

# Opportunity Zones: A Preliminary Examination

The Tax Cuts and Jobs Act of 2017 (the “Act”) made significant changes to U.S. federal tax law. One of these changes was the establishment of a new tax regime relating to qualified opportunity zones (“Opportunity Zones”) under Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code of 1986, as amended (the “Code”), to encourage private investment in distressed communities throughout the United States. Investors that wish to defer capital gains recognized upon a sale or exchange of an asset to an unrelated<sup>1</sup> party on or prior to December 31, 2026 can invest that gain in a Qualified Opportunity Fund (QOF), which in turn invests in so-called “qualified opportunity zone property.” This newsletter will discuss the current status of the Opportunity Zone program, the tax benefits associated with investing in QOFs, what qualifies as qualified opportunity zone property and issues relevant to sponsors in connection with the formation of QOFs.

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<sup>1</sup> Throughout this memorandum, parties are “related” to each other if such parties have at least 20 percent common ownership.

## Part I – The Designation of Opportunity Zones

Individual States (which for this purpose includes possessions of the United States and the District of Columbia) have been tasked with the nomination of census tracts to be designated as Opportunity Zones. Initial nominations were due on March 21, 2018, but the Act permitted each State a 30-day extension. Information with respect to the nominated Opportunity Zones is available on the Department of the Treasury's Community Development Financial Institutions Fund website (<https://www.cdfifund.gov/pages/opportunity-zones.aspx>). According to the website, the official list of Opportunity Zones (i.e., those that have been certified and designated by the Secretary of the Treasury) will be published in an Internal Revenue Bulletin at a later date. This timing is consistent with the Act, which provides that the Secretary of the Treasury has a 30-day consideration period after the States have submitted their lists of nominated Opportunity Zones. Given this guidance, we expect the official list of Opportunity Zones will be available by the end of May or early June 2018, which takes into account the 30-day extension and the 30-day consideration period.

An Opportunity Zone generally must be a population census tract within a State that qualifies as a "low income community" (LIC) as such term is defined under Code Section 45D(e) (the provision of the Code that applies to the New Market Tax Credit program). In order to qualify as an LIC, a population census tract must have a poverty rate of no less than 20 percent, or a median family income not to exceed 80 percent of either the statewide or metropolitan area income, depending on the tract's location. A tract that is not an LIC but is contiguous to an LIC that is designated as an Opportunity Zone (even if not in the same State) and has a median family income not exceeding 125 percent of the median family income of such LIC may also be designated as an Opportunity Zone. The total number of non-LIC tracts that are designated as Opportunity Zones in a state cannot exceed five percent of the total number of designated Opportunity Zones in such state. Generally, the number of Opportunity Zones designated in each state cannot exceed 25 percent of the number of population census tracts in such State that qualify as LICs, except that if a State has fewer than 100 LICs, it may designate up to 25, and all LICs in Puerto Rico were designated as Opportunity Zones by the Act. Based on information from Treasury, over 41,000 population census tracts are eligible for designation as an Opportunity Zone (31,680 of which are LICs and 9,453 of which are non-LICs that are contiguous to LICs).

## Part II – Tax Benefits From Investing in Opportunity Zones

An investor may obtain three types of U.S. federal income tax benefits as a result of its investment of cash in a QOF. Such benefits are available, however, only to the extent the cash the investor invests in QOF interests does not exceed the gains (whether short-term or long-term)<sup>2</sup> it has realized from a sale to, or exchange with, an unrelated party of any property held by the investor. Further, in order to be eligible for such benefits, the investor's sale or exchange must occur (x) not later than December 31, 2026 and (y) not more than 180 days prior to its investment in the QOF (such a sale or exchange satisfying clauses (x) and (y), a "recent sale or exchange"). There are no individual or aggregate limitations on the amount of gains that can be deferred or eliminated under the Opportunity Zone program.

If an investor makes an investment in a QOF in excess of the gains it realized from recent sales or exchanges, its investment in the QOF is treated as two separate investments, one investment relating to its recent sales

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<sup>2</sup> It is unclear whether gains that are characterized as ordinary income benefit from the Opportunity Zone program or whether such benefits are available only for capital gains.

or exchanges, which may qualify for the Opportunity Zone tax benefits, and a separate investment, consisting of the excess amount, which will not qualify for those tax benefits.

The U.S. federal income tax benefits associated with investing in QOF interests are described directly below.

### **Deferral of Gains From Recent Sales or Exchanges**

First, upon investing in a QOF, the investor receives a temporary deferral of any reinvested gains that it realized from recent sales or exchanges. Such deferral will extend until the earlier of (i) the investor's disposition of its interest in the QOF, or (ii) December 31, 2026. It is unclear whether the long-term v. short-term character of gains (or, potentially, the ordinary income character of gains, in the case of gains characterized as ordinary income if such gains are deferrable) that are recognized after their deferral under the Opportunity Zone program will be the same as the character such gains would have had if they had not been deferred. Like Section 1031 exchanges, QOF investments provide a deferral benefit, but one important difference is that only the gains an investor seeks to defer need to be reinvested in the QOF, whereas in Section 1031 exchanges the entire value of the "relinquished property" must be reinvested in like-kind property. On the other hand, the deferral benefit of a Section 1031 exchange is indefinite, whereas any gain deferred under the Opportunity Zone Program must be recognized no later than December 31, 2026.

### **Elimination of a Portion of Gains From Recent Sales or Exchanges Reinvested in QOF Interests Upon Fifth and Seventh Anniversaries**

Second, up to 15 percent of the gains realized from recent sales or exchanges and reinvested in a QOF can be eliminated, depending on the investor's holding period with respect to its interest in the QOF. The initial tax basis of an interest in the QOF acquired with reinvested gains from recent sales or exchanges is \$0.<sup>3</sup> If an investor holds its QOF interest for at least five years, the tax basis of the QOF interest is increased on the fifth anniversary of the investment by 10 percent of the amount of gain initially reinvested in such QOF interest. If an investor holds its QOF interest for at least seven years, the tax basis of the QOF interest is increased on the seventh anniversary of the investment by an additional five percent of the amount of gain initially reinvested in such QOF interest. For example, if the investor acquires its QOF interest on June 30, 2019, for \$10 million of reinvested gains from recent sales or exchanges and holds such interest into 2027, then on December 31, 2026, the investor will recognize gains previously deferred in an amount equal to the amount by which the lesser of \$10 million and the fair market value of the QOF interest exceeds \$1.5 million.

### **No Gain Upon Sale or Exchange of QOF Interest After Tenth Anniversary of the Investment**

Third, if an investor holds its interest in the QOF for 10 years or more, for purposes of determining the gain or loss the investor recognizes from the sale or exchange of such QOF interest, the investor may elect for the basis of such QOF interest to be equal to its fair market value on the date such QOF interest is sold or exchanged (the "FMV Basis Election"). As a result, the investor will not recognize gain and will not owe tax on the sale or exchange of its QOF interest 10 years or more after it acquired the QOF interest.

Investors who are not seeking to defer gain may still invest in a QOF. However, if an investor is not reinvesting gains from recent sales or exchanges, or an investor that is otherwise seeking deferral of gain invests funds in excess of such gain in a QOF, the tax benefits described above will not apply, even if the investor holds its QOF interest for at least 10 years.

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<sup>3</sup> Presumably, if the QOF is taxed as a partnership, the adjusted basis of the QOF interest generally will be increased by the investor's share of income and gain of the QOF and decreased by the investor's share of losses and deductions of, and distributions by, the QOF.

### Part III – Qualified Opportunity Fund Basics

In order to obtain the tax benefits associated with investing in an Opportunity Zone, the investor needs to invest gain the investor has realized from any recent sales or exchanges of property to or with an unrelated party in an equity interest issued by a QOF. A QOF is any investment vehicle organized as a corporation or a partnership<sup>4</sup> for the purpose of investing in “qualified opportunity zone property” (which does not include interests in another QOF) and that holds at least 90 percent of its assets in qualified opportunity zone property (the “90-Percent Test”). See Step Three in the diagrams below.

To qualify as a QOF, the applicable entity will need to complete a self-certification form (which will be released by the IRS in the summer of 2018) and attach that form to the entity’s timely filed (taking extensions into account) U.S. federal income tax return for the taxable year. Thus, no pre-approval or action by the IRS is required.

The 90-Percent Test is applied by taking the average of the percentage of qualified opportunity zone property held by the QOF (1) on the last day of the first six-month period of the taxable year of the QOF and (2) on the last day of the taxable year of the QOF. If a QOF fails to meet the 90-Percent Test, the QOF will be subject to a penalty for each month that it fails to meet the requirement. The amount of the penalty for each month will be equal to the product of (1) the excess of (a) the amount equal to 90 percent of the QOF’s gross assets over (b) the aggregate gross value of qualified opportunity zone property held by the QOF, multiplied by (2) the underpayment rate under Code Section 6621(a)(2) for such month. If the QOF is a partnership, the penalty is taken into account proportionately as part of the distributive share of each partner of the partnership. This means that even investors who have little control over the QOF’s investments would share in the penalty. There is no penalty, however, if the QOF’s failure to meet the 90-Percent Test can be shown to be due to reasonable cause.<sup>5</sup> It is not yet clear which of the investor-level tax benefits described in Part II above may be lost as a result of a QOF’s failure to meet the 90-Percent Test, and we expect that Treasury will provide guidance to address this issue.

Qualified opportunity zone property means any of the following: (1) qualified opportunity zone stock; (2) qualified opportunity zone partnership interests; and (3) qualified opportunity zone business property. The rules and definitions relevant to determining what constitutes qualified opportunity zone property are described directly below.

*Qualified opportunity zone stock.* “Qualified opportunity zone stock” is any newly issued equity interest in an entity classified as a domestic corporation for U.S. federal tax purposes the only trade or business of which is a qualified opportunity zone business (as described below), where such stock is acquired by a QOF after December 31, 2017 directly or through an underwriter solely in exchange for cash. For the qualified opportunity zone stock to retain this designation, the issuing corporation needs to be an entity the only trade or business of which is a qualified opportunity zone business for “substantially all” of the QOF’s holding

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<sup>4</sup> As described below, a limited liability company may not be eligible for QOF status, because it is not “organized” as a corporation or a partnership, although it generally would be classified as a corporation or as a partnership for U.S. federal tax purposes.

<sup>5</sup> In determining whether such a failure is due to reasonable cause, Treasury may decide that rules similar to the REIT income test rules will apply. In the REIT context, there is reasonable cause if the REIT exercised ordinary business care and prudence in attempting to satisfy the requirements. Such care and prudence must be exercised at the time each transaction is entered into by the REIT. However, even if the REIT exercised ordinary business care and prudence in entering into a transaction, if the REIT later determines that the transaction results in the receipt or accrual of nonqualified income and that the amounts of such nonqualified income, in the context of the REIT’s overall portfolio, reasonably can be expected to cause a source-of-income requirement to be failed, the REIT must use ordinary business care and prudence in an effort to renegotiate the terms of the transaction, dispose of property acquired or leased in the transaction or alter other elements of its portfolio.

period for such stock. Under the regulations relating to the New Market Tax Credit regime, “substantially all” has been defined as 85 percent, although Treasury presumably has the authority to determine that a different percentage is appropriate for purposes of the Opportunity Zone program. Because the Act provides that “a rule similar to the rule of section 1202(c)(3)” will apply for purposes of determining whether stock is qualified opportunity zone stock, we expect that stock generally would not be treated as qualified opportunity zone stock in the hands of a QOF if (A) at any time during the four-year period beginning on the date two years before the issuance of such stock, the corporation issuing such stock purchased (directly or indirectly) any of its stock from such QOF or from a person related to such QOF, or (B) during the two-year period beginning on the date one year before the issuance of such stock, the issuing corporation made one or more purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding five percent of the aggregate value of all of its stock as of the beginning of such two-year period.

*Qualified opportunity zone partnership interest.* A “qualified opportunity zone partnership interest” is any capital or profits interest in an entity classified as a domestic partnership for U.S. federal tax purposes, the only trade or business of which is a qualified opportunity zone business (or, in the case of a new partnership, such partnership was organized for purposes of being a qualified opportunity zone business), where the capital or profits interest is acquired by a QOF directly from the partnership after December 31, 2017 solely in exchange for cash. Like qualified opportunity zone stock, partnership interests are not treated as qualified opportunity zone partnership interests unless, during “substantially all” of the QOF’s holding period for such interest, the only trade or business of the issuing partnership is a qualifying opportunity zone business.

*Qualified opportunity zone business property.* “Qualified opportunity zone business property” is tangible property used in a trade or business of a QOF if (i) such property was acquired by the QOF by purchase from an unrelated party after December 31, 2017, (ii) either the original use of such property in the Opportunity Zone commences with the QOF or the QOF “substantially improves the property” and (iii) during substantially all of the QOF’s holding period for such property, substantially all of the use of such property was in a Opportunity Zone. Property shall be treated as substantially improved by the QOF only if, during any 30-month period after the QOF acquires such property, additions to basis with respect to such property in the hands of the QOF exceed an amount equal to the adjusted basis (in the hands of the QOF) of such property at the beginning of such 30-month period.

We note that there has not been any guidance, and there has been some debate, as to what “original use of such property” means in this context. “Original use” is a term used in other areas of U.S. tax law — for example Treasury regulations section 1.168(k)-1, which relates to bonus depreciation. In that context, “original use” means the first business use to which the property is put and does not include a different kind of use to which the property is put after a new owner acquires the property.

We have identified a presumably unintended consequence of the literal language of the 90-Percent Test with respect to its application to a QOF’s interest in land. In the case of a “ground-up” development by a QOF on vacant land (or on land with no structures that can be integrated into the development) in an Opportunity Zone, the QOF’s improvements to the land generally would be put to their “original use” in the Opportunity Zone by the QOF and thus may be qualified opportunity zone business property. As a general matter, however, the land itself would not appear to be placed into original use in the Opportunity Zone by the QOF and its basis would not have been increased by the QOF.

Congress presumably intended that a vehicle that owns one or more ground-up developments (and no other assets) be eligible to qualify as a QOF. But if the land such a vehicle owns is essentially treated as a “bad asset” for purposes of the 90-Percent Test (meaning, an asset of the vehicle that is not qualified opportunity zone business property), then the vehicle cannot qualify as a QOF unless such land is worth less than 10% of

the assets of the vehicle. In order to allow the Opportunity Zone program to achieve its purpose of encouraging private investment in distressed communities throughout the United States, the IRS will need to clarify that land will be treated as a good asset (or at least not counted as a bad asset) for purposes of the 90-Percent Test if the land is the site of a significant amount of qualified opportunity zone business property.

*Qualified opportunity zone business.* An entity is a “qualified opportunity zone business” if (1) substantially all of the tangible property owned or leased by such entity is qualified opportunity zone business property (determined as if such owner were a QOF), (2) such entity does not operate, or lease land to, any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises, (3) at least 50 percent of the total gross income of such entity is derived from the active conduct of such trade or business, (4) a substantial portion of the intangible property of such entity is used in the active conduct of such trade or business and (5) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property, as defined in Code Section 1397C(e) (e.g., stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts and annuities). For purposes of determining whether an entity satisfies the requirements above, tangible property that ceases to be qualified opportunity zone business property shall continue to be treated as qualified opportunity zone business property until the earlier of (i) the five-year anniversary of the date on which such tangible property ceases to be so qualified, or (ii) the date on which such tangible property is no longer held by the entity.

#### Part IV – Considerations for Opportunity Zone Fund Sponsors

Sponsors, developers, operators and others who seek to form QOFs are actively considering how to structure and document QOFs. Here are some initial thoughts based on the initial guidance from Treasury:

*Entity Type.* The Act provides that each QOF needs to be organized as a corporation or as a partnership. None of the guidance provided to date indicates that a QOF could be organized as a limited liability company (LLC), even where such LLC is classified for U.S. federal tax purposes as a corporation or as a partnership. In fact, the guidance under the New Market Tax Credit program clearly provides that LLCs cannot qualify as Community Development Entities (CDEs) under the New Market Tax Credit program, so there is precedent for this type of restriction. We would expect that most QOFs will be organized as limited partnerships. A REIT may qualify as a QOF if it is organized as a corporation or as a limited partnership. REIT status, as compared to partnership status, may result in state or local income tax benefits and may allow non-U.S. investors in the QOF to avoid tax return filing obligations. Furthermore, ordinary REIT dividends entitle shareholders that are U.S. domestic individuals to claim a 20 percent deduction under the Act through 2025.

In addition, a QOF may be formed as a joint venture, a club (or syndicated) transaction or a single limited partner vehicle. Based upon the Treasury guidance so far, including the IRS’s confirmation that QOFs may self-certify, and upon the U.S. securities laws applicable to QOFs described below, we think that forming QOFs as single limited partner vehicles, joint ventures or club transactions will be more common than as co-mingled, blind-pool, multi-asset funds, because there will be challenges in structuring QOFs using a typical private equity fund structure as described below.

*U.S. Securities Laws.* Interests in a QOF will be considered securities. Typically, private fund sponsors rely on exemptions from the securities laws by offering interests in private funds only to accredited investors under Regulation D or non-U.S. investors under Regulation S, both under the Securities Act of 1933. Applicable

exemptions under the Investment Company Act of 1940 will also need to be considered. Finally, nothing indicates that a QOF sponsor could avoid registration under the Investment Advisers Act of 1940 if it is providing advice with respect to investments in securities for a fee, but again, certain standard exemptions from registration may be available.

*Purpose.* The organizational documents of the QOF should clearly state that its purpose is to invest in qualified opportunity zone property pursuant to Code Section 1400Z-2 and, subject to the 90-Percent Test, other property related to qualified opportunity zone property. Certain QOFs may have more narrow purposes — e.g., to invest in specific Opportunity Zones or certain types of qualified opportunity zone property. However, based on the text of the Act, nothing prohibits QOFs from investing broadly across Opportunity Zones and asset classes.

*Timing.* A QOF may acquire qualified opportunity zone property with seed money or loan proceeds prior to receiving contributions from investors. In other words, a QOF can acquire qualified assets first and then bring in investors at a later time. Investors need to invest their gains in a QOF no later than the 180th day after their gain realization event to preserve the tax benefits, but there is not yet any guidance regarding how soon after the QOF receives the investor funds that those funds need to be invested in qualified opportunity zone property — as mentioned above, 90 percent of the QOF's assets (which presumably includes cash) need to be invested in qualified opportunity zone property. A key challenge in setting up QOFs will be matching qualifying investments with investors within the prescribed timeframes. Timing considerations may result in a QOF sponsor identifying a property, putting down a deposit and then using the time between signing and closing to identify potential investors. It is possible that matching services or clearinghouses will develop to connect QOF sponsors that have purchased or identified potential qualified opportunity zone property with taxpayers that have gain to be invested. QOFs may also prove to be ideally suited to offerings under Section 506(c) of Regulation D under the Securities Act of 1933, which permits public offerings of securities to accredited investors subject to additional verification and reporting requirements.<sup>6</sup>

We note that the Opportunity Zone program is available only for investors that reinvest gains realized on or before December 31, 2026. However, the deferral aspect of the tax benefits from the program also expires on that date (unless extended by Treasury). Therefore, an investment in a QOF in January 2020 would never reach the seven-year hold period necessary to achieve the elimination of tax on 15% of the original gain. An investor that enters a QOF late in 2026 would only be able to benefit from the FMV Basis Election, since the ability to defer tax on the original gain would expire at the end of the same year. These timing considerations will make the Opportunity Zone program progressively less attractive for taxpayers starting on December 31, 2019. The mismatch between the expiration of the tax deferral and the 10-year holding period for the FMV Basis Election will also mean that taxpayers will owe tax on their original gain prior to being able to dispose of their investment in the QOF for purposes of the FMV Basis Election.

*Investment Limitations.* The only limitation on the assets in which a QOF may invest is that property owned directly or indirectly by a QOF generally must (i) be placed into service in an Opportunity Zone for the first time by the QOF (or a qualified opportunity zone business), or (ii) be substantially improved by the QOF (or qualified opportunity zone business) within a 30-month period, in order for the QOF to satisfy the 90-Percent Test. The Act does not include any limitations or requirements on the number of properties a QOF may own — it could own one asset or multiple assets — so long as such asset or assets meet the definition of qualified

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<sup>6</sup> Shearman & Sterling Client Publication - SEC Adopts Rule Changes Allowing General Solicitation in Private Placements Under Rule 506 of Regulation D and Rule 144A. July 12, 2013.

opportunity zone property. The Act also does not include any maximum or minimum limits on the amount of contributions to a QOF or on the number of investors in a QOF.

*Capital Commitments and Contribution of Funds.* Investors will receive tax benefits only if they acquire QOF interests 180 or fewer days after they realize gains from a recent sale or exchange. Unlike a typical private equity fund structure or development transaction where capital commitments are called over time, an investor in a QOF will need to invest its entire commitment in the QOF within 180 days after the relevant sale or exchange transaction — even if the investor’s capital will not be put to use by the QOF until a later date. Unless Treasury issues guidance providing that cash a QOF intends to invest in qualified opportunity zone property will not count as a bad asset for purposes of its 90-Percent Test,<sup>7</sup> QOFs will face a tight timeframe in which to acquire qualified opportunity zone property in order to meet the 90-Percent Test for any year in which their investors contribute a significant amount of capital. We anticipate that future guidance will provide that certain cash held for investment in qualified opportunity zone property will not be treated as a “bad asset” for purposes of the 90-Percent Test, but this result cannot be guaranteed.

Because an investor’s gain will likely be contributed to the QOF at one time, or at least will all need to be contributed within 180 days after realization, a typical private equity fund structure will be more challenging to implement. Subsequent closings would need to take into consideration whether new investors will participate in prior deals or only in new investments. Permitting new investors to participate in prior deals would create additional cash management challenges. Individual investor tax benefits based on holding periods will also be more difficult to manage with multiple closings and multiple assets. Based on these considerations, we believe most QOFs will be structured as single asset vehicles.

*Term.* Investors in QOFs realize the tax benefits associated with the QOF investing in Opportunity Zones based on the length of time their investment in the QOF has been held, as described in Part II above. As a result, in order to attract investors, a sponsor will want to make the term of a QOF long enough for the investors to receive the benefits of the tax deferral and the FMV Basis Election (which becomes available after the 10th anniversary of the investment). Alternatively, the QOF could be an open-ended fund permitting redemptions and transfers of interests by investors from time to time and thus allowing investors to exit the QOF based on their tax planning goals.

*Sales and Dispositions by a QOF.* While a QOF does not need to hold any specific asset for any period of time, there are tax issues raised by the QOF’s sale of assets (including interests in qualified opportunity zone businesses). Unless Treasury provides otherwise through guidance, it appears that the gain, if any, from the sale of qualified opportunity zone property by a QOF generally cannot be deferred under the Opportunity Zone program (i.e., through investments by the selling QOF in other QOFs), because QOFs must be organized for the purpose of investing in qualified opportunity zone property other than interests in other QOFs.<sup>8</sup>

QOFs that also qualify as REITs may sell their assets in the context of a liquidation without eliminating their long-term investors’ ability to benefit from the FMV Basis Election. For example, if the QOF in Step Six of the

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<sup>7</sup> Read literally, the Act does not appear to allow a QOF to hold over 10% of its assets as cash in any year, including the years during which the QOF is onboarding new investors and their capital and the years during which the QOF is making substantial improvements to property during the statutory 30-month period. While the Act requires Treasury to provide, through regulations, guidance on how long a QOF can hold cash from the sale of an investment before it needs to reinvest the proceeds, the Act does not directly address Treasury’s authority to provide a grace period and/or start-up period during which the QOF is not required to count cash dedicated or reserved for investment in qualified opportunity zone property as a bad asset.

<sup>8</sup> Another consideration for QOFs that want to sell assets is that Treasury has not yet defined the “reasonable period of time” that QOFs will have to reinvest cash (which generally is a bad asset) received from the sale or disposition of qualified opportunity zone property without jeopardizing their ability to meet the 90-Percent Test.



diagrams below qualifies as a REIT, sells its assets and liquidates, the investors in the REIT QOF who have held their REIT stock for over 10 years should be permitted to use the FMV Basis Election to eliminate any gain that would otherwise result from the liquidation.

The 10 percent and 15 percent basis adjustments for investments held for at least five or seven years, respectively, appear to apply to the basis of the investor in its equity interest in the QOF rather than to the basis of the qualified opportunity zone property held by the QOF. Furthermore, it appears that the way in which the investor exits the QOF after obtaining one or both of those basis adjustments generally would not affect the investor's ability to use those adjustments; the investor could exit the QOF by selling its interest in the QOF or by receiving distributions upon the liquidation or winding up of the QOF and, in each case, the amount of gain the investor would be required to include in income would be the same.

However, with respect to the basis step-up that is available under the FMV Basis Election, if the investment in the QOF is held for at least 10 years, an electing investor steps up only its basis in "such property" so that it equals "the fair market value of such investment on the date that the investment is sold or exchanged." Since it appears that "such investment" is the investor's equity interest in the QOF, if the QOF is a partnership for U.S. federal tax purposes, the investor may not receive the benefit of the FMV Basis Election if the QOF sells its assets at a gain in a taxable transaction before the investor sells or exchanges its interest in the QOF (although we doubt that Congress intended this result). Because of this technicality, investors may look for more liquidity in their QOF interests than investors in private equity funds typically would expect, and may also seek assurances that the QOF will not sell appreciated property without the consent of the investor, which would restrict the QOF's ability to liquidate or monetize its investments. Investors may also require QOFs to sell the interests in the QOF itself to potential buyers, rather than the underlying assets. Such form-driven tax requirements could diminish the efficacy of the Opportunity Zone program and deter investments in QOFs because the sale price a buyer will pay for QOF interests generally will be lower than for a sale of the underlying property. Any requirement to sell the QOF interests rather than the underlying property would also limit the ability to hold multiple assets in a QOF.

*Leverage.* The Act does not prohibit the acquisition of qualified opportunity zone property with either mortgage, mezzanine or fund-level financing. We do not expect any such limitations to be imposed. Because lenders to QOFs do not appear to be eligible for Opportunity Zone program tax benefits available to equity investors, the after-tax cost of debt capital for QOFs may be higher than the after-tax cost of equity capital.

*Reporting.* Investors will expect reporting to demonstrate that the QOF and its investments meet all of the applicable tax requirements for QOFs and that the QOF is able to substantiate such compliance in any tax audit. Similar to the private REIT context, some QOF investors may require the sponsor to provide an opinion of tax counsel, upon request, stating that the QOF has maintained its QOF status.

*Defaults.* Investors may want the ability to redeem their interests in the event the QOF fails (or is in danger of failing) to qualify as a QOF. Investors may require any failure to meet the QOF requirements to be a general partner removal event. Investors may also ask to be indemnified or otherwise made whole with respect to the monthly penalty for failure to meet the 90-Percent Test since investors will bear their proportionate share of any penalty.

*Fees and Promote.* Based on guidance to date, nothing limits the manner in which the sponsor of a QOF may charge fees to the investors for services rendered or prevents the sponsor or an affiliate from taking a promote (or carried interest from the QOF). However, if Treasury does not issue guidance that permits QOF investors to benefit from the FMV Basis Election in connection with a fund-level sale of qualified opportunity zone property, sponsors could be forced to structure the monetization of their promote as a sale of the

promote for cash to a purchaser of the interests in the QOF, instead of the more typical fund-level sale of assets. With respect to fees, we do not expect any restrictions from Treasury. CDEs may charge fees to investors in New Market Tax Credit transactions based on what the market will support. Those deals may have origination fees, management fees, acquisition / disposition fees and financing fees, and we expect that sponsors of QOFs would also charge fees such as these to their investors.

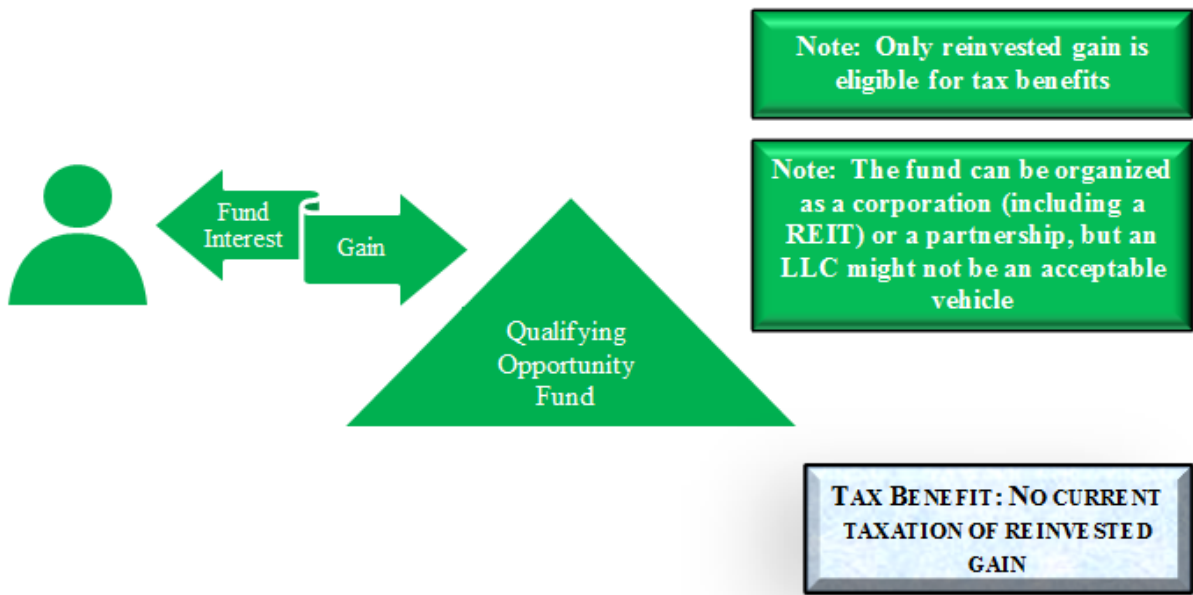
### **What Comes Next for Opportunity Zones?**

We expect that the official list of designated Opportunity Zones will be published by the end of May 2018. In addition, Treasury has indicated that it intends to provide further guidance regarding the Opportunity Zone program in the summer of 2018. This guidance will likely address the definition of “qualified opportunity zone business property” and other key issues relating to the 90-Percent Test (including the time period that may elapse before a QOF must use investor capital to acquire or construct eligible investments). Because of the current number of unresolved technical issues with QOFs, some uncertainty regarding Treasury’s implementation of the Opportunity Zone program may persist into late 2018 or beyond. However, the Act and the existing guidance provide significant visibility for potential investors and fund sponsors to start thinking about how to best structure QOFs.

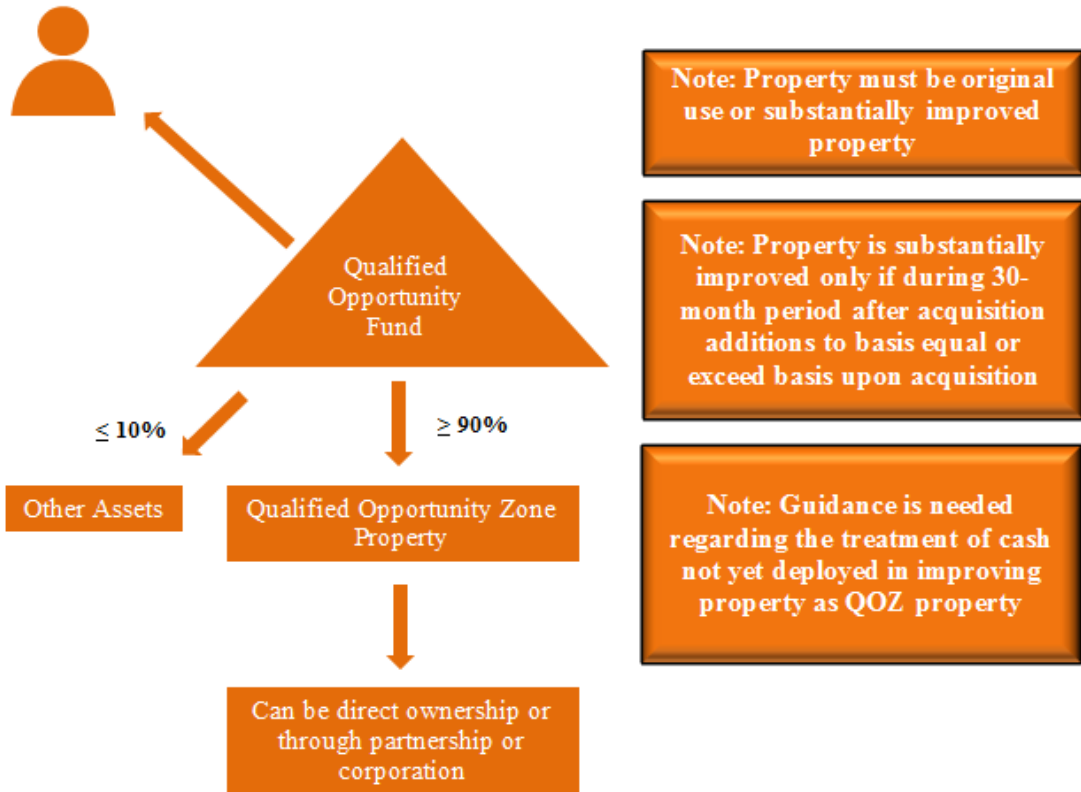
Step One: Investor Recognizes Capital Gain



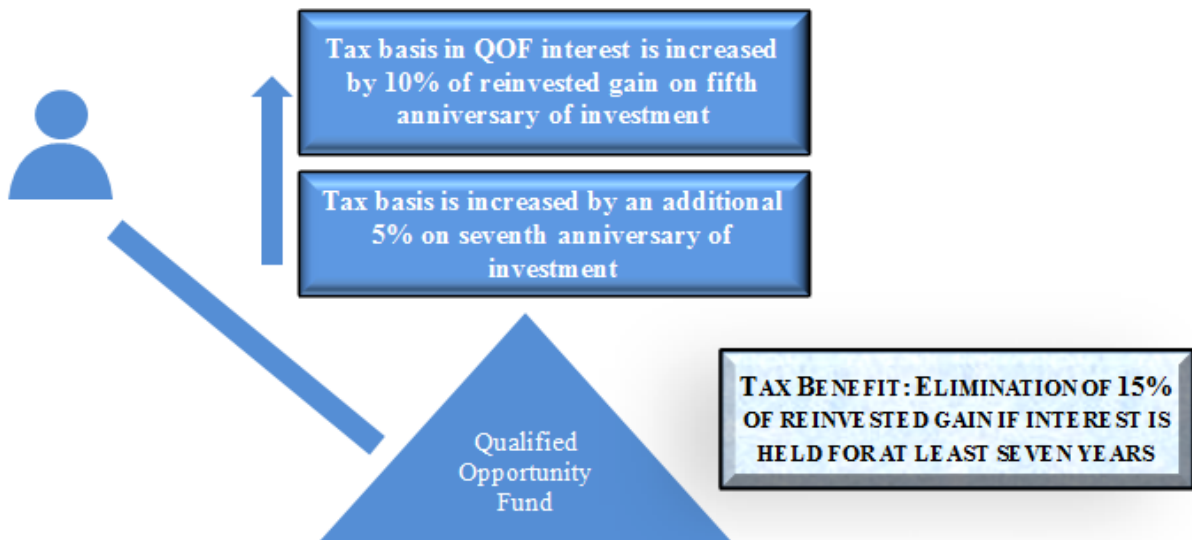
Step Two: Investor Invests Gain into QOF Within 180 Days



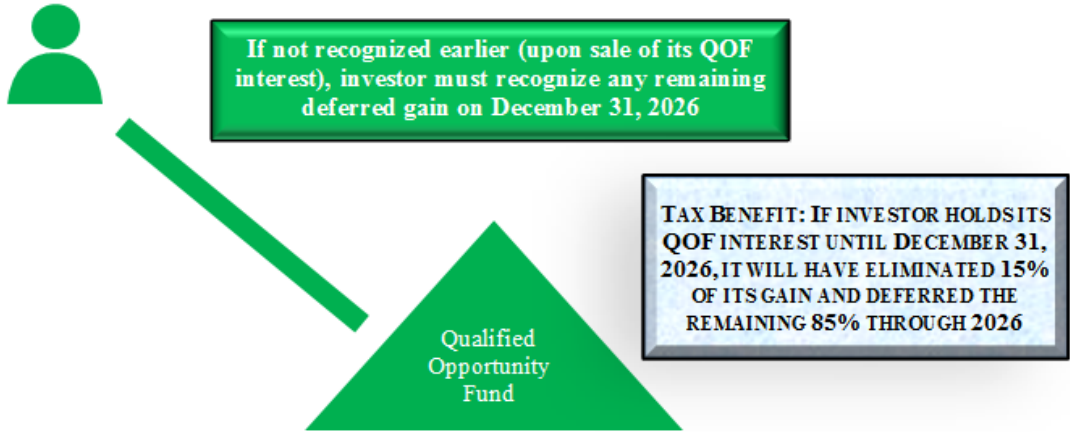
**Step Three: Fund Invests in QOZ Property**



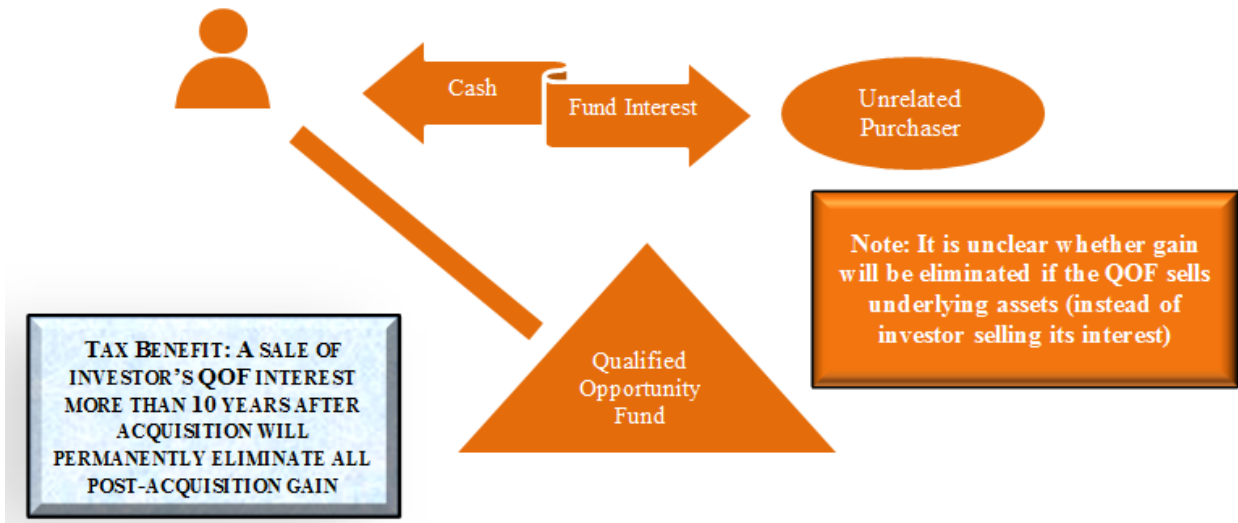
**Step Four: Investor Receives Basis Step Up in QOF Interest**



**Step Five: Investor Recognizes Any Remaining Gain on Dec. 31, 2026**



**Step Six: After 10 Years, Investor Eliminates Gain By Selling QOF Interest**



**THIS NEWSLETTER IS INTENDED ONLY AS A GENERAL DISCUSSION OF THESE ISSUES. IT SHOULD NOT BE REGARDED AS LEGAL ADVICE. WE WOULD BE PLEASED TO PROVIDE ADDITIONAL DETAILS OR ADVICE ABOUT SPECIFIC SITUATIONS IF DESIRED. IF YOU WISH TO RECEIVE MORE INFORMATION ON THE TOPICS COVERED IN THIS PUBLICATION, YOU MAY CONTACT YOUR USUAL SHEARMAN & STERLING REPRESENTATIVE OR ANY OF THE FOLLOWING:**

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