Vinson&Elkins

FEBRUARY 2019

QUALIFIED OPPORTUNITY FUNDS, REAL ESTATE, AND REITS

REIT Series – Q1 Update

velaw.com

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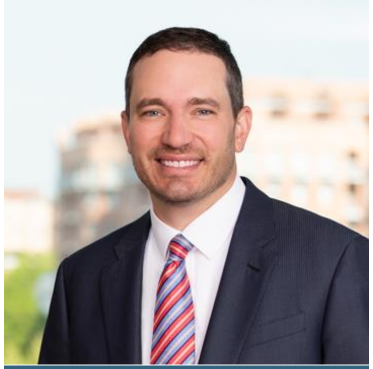

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OPPORTUNITY ZONES
GENERAL OVERVIEW

- Opportunity Zones Generally
  - TCJA created an opportunity for taxpayers to defer and partially eliminate capital gains by making long-term investments in economically depressed areas designated as "Opportunity Zones".
  - The Opportunity Zone provisions are designed to encourage direct investment (and accompanying employment and economic stimulus) in a wide range of businesses (other than certain "sin" businesses) in economically depressed areas.
  - Tax Incentives Available:
    - **Temporary Deferral**: eligible gains rolled into qualified opportunity funds ("QOFs") are deferred until the earlier of December 31, 2026 or the date on which the investment in the QOF is transferred.
    - **Elimination of up to 15% of deferred gain subject to tax**: eligible gains invested in a QOF get a basis increase of 10% of the deferred gain after 5 years and 5% of the deferred gain after 7 years, for a total potential 15% increase in basis.
    - **Exclusion of gain on post-acquisition appreciation**: if an investment in a QOF is held for at least 10 years, the taxpayer recognizes no gain on the post-acquisition appreciation in its QOF interest.

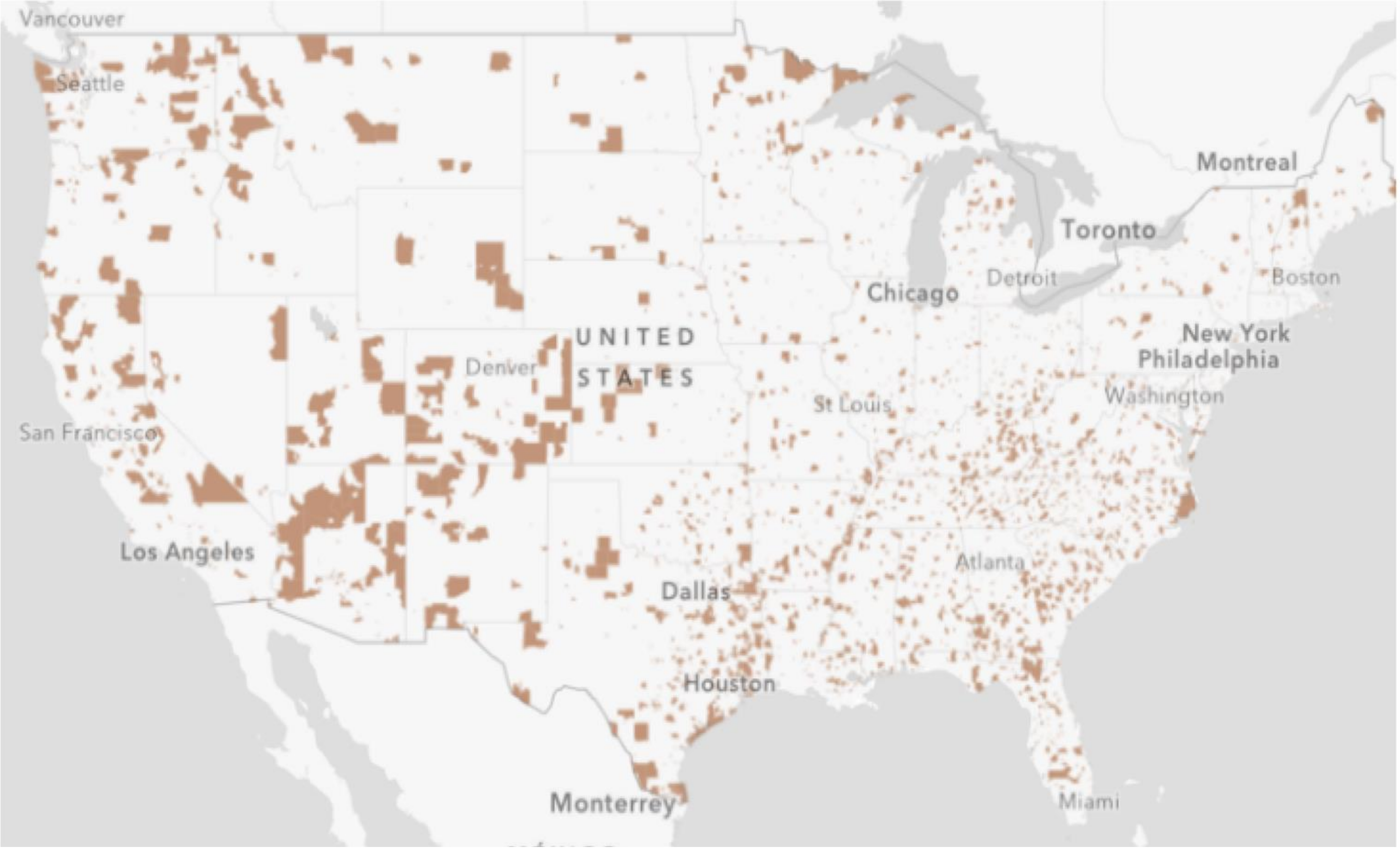
OPPORTUNITY ZONES
POTENTIAL IMPACT ON INVESTMENT RETURNS

The table below illustrates an investor's potential after-tax returns in a QOZ Investment compared to the investment of capital gains in a traditional investment both appreciating at 10%

	Non-QOZ Investment	QOZ Investment
Invested Capital Gain	$1,000,000	$1,000,000
Less: Capital Gain Tax Investment (23.8%)	(238,000)	0
After-Tax Investment	762,000	1,000,000
Year 10 Value (assumes 10% annual investment appreciation)	1,976,432	2,593,742
Less: Year 10 Capital Gains Tax (23.8%)	(289,035)	0
Year 10 After-Tax Value	1,687,397	2,593,742
Less: Cap Gains Taxes on Invested Gains Due on 12.31.26*	0	(202,300)
Total Year 10 After-Tax Value	$1,687,397	$2,391,442
Total Year 10 After-Tax Net Gain**	$687,397	$1,391,442

* Assumes investment is held for 7 years and a 15% step-up in basis is applied to original capital gain that was invested
** Assumes 10-year holding periods, annual rate of investment appreciation of 10%, and a long-term capital gains tax rate of 23.8%.
Note: The amounts shown are not net of fees and carry in either the traditional investment or the QOZ investment. This is to illustrate the tax benefits of QOZ investments prior to any fee structures.

OPPORTUNITY ZONES
LOCATIONS



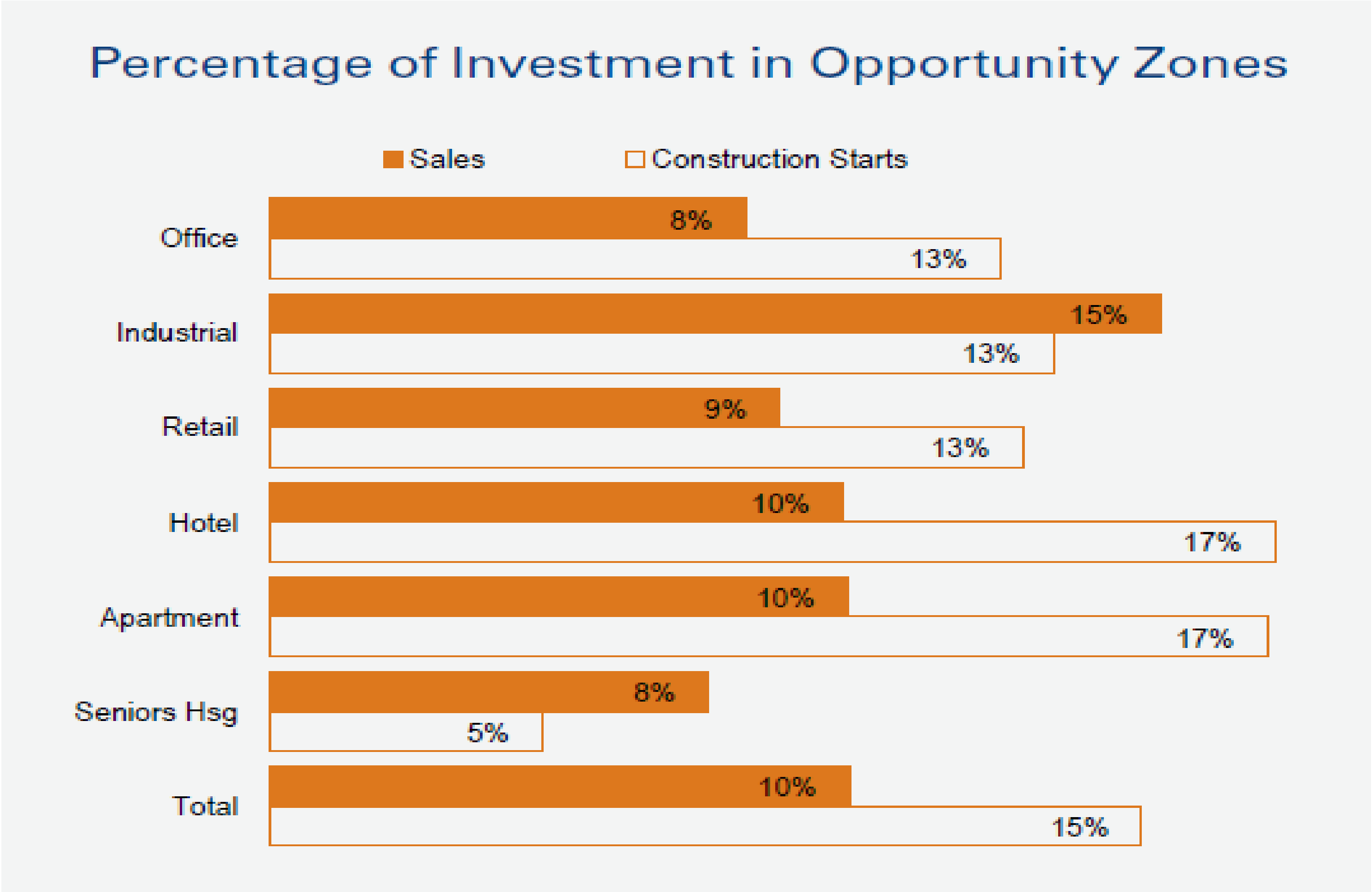
38%
Urban

22%
Suburban

40%
Rural

A list and map of all QOZs that have been designated can be found at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

OPPORTUNITY ZONES
CHARACTERISTICS

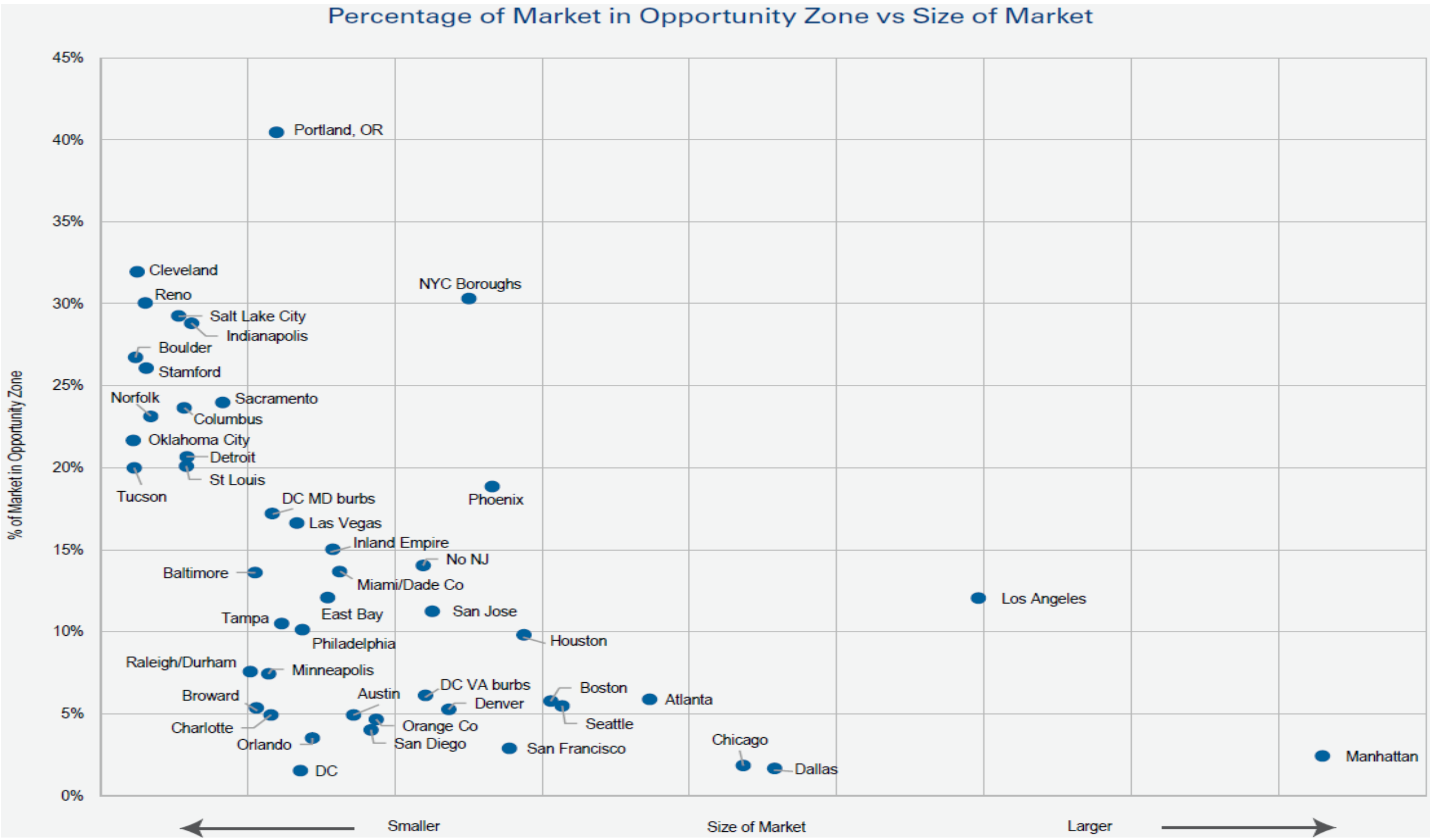


- Source: Real Capital Analytics, Inc.
- Data: 2015-Q3 2018

OPPORTUNITY ZONES
CHARACTERISTICS

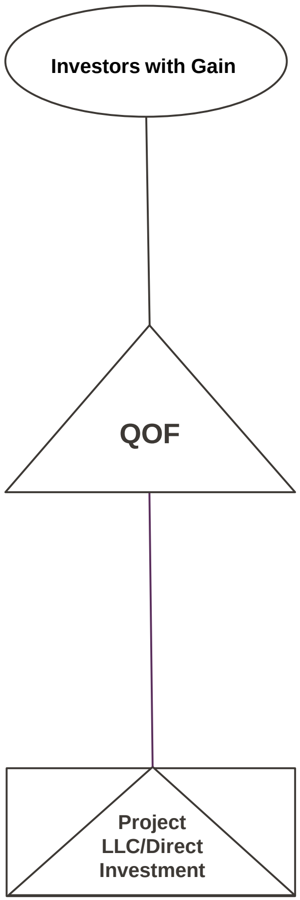
- Source: Real Capital Analytics, Inc.

OPPORTUNITY ZONES
CHARACTERISTICS

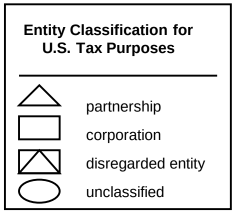


- Source: Real Capital Analytics, Inc.

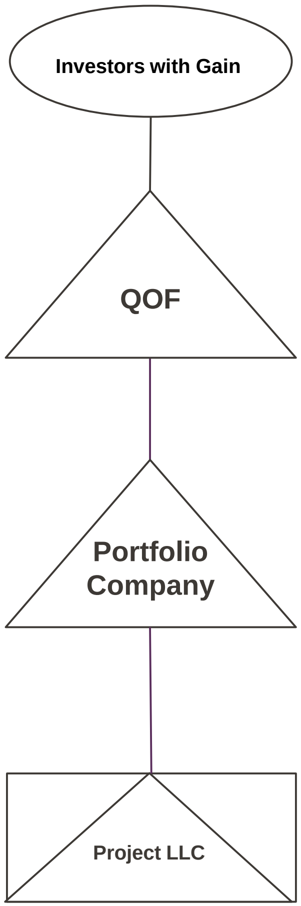
TIMING CONSIDERATIONS: DIRECT INVESTMENT



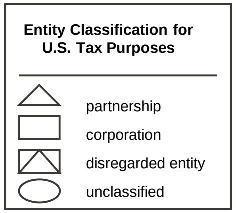
- Investors with qualified gain invest cash in QOF within 180 days of triggering gain.
- Investments made in a Fund before its QOF start date are not eligible for benefits.
- QOF must comply with the 90% test starting 6 months after its QOF start date.
- Working capital safe harbor is not available in direct investment structure, so QOF must have at least 90% QOZ business property (and no more than 10% cash) by 6 months after date first investor rolls gains into QOF.
- Consequently, in direct investment structure, QOF would need to own at least 90% QOZ business property within 180 days after investor rolls gains into QOF.



OPPORTUNITY ZONES
TIMING CONSIDERATIONS: PORTFOLIO COMPANY



- Investors with qualified gain invest cash in QOF within 180 days of triggering gain.
- Investments made in a Fund before its QOF start date are not eligible for benefits.
- QOF must comply with the 90% test starting 6 months after its QOF start date.
- Working capital safe harbor is available at portfolio company level.
- Investment in portfolio company is qualifying asset for purposes of 90% test.
- Portfolio company, in turn, has 31 months safe harbor in which to deploy cash into QOZ business property.
- Consequently, in portfolio company structure, QOF may satisfy 90% test within 180 days after investor rolls gains into QOF my merely contributing cash representing those gains into portfolio company.
- Portfolio company then has 31 additional months to deploy cash.



What is a QOF?

- A QOF is defined as a partnership or corporation organized to invest in qualified opportunity zone property.

How does a QOF Become Certified?

- QOFs can self-certify by filing IRS Form 8966 attached to their federal income tax return for the taxable year for which the QOF election is being made.
- QOFs have the ability to indicate the first month and year they wish to qualify as a QOF.
  - Any investments made prior to the month with respect to which the QOF elects to begin its QOF status are not eligible for tax benefits.
- QOFs must continue filing the Form 8966 annually and must certify compliance with the 90% Test (defined below).

What Kind of Entity is Eligible to be a QOF?

- Any domestic entity that is treated as a corporation or a partnership for federal income tax purposes can qualify as a QOF, including:
  - Limited partnerships.
  - Limited liability companies taxed as partnerships or corporations.
  - REITs.
- The IRS also noted in the preamble to the proposed regulations that entities must be created or organized in one of the 50 states, the District of Columbia, or a U.S. possession to be eligible to be a QOF.

Can a Pre-Existing Entity Qualify as a QOF?

- Yes, provided it can meet the requirements discussed below, with the caveat that any property acquired prior to the QOF designation will not be QOZ Property.

What Testing Requirements Apply to a QOF?

- 90% Test. A QOF must hold at least 90% of its assets in QOZ property (the “90% Test”).
- The test is applied by measuring the average of the percentage of QOZ property in the QOF on two testing dates, the last day of the first six-month period of the QOF’s taxable year and the last day of the QOF’s taxable year.
- QOFs that choose to begin their QOF qualification other than on January 1 of a given year will have their first testing period 6 months after their first QOF month, and again at year end.

How are Values Determined for Purposes of the 90% Test?

- A QOF must use asset values as reported on its applicable financial statements (as defined in Treasury Regulations Section 1.475(a)-4(h) (i.e., financial statements required to be filed with the SEC, another federal agency other than the IRS, or certificated audited financial statements)) to determine compliance with the 90% Test.
- If a QOF does not have applicable financial statements, it must use the unadjusted cost basis of its assets.

What Happens if a QOF Fails the 90% Test?

- If a QOF fails the 90% Test in any month, the QOF must pay a penalty equal to the shortfall in its 90% Test multiplied by the underpayment rate provided for in Code Section 6621(a)(2) (currently approximately 5%).
- Forthcoming additional guidance will address potential decertification of QOFs that fail the 90% Test.

What Qualifies as QOZ Property?

- QOZ property includes:
  - QOZ trade or business property; and
  - QOZ partnership interests or corporate stock (a "QOZ Entity")
    - A QOZ partnership interest is a partnership capital or profits interest that:
      - is acquired by the QOF after December 31, 2017 solely in exchange for cash;
      - at the time the interest was acquired the partnership was a QOZ business or was being organized for purposes of being a QOZ business; and
      - during substantially all of the QOF's holding period of such interest, the partnership qualifies as a QOZ business.
    - QOZ stock is stock in a domestic corporation provided that:
      - the stock is acquired by the QOF after December 31, 2017 at original issuance solely in exchange for cash;
        - QOZ stock may be issued through an underwriter.
      - at the time the stock was issued, the corporation was a QOZ business or was being organized for the purposes of being in a QOZ business; and
      - during substantially all of the QOF's holding period in the stock, the corporation qualified as a QOZ business.

What is QOZ Business Property?

- QOZ business property is tangible property used in a trade or business of the QOF, provided that it must meet all of the following requirements:
  - The property is acquired by the QOF from an unrelated person after December 31, 2017;
    - As noted earlier, 20% common ownership will generally trigger the related party definition.
    - The related party rules may complicate the ability of typical real estate joint venture structures in which a property owner and developer form a JV to develop property to qualify as QOFs.
  - The original use of the property in the QOZ commences with the QOF; or the QOF "substantially improves" the property;
    - Substantial improvement results if the costs of improvements during the 30-month time period from the date of purchase are greater than the QOF's purchase price of the property. In other words, the investment must be doubled.
    - In the case of land and buildings, additions to the basis in the building only need exceed the adjusted basis in the building at the beginning of the 30-month period. Importantly, the cost of land is not included in the taxpayer's basis for purposes of determining substantial improvement.
  - During substantially all of the QOF's holding period in the QOZ business property, substantially all of the use of the QOZ business property is in the QOZ.

What is a QOZ business?

- A QOZ business is a trade or business which meets all of the following requirements:
  - Substantially all of the tangible property owned or leased by the taxpayer is QOZ business property;
    - For this purpose only, "substantially all" means at least 70%.
    - If a QOF owns more than one QOZ Entity, each entity must satisfy the 70% test.
  - A working capital safe harbor is available for QOZ Entities, which allows funds to be placed in a working capital account (i.e., cash, cash equivalents, and debt instruments with maturities of 18 months or shorter) for up to 31 months if certain recordkeeping requirements are met.
    - Importantly, the working capital safe harbor is only available at the QOZ Entity level and not at the QOF level.
  - A minimum of 50% of the total gross income of the entity is derived from the active conduct of such trade or business;
    - An active trade or business for this purpose has not been defined by the IRS and Treasury.
  - A substantial portion of any intangible property of the QOZ Entity must be used in the active conduct of such trade or business;
  - Less than 5% of the average aggregate unadjusted basis of the property of the QOZ Entity is attributable to nonqualified financial property (generally debt, stock, partnership interests, options, futures contracts, forward contracts, notional principal contracts, annuities, and similar types of property);
    - The working capital safe harbor described above also applies to compliance with this requirement.
  - The business is not one of a list of enumerated "sin" business, including a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or liquor store.

- Recall that the definition of "QOZ business property" requires either that the original use of the property in the QOZ commences with the QOF or the QOF "substantially improves" the property.
- Original Use. In Revenue Ruling 2018-29, the IRS confirmed that the "original use" requirement in the statute does not apply to land on which a building is located as, given the permanence of land, land can never have its original use in the QOZ.
- Substantial Improvement: Measurement in the Real Estate Context. Also in Revenue Ruling 2018-29, the IRS rules that if a QOF purchases a building, "substantial improvement" is measured in terms of the adjusted basis of the building only. In other words, a QOF will meet the substantial improvement requirement if it adds 50% to the basis of the building only.
- Substantial Improvement: Application to Land. Finally, Revenue Ruling 2018-29 confirmed that substantial improvement requirement with respect to a building does not require the QOF to separately substantially improve the land upon which the building sits.

KEY ISSUES RELATING TO REAL ESTATE INVESTMENTS

- Example:
  - QOF purchases Property X in a QOZ for $800.
  - Property X consists of land and a previously erected factory.
  - QOF intends to convert the factory into a residential rental property.
  - Sixty percent of purchase price ($480) is attributable to value of the land, while forty percent ($320) is attributable to the building.
  - QOF invests an additional $400 to convert the factory to residential property during the 30 month period beginning on the date of acquisition.
- Application of Revenue Ruling 2018-29:
  - QOF's $400 of improvements more than doubled the adjusted basis of the building ($320).
  - Consequently, the entire parcel is QOZ business property.
  - The QOF need not take the land value of $480 into account in measuring its additions to the basis of the building.
  - The QOF is not separately required to substantially improve the land.

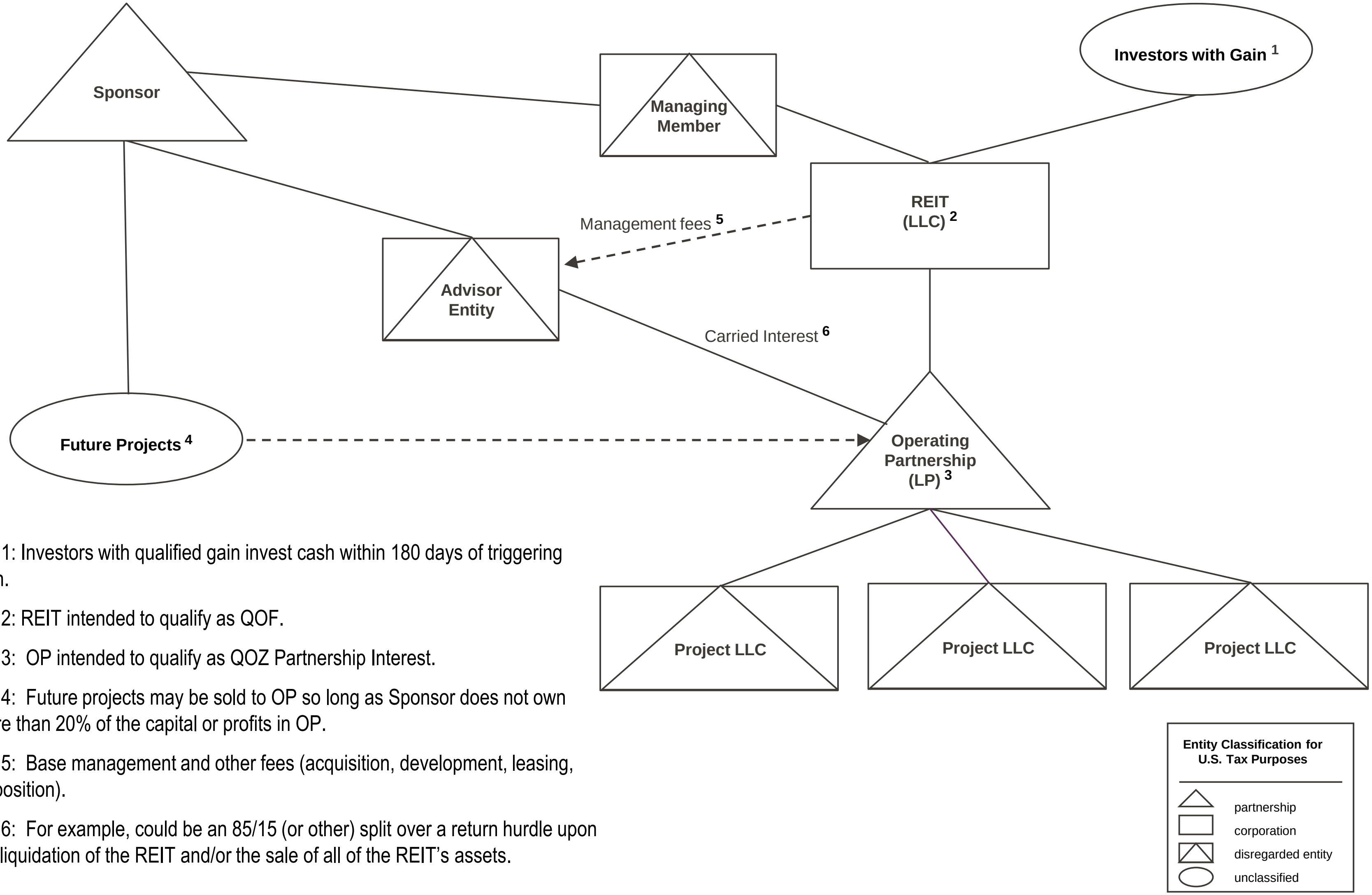
REITS AND OPPORTUNITY ZONES

- What Role for REITs?
  - Eligible Gains for Deferral: includes capital gain dividends received from REITs, and shareholder's portion of undistributed REIT capital gains required to be included in shareholders' income.
  - Eligible Taxpayers to Defer Gain. REITs are among the taxpayers who may utilize the opportunity zone rules to defer gain.
    - QOZ rules more flexible than 1031
    - Ability to manage recognized gains to distribution level
  - QOF: may be formed as a REIT (and several QOFs currently in the market are structured as REITs).
    - Importantly, the QOZ rules appear to require that taxpayers sell their interests in a QOF.
    - This could cause commercial issues as buyers generally strongly prefer purchasing assets instead of purchasing entities.
    - For QOFs in corporate form, the requirement of an entity sale raises the issue of the inability of the buyer to obtain a basis step-up in the assets without paying tax on a liquidation of the corporation.
    - In such cases, corporate QOFs would be well advised, to the extent possible, to consider utilizing the REIT form as a REIT could be liquidated post-sale without triggering tax due to the availability of the dividends-paid deduction upon liquidation, while also providing the buyer with a fair market value tax basis step-up in the assets upon liquidation.

REITS AND OPPORTUNITY ZONES

- What Role for REITs?
  - Liquidity Scenario: QOZ rules require that investor sell its interest in the QOF (as opposed to the QOF selling assets) in order to obtain exclusion of post-acquisition appreciation.
    - Proposed regs have not, thus far, allowed for QOFs to reinvest interim sale proceeds on a tax-deferred basis or allowed QOF investors to take QOF benefits on their share of sale gains by the QOF.
    - In the absence of such guidance, sales of property (as opposed to interests in the QOF) by a QOF organized as a tax partnership would trigger allocation of gains on the sale of such properties to the QOF LPs under general subchapter K principles.
    - Conversely, a REIT, as a corporation for tax purposes, may adopt a plan of liquidation.
    - Plan of liquidation is required to be completed in 24 months.
    - Pursuant to a plan of liquidation, the REIT may sell its properties and make distributions to shareholders.
    - Such distributions are treated first as a return of tax basis and then as a sale or exchange of the shareholder's stock in the REIT.
    - The result is that (a) the gain is attributable to the shareholder selling its interest in the QOF and therefore qualifies for QOZ benefits, and (b) the REIT gets a dividends paid deduction for the liquidating distributions, eliminating the entity-level gain from the sale of properties.

OPPORTUNITY ZONES
STRUCTURE CONSIDERATIONS: REIT AS POOLED VEHICLE



- Fn. 1: Investors with qualified gain invest cash within 180 days of triggering gain.
- Fn. 2: REIT intended to qualify as QOF.
- Fn. 3: OP intended to qualify as QOZ Partnership Interest.
- Fn. 4: Future projects may be sold to OP so long as Sponsor does not own more than 20% of the capital or profits in OP.
- Fn. 5: Base management and other fees (acquisition, development, leasing, disposition).
- Fn. 6: For example, could be an 85/15 (or other) split over a return hurdle upon the liquidation of the REIT and/or the sale of all of the REIT's assets.

OPPORTUNITY ZONES
STRUCTURE CONSIDERATIONS: REIT AS POOLED VEHICLE

General Considerations

- Need Operating Partnership in structure to benefit from 31 month safe harbor for working capital.
- All cash taken in from investors is contributed down into operating partnership in exchange for additional units.
- In order to reap the benefits of the basis step up on a 10-year hold, QOZ rules require taxpayers to sell their interests in a QOF (as opposed to having the QOF sell assets).
- Proposed regulations do not, thus far, allow QOFs to reinvest interim sale proceeds on a tax-deferred basis or allow QOF investors to take QOF benefits on their share of sale gains by a QOF.
- In the absence of such guidance, sales of property (as opposed to sales of interests in a QOF) by a QOF that is organized as a tax partnership would trigger allocations of gains on the sale of such properties to the QOF LPs under general subchapter K principles.

REIT Advantages

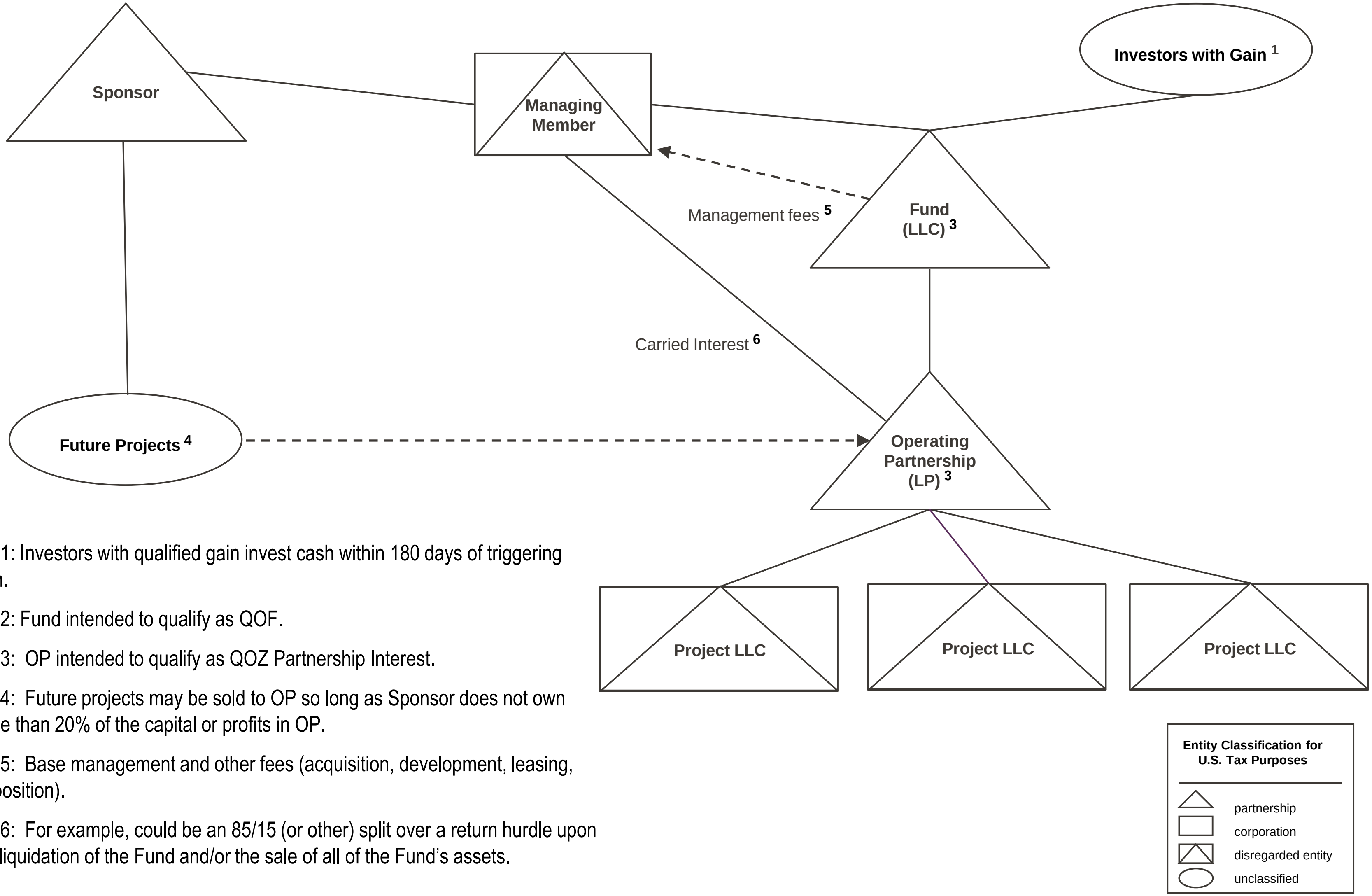
- With respect to regular operating income that is distributed, REIT dividends, including those paid by non-public REITs, carry with them the 20% deduction under Code section 199A on a dollar for dollar basis, resulting in an effective federal tax rate on dividends of 29.6%.
- Unlike a partnership, as a corporation for tax purposes, a REIT may adopt a plan of liquidation.
- Plan of liquidation is required to be completed in 24 months.
- Pursuant to a plan of liquidation, the REIT may sell its properties and make distributions to shareholders.
- Such distributions are treated first as a return of tax basis and then as a sale or exchange of the shareholder's stock in the REIT.
- The result is that (a) the gain is attributable to the shareholder selling its interest in the QOF and therefore qualifies for QOZ benefits, and (b) the REIT gets a dividends paid deduction for the liquidating distributions, eliminating the entity-level gain from the sale of properties.
- This provides flexibility to sell dirt or disregarded entities to buyers, rather than an entity with a history, whether a partnership or REIT.

STRUCTURE CONSIDERATIONS: REIT AS POOLED VEHICLE

REIT Disadvantages

- Complying with the REIT qualification rules as it relates to operations.
- Limited flexibility in varying management fees paid by different shareholders.
- Compliance with REIT ownership diversity rules.
- Compliance with dealer sales rules (not likely to be an issue in a QOZ context).

OPPORTUNITY ZONES
STRUCTURE CONSIDERATIONS: FUND AS POOLED VEHICLE



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- Fn. 5: Base management and other fees (acquisition, development, leasing, disposition).
- Fn. 6: For example, could be an 85/15 (or other) split over a return hurdle upon the liquidation of the Fund and/or the sale of all of the Fund's assets.

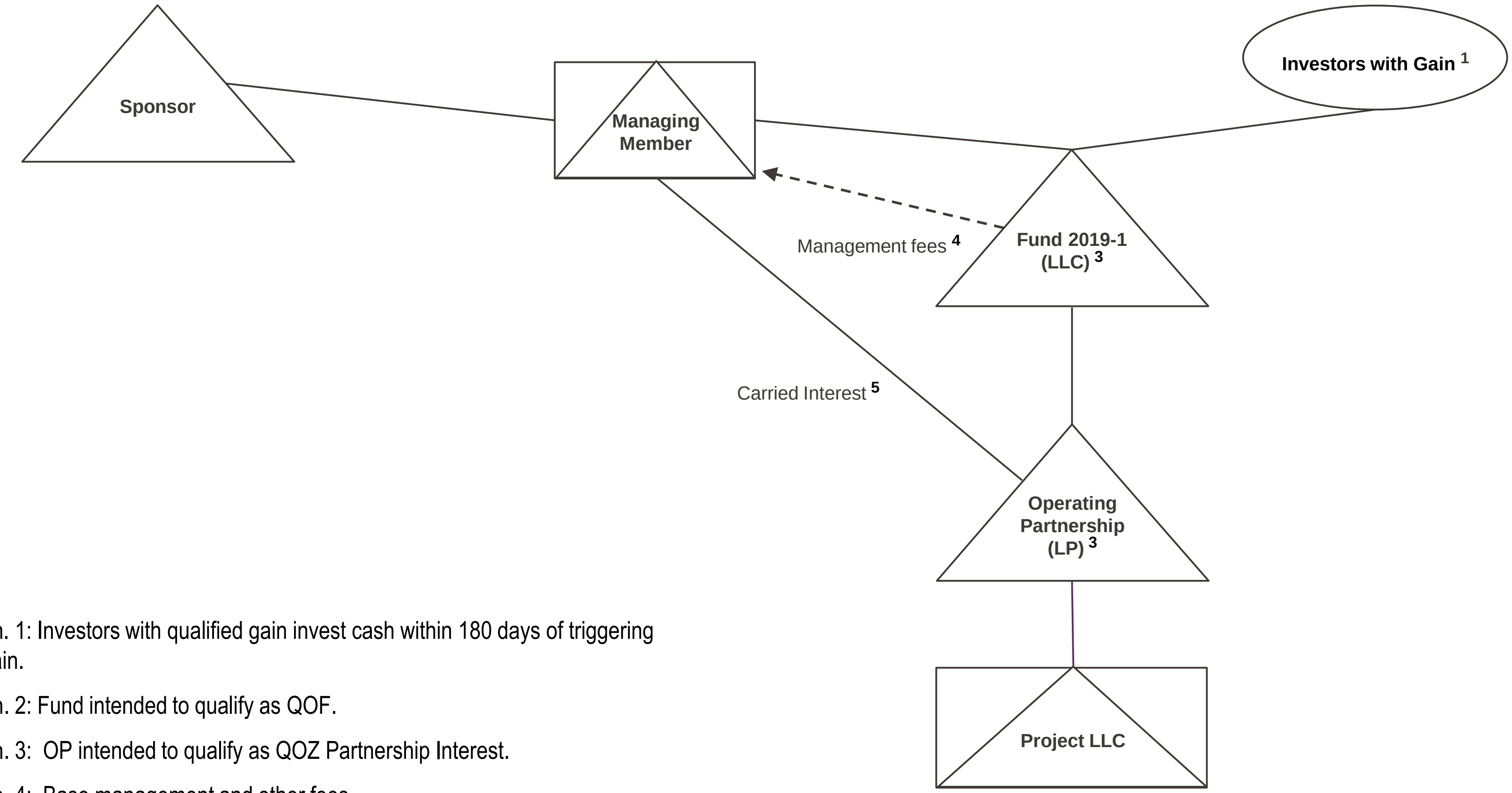
Fund/Partnership Advantages

- More flexibility in ownership and operations than a REIT.
- More flexibility in crafting bespoke fee arrangements for larger investors.
- Less overall complexity.
- Outside chance that carried interest could escape tax entirely if GP also purchases a small capital interest using qualifying gains.

Fund/Partnership Disadvantages

- Liquidation issue described above in “REIT as Pooled Vehicle”. Without further administrative guidance, partnership would have to force buyers to purchase the QOF entity upon exit, eliminating the ability to sell properties on a one-off basis in a liquidation scenario.
- Zero basis issue: tax distributions may require further gross up.
- Unlikely that entire income allocation will qualify for 199A deduction as with REIT.
- Difficulty managing future capital calls in conjunction with working capital safe harbor and requirement that investors roll gains within 180 days.

OPPORTUNITY ZONES
STRUCTURE CONSIDERATIONS: SINGLE ASSET FUND



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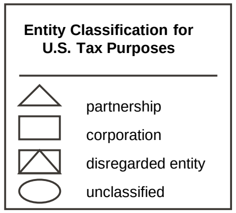

OPPORTUNITY ZONES
CAPITAL RAISING ALTERNATIVES

- QOFs currently raising capital privately
  - Reg D Private Placements
  - Could also use other exemptions such as Rule 144A and Reg S
  - Crowdfunding
  - Using REIT and fund structures
- Could QOFs raise public capital?
  - Tax deferral only with new investment into the QOF
  - Tax benefits cannot be transferred through trading interests in the QOF
  - Could result in limited trading due to extended hold periods to obtain tax benefits
  - May consider a stock repurchase or redemption program to provide liquidity similar to non-traded REITs
  - Blind pool vs SPAC

OPPORTUNITY ZONES
OPEN QUESTIONS/ISSUES

- How do the original use/substantial improvement requirements apply to leased property?
- Exit transactions: will the rules continue to require that QOF fund interests, as opposed to the underlying properties themselves, be disposed of in order to benefit from the 10 year step up?
- Will a mechanism be put in place to allow QOF’s to recycle capital?
- Interaction of QOZ and Subchapter K rules:
  - Will debt-financed distributions be allowed?
  - If an investor runs his/her capital account negative due to losses and or cost recovery allocations made possible by debt basis, are those amounts also excluded from gain recognition after a 10 year hold?
- Will the gross income requirement continue to require that 50% of the gross income of the QOZ business be derived from the active conduct of a trade or business in the zone itself?
- Will QOFs be given additional time to invest cash and/or will the working capital safe harbor be expanded to cover QOFs themselves, and not merely lower-tier entities.

OPPORTUNITY ZONES
FURTHER INFORMATION

For additional information see V&E's detailed Qualified Opportunity Zone Q&A at:

https://www.velaw.com/Insights/Treasury-Department-Issues-Opportunity-Zone-Opportunity-Fund-Guidance/

THANK YOU

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