeds and the distribution exceeded the investors' bases in their QOF interest). However, the relief in the final regulations does not shield investors from ordinary partnership tax rules requiring inclusion of their share of the QOF's gain.

19 Notice 2020-39 clarified that, as a result of the Federally declared disasters resulting from the COVID-19 pandemic, if any QOF's 12-month reinvestment period includes January 20, 2020 (that is, the date of the Federally declared disaster relating to the pandemic), that QOF receives up to an additional 12 months to reinvest, provided that the QOF invests the proceeds in the manner originally intended before January 20, 2020.

Scenario 5: Multi-QOF Structure[20]



Tax Objectives

The structure illustrated in this scenario generally would be used by a sponsor who wants to form a fund to facilitate investment in multiple businesses within a particular QOZ or similar types of businesses in multiple QOFs, where the sponsor invests Eligible Gain and will act as the fund manager and the limited partner investors will invest Eligible Gain. The multi-QOF structure is intended to facilitate investors' exit from the funds. Because the rules were clarified in the final regulations, sponsors may be considering whether to simplify such structures.

20 GP entity or entities omitted from diagram for simplicity.

Timeline/Overview of Scenario

- On March 1, 2019, Sponsor recognizes a $500,000 capital gain.
- On August 1, 2019, Sponsor invests the proceeds into three newly formed QOFs.
  Between August 1, 2019 and April 1, 2020, LP investors invest Eligible Gain amounts totaling $1.5 million in the three QOFs.
- On April 1, 2020, each QOF contributes the funds it has received to a newly formed QOZB, which borrows an amount to bring its total funds to $1 million.
- Each QOZB has a written schedule in place to expend the $1 million in various real estate projects and operating businesses in QOZ X between April 1, 2020 and November 1, 2022. In the meantime, each QOZB holds the investment in cash, cash equivalents, or short-term debt.
- On March 1, 2020, Sponsor decides to simplify its QOF structure and merges QOF 1 and QOF 3 into QOF 2. Sponsor and the LP investors in QOF 1 and QOF 3 receive only interests in QOF 2 in the merger.

Considerations for Multi-QOF Structure

Potential Benefits of Retaining a Multi-QOF Structure
Simplifying a Multi-QOF Structure via Mergers
Multiple QOFs Investing in a Single QOZB

A multi-QOF structure generally should make it easier to structure exit from investments as the direct sale of investors' interests in a QOF. As a result of the gaps in the proposed regulations described above in Scenario 4.A, *Structuring Exits After 10 Years*, many multi-asset QOFs preferred this kind of parallel structure prior to the issuance of the final regulations. Now that the final regulations have filled many of those gaps, sponsors and fund managers may be considering simplifying these structures.

A. Potential Benefits of Retaining a Multi-QOF Structure

In deciding whether to simplify a multi-QOF structure (or whether to create a new multi-QOF structure), sponsors and fund managers should consider the two remaining gaps in the final regulations, described above in Scenario 4.A, *Sale of Assets vs. QOF Interests*. These potential benefits of a multi-QOF structure will have to be weighed against other non-tax considerations, such as the desire for cross-collateralization.

First, the final regulations permit a taxpayer that invests in a QOF partnership or QOF S corporation to make an election for each taxable year to exclude a QOF's gains and losses from all sales or exchanges in the taxable year, both ordinary and capital, whether or not from sales of QOZ Business Property. The only exception is for gains or losses from the sale of inventory in the ordinary course of business. Because of this exception, taxpayers investing in businesses with substantial inventory may still benefit from structuring an exit as a sale of QOF interests rather than as a sale of assets. Using a multi-QOF structure will help retain the flexibility to structure an exit as a sale of QOF interests.

Second, a multi-QOF structure may be helpful to avoid the issues with applying the deemed distribution and recontribution rules to sequential sales of QOZBs, described above in Scenario 4.A, *Sale of Assets vs. QOF Interests*. These issues may also be avoided by ensuring that the proceeds of any asset sales are distributed to investors within the same tax year. Funds that wish to have the flexibility to retain the proceeds from asset sales may want to use a multi-QOF structure.

If the investors want to use a multi-QOF structure but still coordinate their investments as part of an overall program to achieve results similar to a single QOF, the investors could enter into a contractual arrangement with the sponsor known as a commitment agreement. The commitment agreement provides a framework under which investors will make a series of investments under an overall investment program. As the sponsor identifies individual investments, capital calls will be made and investors will invest directly in a special purpose QOF created for each investment. Alternatively, a series partnership might be used for this purpose.

B. Simplifying a Multi-QOF Structure via Mergers

After considering the potential benefits of retaining a multi-QOF structure described above, a multi-QOF fund may nevertheless decide to simplify its structure. The final regulations generally permit this to be accomplished via a merger of QOF partnerships. In particular, the final regulations generally provide that a merger or consolidation of a QOF partnership with another QOF partnership in a transaction to which section 708(b)(2)(A) applies[21] is not an Inclusion Event if, immediately after the merger or consolidation, the resulting partnership is a QOF and the partners of the merging QOFs do not receive any property in the merger or consolidation other than an interest in the resulting partnership.

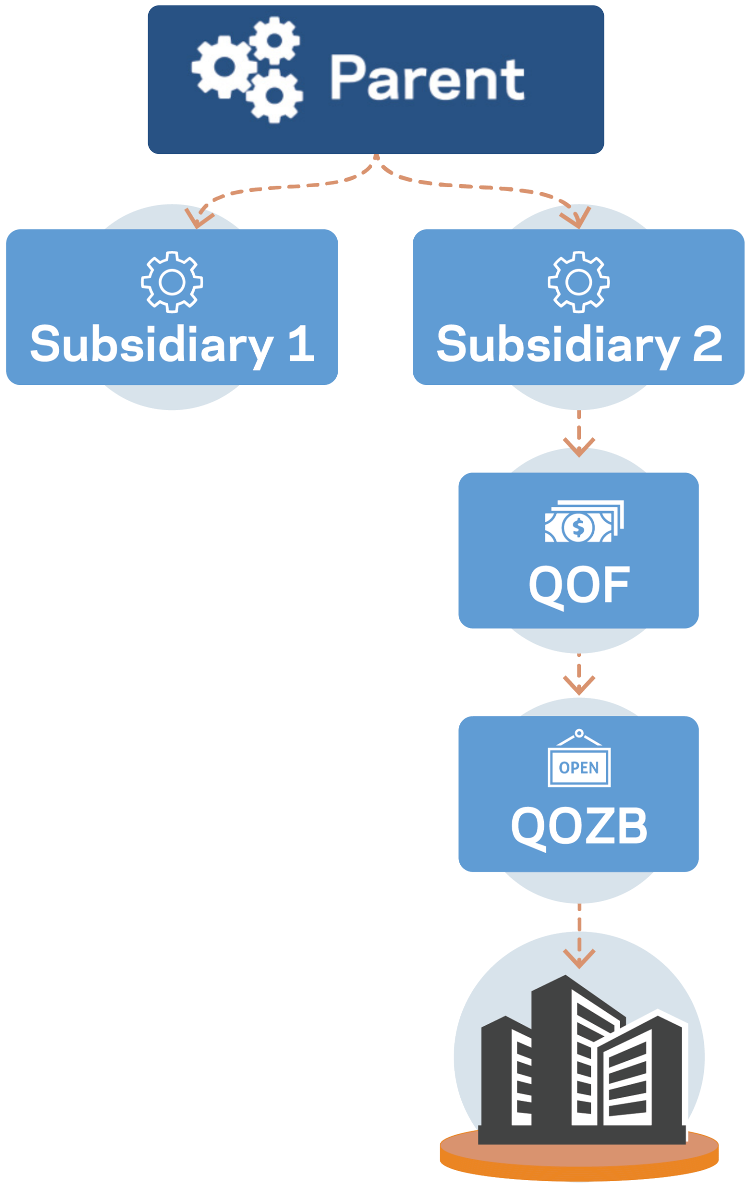
As a result of these rules, as long as there is sufficient overlap in the LP investors for each QOF, the simplification of the multi-QOF structure illustrated above generally should not, in and of itself, result in an Inclusion Event. Moving forward, the 90% Assets Test will need to be satisfied by QOF 2, taking into account all of the assets that QOF 2 receives in the merger.

C. Multiple QOFs Investing in a Single QOZB

Some fund sponsors also may wish to consider creating multiple QOFs that invest in a single QOZB. The QOZ rules generally permit multiple different QOFs to invest in a single QOZB, and this structure can present some benefits. For example, by creating multiple different QOFs, a sponsor may more easily offer different terms to different investors without needing to create and maintain multiple distinct classes or series of equity in a QOF. In addition, by keeping different deals with different equity investors separate, a sponsor may be able to avoid disclosing terms of one investor's deal to other investors, thus providing enhanced confidentiality.

21 Section 708(b)(2)(A) generally applies when partners of a merging partnership own an interest of more than 50 percent in the capital and profits of the resulting partnership after the merger.

Scenario 6: QOF as a Member of a Consolidated Group



Tax Objectives

This scenario illustrates a structure where a QOF is a member of a group of corporations that file a consolidated federal income tax return.

Timeline/Overview of Scenario

- On March 1, 2020, Subsidiary 1 recognizes a $1,000,000 capital gain.
- On August 1, 2020, Subsidiary 2 invests the proceeds into a newly formed QOF.
- On September 1, 2020, the QOF contributes $1 million to a newly formed QOZB, and the QOZB borrows another $1 million, which the QOZB invests in QOZ Business Property.

Considerations for Multi-QOF Structure

Type of Entities
QOF as a Member of a Consolidated Group

A. Type of Entities

Each of the QOF and the QOZB are depicted in the diagrams in Scenarios 1 through 5, above, as a triangle—usually used to reflect an entity treated as a partnership for tax purposes. In many cases, a fund manager will prefer to use a partnership for the QOF and QOZB in establishing the structure. However, a corporation also may be used for either the QOF or the QOZB. The main difference is that a partnership's income and deductions flow through and is taxed directly to the partners, whereas a corporation is generally subject to tax as a separate entity, and its shareholders are taxed again when the corporation's earnings are distributed to the shareholders (the so-called "double tax"). Corporations treated as real estate investment trusts or S corporations, which are subject to special rules and are not generally subject to the double tax, might be suitable for certain QOFs.

Traditional real estate investments may be made through portfolio companies that are single member LLCs, treated as a disregarded entity for tax purposes. In the QOF context, if the QOZB is a disregarded entity, then the QOF will not be able to take advantage of the 70% Assets Test and the Working Capital Safe Harbor, which would make it much more difficult to qualify for QOZ tax benefits. As a result, most QOFs will want to invest through a QOZB that is not treated as a disregarded entity.

B. QOF as a Member of a Consolidated Group

When investors are members of a consolidated group, a QOF that is a C corporation might be used instead of a partnership or S corporation. This is because the regulations allow subsidiary QOF C corporations to join in the filing of consolidated returns, and the regulations provide rules to harmonize the consolidated return and QOZ rules.[22]

A QOF C corporation can only be a member of a consolidated group if two requirements are satisfied: (i) the consolidated group member that makes the direct investment in the QOF member generally must maintain a direct equity investment in the QOF; and (ii) all QOF investor members must be wholly owned, directly or indirectly, by the common parent of the consolidated group.

22 For example, the regulations provide that the QOF and QOZB requirements must be satisfied on a separate entity basis and that the 10-year basis step-up election cannot eliminate an excess loss account in a QOF member stock. In addition, the regulations limit the ability to transfer QOF interests within a consolidated group.

In certain circumstances, the regulations permit a consolidated group to elect to treat the investment by one member of the group (e.g., Subsidiary 2) as a qualifying investment by another member (e.g., Subsidiary 1). This can allow consolidated groups more flexibility in forming a QOF. This flexibility might be needed, for example, if Subsidiary 1 has an Eligible Gain but is not itself permitted to invest in a QOF because it is a regulated entity.

The election is available when Subsidiary 1 has an Eligible Gain and Subsidiary 2 makes an investment in a QOF that would be a qualifying investment if Subsidiary 1 (rather than Subsidiary 2) had made the investment. If the consolidated group makes this election, for all federal income tax purposes, Subsidiary 1 is treated as making an investment in the QOF and immediately selling the qualifying investment to Subsidiary 2 for fair market value. This sale is subject to the intercompany transaction rules under the consolidated return regulations, which generally cause the sale to be treated as if it were a sale between two divisions of a single corporation (so-called "single entity treatment").

Appendix I
Glossary of Terms

Eligible Gain: An amount of gain that is eligible for deferral under section 1400Z-2. Such gain must be treated as a capital gain for federal income tax purposes, which would be recognized absent deferral before January 1, 2027, and must not arise from a sale or exchange with a Related Person.

Gross Income Test: At least 50% of the gross income of the QOZB must be derived from the active conduct of a trade or business in the QOZ. Certain safe harbors exist for meeting this test based on the location of employees, operations, or performance of services.

Hot Assets: For federal tax purposes, a partner recognizes ordinary income or loss instead of capital gain or loss on any portion of a sale of a partnership interest that is attributable to his or her share of the partnership's hot assets. Common examples include depreciable assets subject to depreciation recapture, inventory, and accounts receivable.

Inclusion Events: Events that accelerate the deferred Eligible Gain of investors in whole or in part. Inclusion events include a transfer of a qualifying investment, a reduction in the investor's equity interest in a qualifying investment, and a distribution of property from a QOF, subject to certain exceptions (for example, distributions to the extent of the investor's basis in the QOF).

Intangibles Test: A substantial portion (i.e., at least 40%) of the intangible property of the QOZB must be used in the active conduct of a trade or business in the QOZ.

Mixed Funds Investment: In the case of any investment in a QOF only a portion of which consists of investments of Eligible Gain, such investment is treated as two separate investments: (i) one investment that includes only the Eligible Gain; and (ii) one investment consisting of other amounts.

Nonqualified Financial Property Requirement: No more than 5% of the average unadjusted basis of the QOZB's assets may be "nonqualified financial property." Nonqualified financial property is debt, stock, partnership interests, options, futures contracts, and other similar property, but does not include reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less.

Original Use: The first use by which property is placed in service (for depreciation purposes) within the QOZ. Property may have previously been used outside of the QOZ.

Qualified Opportunity Zone (QOZ): A low-income/high-poverty census tract designated by the States and certified by the U.S. Treasury Department.

Qualified Opportunity Fund (QOF): An entity (corporation or partnership) into which a taxpayer reinvests capital gains and from which investments into a QOZ are made.

Qualified Opportunity Zone Business (QOZB): An entity (corporation or partnership) conducting a trade or business substantially all of the tangible property of which is QOZ Business Property and which satisfies the Gross Income Test, Intangibles Test, Nonqualified Financial Property Requirement, and Sin Business Limitation.

Qualified Opportunity Zone Business Property (QOZ Business Property): Tangible property used in a trade or business of the QOF and that counts towards its 70% Assets Test.

Qualified Opportunity Zone Property (QOZ Property): Property in which a QOF is eligible to invest and that counts towards its 90% Assets Test. Consists of QOZ Business Property, QOZB stock, or QOZB partnership interest.

Related Person: Includes members of the same family, a grantor or fiduciary and a trust, an individual and an entity in which the individual owns more than 20% of the interests, and entities that have 20% or more of the same ownership or common control.

Sin Business Limitation: The following trades or businesses cannot qualify as a QOZB: (i) any private or commercial golf course, (ii) country club, (iii) massage parlor, (iv) hot tub facility, (v) suntan facility, (vi) racetrack or other facility used for gambling, or (vii) any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

Substantial Improvement: Property is treated as "substantially improved" if, during any 30-month period beginning after the acquisition of the property, additions to basis of the property exceed an amount equal to the adjusted basis of the property at the beginning of such period. Where there is a purchase of land and an existing structure, only the amount allocated to the existing structure must be "doubled."

Working Capital Safe Harbor: QOZBs have a 31-month safe harbor period to deploy capital and develop an active trade or business, including the construction or improvement of property.

90% Assets Test: 90% of a QOF's assets must be QOZ Property.

70% Assets Test: 70% of the tangible assets of a QOZB must be QOZ Business Property.

Appendix II
Key Differences Between Traditional Investment Funds and QOFs

Tax Consideration	Traditional Investment Funds	Qualified Opportunity Funds
Screening Investors	Traditional funds have well-established procedures for complying with securities law requirements that limit the kind of investors who can invest in their funds.	In addition to the traditional procedures, managers may want LP investors to certify that 100% of their investment in the QOF consists of eligible gain (or investors may wish to avoid making contributions other than eligible gain). This should help avoid Mixed Funds Investments that would complicate tax compliance and accounting.
Raising Equity Capital	Managers often receive capital commitments from LP investors that can be called by the fund manager when needed (e.g., when a new investment has been identified or funds in their bank account are low).	Because qualifying investments in a QOF must match the 180-day period of the LP investor, the traditional model may frustrate the tax objectives of QOF investors. However, managers will also not be able to give LP investors complete discretion over when they put in their funds because the QOF will have to be able to initially deploy capital in a timely fashion (typically within 6-12 months) in order to avoid tax penalties.

Tax Consideration	Traditional Investment Funds	Qualified Opportunity Funds
Timeline for Deploying Capital	The timeline for deploying capital can vary. For example, a traditional private equity or venture capital fund may deploy capital quite quickly after a capital call to make an acquisition or investment, although there may be multiple distinct rounds of investment. A real estate development fund may deploy capital over a long period of time based on the needs of particular construction projects.	QOFs generally will need to stick to relatively strict timelines for both the initial deployment of capital and the establishment of an active trade or business.
Single vs. Multiple Tier Structures	Can be structured in multiple tiers of entities.	The QOZ rules contemplate only a single tier (QOF only) or two-tier (QOF and QOZB) structure because of the way in which the capital must flow to the QOF and QOZB.
	Investments may be made through portfolio companies that are disregarded entities for tax purposes.	If the QOZB is a disregarded entity, it will not be able to take advantage of the more favorable rules for QOZBs. However, QOZBs may make investments through disregarded entities.
	Can use feeder funds to collect investments by LP investors.	Because the Eligible Gain must be invested directly into the QOF, a feeder fund may not be used to manage the timing of capital contributions.

Tax Consideration	Traditional Investment Funds	Qualified Opportunity Funds
Identifying Investments	Can focus on the fund's investment strategy and investment objectives in identifying investments.	Will need to consider the traditional objectives while also ensuring that the investments will meet a variety of tests for QOZ Property.
Compliance Costs	Compliance costs are fairly standardized.	Tracking and monitoring compliance with the QOZ requirements is likely to generate significant compliance costs, particularly in the early stages of investment. In addition, if the QOF fails the 90% Assets Test, there is a penalty imposed, which flows through to investors.
Management Compensation	Rely on management fee and carried interest arrangement to compensate management.	Carried interests may be used; however, they do not qualify as eligible investments in a QOF and so do not qualify for the tax benefits.
	Management compensation is based on economic performance.	A successful QOF may be judged on social impact parameters and not solely on economic performance.
Ability to Make Tax-Free Interim Distributions	Some constraints on the ability to make tax-free interim distributions based on the amount of tax basis that investors have in their interest in the fund.	These constraints typically will be more significant for QOF investors and may require more careful monitoring. In addition, a substantial portion of the deferred capital gains taxes of investors will become payable at the end of 2026. Investors will need cash in order to make these payments.

Tax Consideration	Traditional Investment Funds	Qualified Opportunity Funds
International Aspects	Generally can invest in non-US portfolio companies and non-US real estate.	QOFs must limit their investments to the US and its territories and only within QOZs within the US and its territories.
	Furthermore, private equity and real estate funds may employ non-US entities within their investment structures for lender or other local law requirements or to attract certain foreign investors.	QOFs generally must use and invest in only US entities.
	Finally, US corporate blockers can be inserted into private equity and real estate fund structures as tax "blockers" for certain foreign and tax-exempt investors.	QOF partnerships generally cannot offer this blocker structure to foreign investors, though a QOF corporation might be used for this purpose.
Active Business Requirement for Real Property	While private equity and real estate funds actively involve themselves in business investments, they nevertheless often constitute passive investments from a tax perspective.	In order for real estate businesses (after a ramp-up period) to qualify for QOZ benefits, they must be actively conducted.
	Furthermore, in connection with real property specifically, such funds often engage in triple-net-leasing.	The regulations indicate that a triple-net-lease of real property does not alone constitute the active conduct of business.
Investment Time Horizon	Private equity and real estate funds often have shorter investment time horizons, on the order of seven years or less.	QOFs may aim to adhere (although likely not contractually commit) to a minimum 10+ year investment horizon in light of the 10+ year elective step-up-to-fair-market-value QOF exit benefit.

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