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To Colleagues, Friends, and Clients:

Re: Summary of Opportunity Zone Proposed Regulations

This letter provides a summary of the recently issued Opportunity Zone Proposed Regulations. Although the regulations are only proposed, they state that they can be relied on now if they are applied in a consistent manner. In order to make the complex regulations somewhat understandable, I have left off a number of details, simplified the discussion, used my best judgment to fill in some missing gaps, and added a number of my own defined terms that do not match the terms used in the regulations. It is thus critical to consult with a tax advisor based on your particular facts before relying on this summary.

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1. Definitions. Here are the definitions used in this letter:

a. "Deferred Gain" means the Gain that is deferred by investing in a Fund.

b. "Gain" is all capital gain, including (i) short-term capital gain, (ii) capital gain on collectibles (normally taxed at a special rate), and (iii) distributions and allocations from entities that are treated as capital gains to the owners. Gain does not include recapture income, which is taxed as ordinary income.

c. "Fund" means an entity that is a Qualified Opportunity Fund meeting certain requirements, as discussed in Section 5.

d. "Fund Interest" means equity ownership (including preferred equity) in a Fund.

e. "Sub-Fund" means an entity that a Fund invests in that meets certain requirements, as discussed in Section 6.

f. "Sub-Fund Interests" means equity ownership (including preferred equity) in a Sub-Fund by a Fund.

g. "Zone" means certain designated low-income areas, as discussed in Section 4.

h. "Zone Property" means property that meets certain requirements, as discussed in Section 7, including Zone Working Capital.

i. "Zone Working Capital" means working capital that meets certain tests as discussed in Section 7(c).

2. Benefits of Investing Gain in a Fund. Investing in a Fund provides enormous tax benefits to any taxpayer that has recognized Gain, namely:

a. Tax on the Gain is deferred until the earlier of (i) when the Fund Interest is sold or (ii) December 31, 2026, even if the taxpayer takes out a loan against the Fund Interest.

b. When the Deferred Gain is finally recognized, the amount recognized is the lesser of (i) the amount of the Deferred Gain or (b) the value of the Fund Interest at that time. The character of the Deferred Gain when ultimately recognized is the same as in the year of the original sale.

c. Ten percent of the Deferred Gain is excluded entirely if the Fund Interest is held for five years, and 15% of the Deferred Gain is excluded entirely if the Fund Interest is held for seven years.

d. There is NO tax at all on a sale of the Fund Interest (other than the Deferred Gain) if the Fund Interest is held for ten years and the entire Fund Interest is sold, and there is no recapture of depreciation or even recognition of debt in excess of basis. This benefit applies even if the relevant area is no longer designated as a Zone for any reason. However, this benefit does not apply to Gain recognized on sales of property by the Fund itself, even if it is a pass-through entity for tax purposes. Thus, it is necessary to structure the transaction as a sale of Fund Interests, so it is beneficial to have a separate Fund for each project.

3. Technical Requirements.

a. The benefits apply to the reinvestment of any Gain recognized from 2018 through 2026 by all individuals and entities on sales to unrelated parties (not more than 20% overlapping ownership for sales to or by entities), including any Gains recognized on a sale of a Fund Interest, including Deferred Gain. The benefits do not apply (i) to recapture income or (ii) if the taxpayer held an offsetting position that substantially diminished the risk of holding the property that was sold, whether or not either of the positions were publicly traded.

b. The taxpayer must elect these benefits on Form 8949 filed with the tax return for the year of the original sale. For Gain recognized by pass-through entities, either the entity or the owners may make the election.

c. The Fund Interest must be acquired within 180 days after the Gain is recognized. If a pass-through entity does not make the election, the owners may elect to start the 180 days from either the end of the entity's tax year or when the entity recognizes the Gain. Gain allocated to shareholders of a REIT is deemed to be on the last day of the year. A difficulty for owners of pass-through entities is that they may not be advised of a sale by the entity until they receive their K-1s, and they may not have time to acquire a Fund Interest.

d. The Fund Interest must be acquired directly upon original issue from an entity that is a Fund at the time of the investment.

e. All the benefits (including the exclusion of tax on the sale of a Fund Interest) only apply to the extent of the lesser of (a) the Deferred Gain or (b) the amount invested in the Fund. If more than this amount is invested, the Fund Interest is allocated pro rata between the qualifying investment and non-qualifying investment for purposes of the exemption from tax on sale of the Fund Interest beyond the Deferred Gain. Tracing of cash from the Gain to the Fund Interest is not required. The amount of the investment in the Fund Interest appears to include debt (even non-recourse debt), but not any portion of the debt of a partnership (including an LLC) that is allocated to the investor.

4. Zones. Zones are located in the U.S. and its possessions. The designation of an area as a Zone remains for ten years. The map of Zones in California can be found at: http://bit.ly/2zlXJqO. The locations of national zones are listed in IRS Notice 2018-48.

5. Requirements for Funds

a. A Fund must be a corporation (even an S corporation) or a partnership (including an LLC) for tax purposes. As a practical matter, a Fund will almost always be formed as an LLC with multiple owners, to provide limited liability, partnership characterization for tax purposes, and pass-through tax treatment. The organizational documents (probably the articles) for the Fund must state that the purpose of the entity is to invest in a Zone and the description of the business. The Fund must be formed in the U.S. or in U.S. possessions, but it can be formed in a U.S. possession only if it invests in a Zone that is in that possession.

b. The entity must elect to be a Fund on Form 8996 and must file this form annually. On this form, the entity designates the first month it is a Fund, and if it does not make this designation, it is a Fund from the first day of entity for that year.

c. The Fund must hold 90% of its gross assets in the form of (a) Sub-Fund Interests acquired directly upon original issue from an entity that is a Sub-Fund at the time of acquisition or (b) Zone Property. For any period that the Fund does not meet this test, the Fund must pay penalty interest (currently 5% per year) on the amount of the shortfall. In each case, the assets must be acquired after 2017, so entities with substantial retained pre-2017 property cannot qualify, even if the property is in a Zone. The test is measured each year based on the average of the value of all assets at the end of (a) the first six months of the tax year (or the first six months from commencement as a Fund for its first year) and (b) the end of each tax year, as reported on Form 8996 each year. The test is applied based on the values stated on certified audited financial statements prepared in accordance with GAAP, or if none, based on cost. Under this approach, the asset values should include debt (even non-recourse debt) incurred in connection with acquiring the assets.

d. A Fund is allowed a "reasonable period" to reinvest in a Sub-Fund or in Zone Property if it sells a Sub-Fund Interest or Zone Property, but the sale is taxable to the owners of the Fund if it is a pass-through for tax purposes, unless they make a further election to defer the Gain by investing that amount in a Fund. Critically, there is no look-through to the assets of a Sub-Fund, even if it is a pass-through for tax purposes, so most Funds will be forced to meet the 90% test by holding interests in Sub-Funds, since the requirements for the assets of Sub-Funds are more lenient than for Funds, as discussed in Section 6 below. This means that the typical structure will be a Fund that is an LLC with multiple owners (to be treated as a partnership for tax purposes) that owns interests in one or more Sub-Funds that are also formed as LLCs with multiple owners (to also be treated as partnerships for tax purposes).

6. Requirements for Sub-Funds

a. A Sub-Fund must be a corporation or a partnership (including an LLC) for tax purposes. As a practical matter, a Sub-Fund will almost always be formed as an LLC with multiple owners, to provide limited liability, partnership characterization for tax purposes, and pass-through tax treatment. It does not appear that the organizational documents for a Sub-Fund must state that the purpose of the entity is to invest in a Zone and the description of the business (as is the case with Funds), but it would be prudent to do so. The Sub-Fund must be formed in the U.S. or in U.S. possessions, but it can be formed in a U.S. possession only if it invests in a Zone that is in that possession.

b. Substantially all (with a safe harbor of at least 70%) of the gross assets of the Sub-Fund must be Zone Property. The property remains Qualified Business Property for five years even if it is moved out of the Zone (as long as the entity owns it). Note that this test is more lenient than the 90% asset test for a Fund, but it is also all or nothing, as opposed to the interest charge imposed on Funds while they don't meet the 90% test. The property must be acquired after 2017, so entities with substantial retained pre-2017 property cannot qualify, even if the property is in a Zone. The test is applied based on values on "applicable financial statements" (certified audited financial statements prepared in accordance with GAAP) of the Sub-Fund, or if none, based on cost. Under this approach, the amount of the investment should include debt (even non-recourse debt) incurred in connection with acquisition of the property, but it would not include leased property. As opposed to Funds, Sub-Funds do not have to file Form 8996 each year, so it is not clear how the IRS will monitor compliance with the 70% test.

c. The following requirements all apply to Sub-Funds but oddly not to Funds:

i. At least 50% of the gross income of the entity must be from an active trade or business. Income from Zone Working Capital counts as qualifying income.

ii. A substantial portion of intangible property (such as trademarks and financial assets) of the Sub-Fund must be used in connection with an active trade or business in the Zone. Zone Working Capital counts as a "good" asset for this purpose.

iii. Less than 5% of the assets of the Sub-Fund can be comprised of investment property (including stock, partnership interests, and debt) other than Zone Working Capital.

iv. The Sub-Fund may not operate a 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.

v. If the Sub-Fund is a corporation, it cannot make certain redemptions, but it is highly unlikely that Sub-Funds will be formed as corporations.

7. Zone Property. The property that is included as Zone Property is listed below. Much of this list is based on extrapolation from examples in the Proposed Regulations and a Revenue Ruling, both of which conflict with the express wording of the regulations, so preparing this list takes some conjecture. In each case, the property must be used in the conduct of a trade or business in the Zone for substantially all of the Fund's holding period of the property:

a. Trademarks. Trademarks used in connection with business conducted in the relevant Zone.

b. Tangible Property Other than Land. Tangible property other than land that meets all the following requirements:

i. It must be used in a trade or business (or active trade or business for a Sub-Fund).

ii. It must be acquired by purchase by a Fund or Sub-Fund from an unrelated third party (not more than 20% common ownership) after 2017. However, for a Sub-Fund, it may also be leased, but presumably also from an unrelated third party after 2017.

iii. The property must either be (a) used in the Zone for the first time by the Fund or the Sub-Fund; or (b) the property is already in the Zone but the Fund or Sub-Fund invests in the property an amount equal to at least 100% of the Fund's original gross cost of the property within thirty months ("100% of Cost Test"). This last clause can only apply to buildings on real estate as a practical matter, and only the cost allocated to the acquired buildings is included for purposes of the 100% of cost test. The acquired buildings and all improvements to them count as Zone Property during the thirty months.

c. Land. Most importantly, it appears that land is included as Zone Property if the land was acquired by a Fund or Sub-Fund after 2017 and improvements are being built on the land for use in a trade or business (or in an active trade or business for a Sub-Fund). This conclusion is the most difficult to square with the statute and the Proposed Regulations, but it appears to follow from Revenue Ruling 2019-29 and an example in the Proposed Regulations.

d. Zone Working Capital. Liquid assets count as Zone Property if there is a written plan and written schedule for the use of the liquid assets for improvement to other Zone Property (and within thirty months, if the 100% of Cost Test applies) and the liquid assets are in fact spent in substantial compliance with such plan and schedule.

Please let me know if you have any questions on this summary.

Sincerely,

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