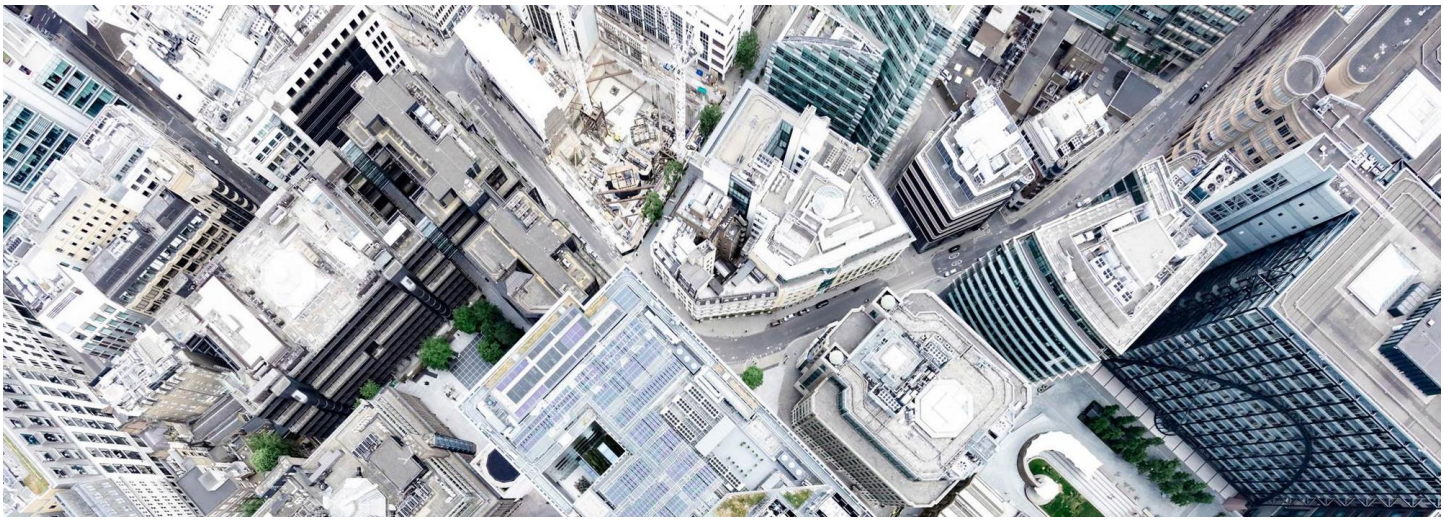

Qualified opportunity zones

By Todd D. Mayo

The Tax Cuts and Jobs Act of 2017 (Act) provided income tax relief to corporate taxpayers, pass-through taxpayers, and individual taxpayers alike.[1] Since its enactment, much has been explored and written by tax professionals regarding the reduced corporate and individual tax rates, deductions for pass-through entities, the increased transfer tax exemption amounts, and how these changes to the Internal Revenue Code intertwine to assist high net worth clients with their financial planning.

Folded into the Act is a benefit that has gained significant traction since the enactment of the Act. Known as the qualified opportunity zone (QOZ) incentive program, this benefit is found in new Section 1400Z-2 of the Internal Revenue Code. It allows an investor to defer capital gains tax and potentially to reduce tax, if those capital gains proceeds are rolled over into a qualifying investment in a QOZ and certain other conditions are met. A qualifying investment is made through a corporation, partnership, or other business in a low-income community in the United States, including Washington, D.C., and US territories.[2] The QOZ tax incentives are designed to attract investment to the nation's most economically distressed communities by offering powerful tax planning opportunities for investors who inject capital into these areas.

In a nutshell, the new QOZ provisions under Section 1400Z-2 may provide investors with (1) temporary deferral of capital gain recognition, (2) a possible step-up in their basis in their investment, and (3) possible permanent exclusion of capital gains from the growth of the QOZ investment if the holding period is at least 10 years.[3]

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[1] The Act's full title is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." Pub. Law. 115-97 (December 22, 2017).

[2] The term "low-income community" is defined in Section 45D(e) as having a poverty rate of at least 20% or is determined by certain levels of median family incomes. IRC § 1400Z-1(c).

[3] In 2021, the top marginal capital gains tax rate is 20%, and taxpayers may also be subject to an additional 3.8% net investment income tax under Section 1411. Certain states levy their own separate state income tax and may

The creation of QOZ tax deferral under new Section 1400Z-2 has generated a substantial amount of interest. Like many of the Act's other tax provisions, Section 1400Z-2 is complicated. The Treasury Department published two sets of proposed regulations (the first in October 2018 and the second in May 2019) before issuing lengthy final regulations in December 2019. The final regulations clarify the requirements for qualifying investments and the deferral of gain.

KEY TERMINOLOGY

It makes sense to begin with a discussion of some key definitions before exploring the tax implications.

Qualified opportunity zone

As mentioned in the introduction, a QOZ is an area or community that the Treasury Department has certified as economically distressed. The area can be urban, suburban, or rural. Each state or territory nominates its own low-income communities to the Treasury Department for designation. Although most QOZ communities are characterized as "low-income," the Act allows for population census tracts that are not necessarily low-income to be designated as QOZs under certain circumstances. The Treasury Department maintains a list of certified zones that are eligible for investors to receive preferential tax treatment under Section 1400Z-2.[4]

Qualified opportunity fund

A qualified opportunity fund (QOF) is the investment vehicle created to invest in property located in a QOZ. A QOF's investments may include stock or partnership interests in a QOZ business or a direct investment QOZ business property. As with many federal incentives, a QOF must satisfy a daisy chain of requirements in order for investors to avail themselves of tax deferral or minimization. For example, a QOF is required to hold at least 90% of its assets in QOZ property. When talking about QOZ tax benefits, it is important to distinguish the zone (i.e., the QOZ), which is the geographic area where the investment is located, from the fund (i.e., the QOF), which the investment vehicle through which an investor may qualify for tax benefits.

QOZ business

A QOZ business is a trade or business in which at least 70% of its tangible property is QOZ business property. It must generate at least 50% of its total gross income from the active conduct of a trade or business in a QOZ, and it must use a substantial part of its intangible property in the active conduct of that trade or business. In addition, nonqualified financial property must account for less than 5% of the average of the total unadjusted basis of its property. Certain businesses do not qualify as QOZ businesses. They are golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks and other facilities used for gambling, and any stores the principal business of which is the sale of alcoholic beverages for consumption off premises.

QOZ property

QOZ property is any QOZ stock, QOZ partnership interest, or QOZ business property.

QOZ stock

QOZ stock is any stock in a domestic corporation that a QOF acquires from the corporation after 2017 in exchange for cash. The corporation must be a QOZ business when the QOF acquires the stock (or, if it is a new corporation, it must be organized to qualify as a QOZ business).[5] The corporation must qualify as a QOZ business for at least 90% of the time that the QOF holds the stock.

QOZ partnership interest

A QOZ partnership interest is any capital or profits interest in a domestic partnership that a QOF acquires from the partnership after 2017 in

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have their own rules and regulations that may affect rolling over capital gains into a QOF.

[4] The Treasury approved and designated a complete list of census tracts that are designated by the Secretary of the Treasury as QOZs in IRS Bulletin No. 2018-28, released on July 9, 2018.

[5] The corporation must continue to be a QOZ business during substantially all of the period the QOF holds the stock.

exchange for cash. The partnership must be a QOZ business when the QOF acquires the partnership interest (or, if it is a new partnership, it must be organized to qualify as a QOZ business).[6] The partnership must qualify as a QOZ business for at least 90% of the time that the QOF holds the partnership interest.

QOZ business property

QOZ business property is tangible property that a QOF or QOZ business acquires by purchase or lease after 2017 and uses in a trade or business.[7] In the case of purchased tangible property, the QOF or QOZ business generally must be the first person to use the property in the QOZ (satisfying what is known as the original use requirement), or it must substantially improve the property (satisfying what is known as the substantial improvement requirement). Unimproved land potentially can qualify as QOZ business property without meeting the original use requirement or the substantial improvement requirement, so long as it is used in a trade or business. Land banking (i.e., holding land for speculative investment), on the other hand, is prohibited as contrary to the essence of the QOZ legislation. The original use requirement and the substantial improvement do not apply to leased tangible personal property.

WAYS TO INVEST IN A QOF

Any investor who recognizes capital gain for federal income tax purposes is eligible to defer gain using QOZ tax benefits. The investor may be an individual or a corporation, partnership, or other type of entity.

Generally, there are three ways to invest in a QOZ: (1) creating a QOF using the investor's funds or possibly pooling resources from other investors; (2) investing with third-party asset managers (e.g., private investment that raises capital to be deployed); and (3) investing in local and regional economic development funds (e.g., community hospitals investing in patient base). An investor should consult with the investor's financial advisors, attorneys, and other tax professionals before forming or investing in a QOF.[8]

To create or to become a QOF, an investor may self-certify the fund. Self-certification involves annually filing Form 8996. The Internal Revenue Service does not approve self-certified QOFs, and each self-certified QOF should maintain adequate records to evidence compliance with all qualification and reporting requirements, which may include records of community impact data.

One view is that QOFs that invest in only a single property, known as "single asset funds," will be more straightforward to administer due to the simplicity of tracking a single asset. Many QOFs, however, are created to invest in a diversified portfolio of multiple properties, known as "multi-asset funds," and may require multiple contributions to acquire and develop various properties.

When forming a QOF, an investor should consult with an attorney to determine the specific language in the QOF's governing document (such as the bylaws or limited partnership agreement), so that it will qualify as a QOF. Investors who are interested in the gain deferral opportunities offered by the QOZ incentives but do not wish to establish their own QOFs may instead consider investing in a QOF offered by a financial institution or other third-party asset manager.

INCOME TAX IMPLICATIONS

An investor can take advantage of a QOF investment by taking proceeds from a sale or exchange that would otherwise be subject to capital gains tax and investing them in a QOF. This generally includes any short-term and long-term capital gains. It includes Section 1231 gains, which are gains from the sale of depreciable or real property that is used in a trade or business and has been held for more than one year.

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[6] The partnership must continue to be a QOZ business during substantially all of the period the QOF holds the partnership interests.

[7] Substantially all of the use of the QOZ business property must be in a QOZ during substantially all of the period the QOF or QOZ business holds the property.

[8] Investing involves risks, including the potential of losing money or the decline in value of the investment. Performance is not guaranteed.

Under Section 1400Z-2, an investor must roll the capital gains into a QOF within 180 days from the date of the sale or exchange of the capital gain property.[9] A partnership has 180 days from the date of sale to invest the capital gain in a QOF, so that the tax deferral and other benefits apply to its partners. If the partnership does not invest within 180 days, then each partner may choose to invest in a QOF within 180 days of the end of the partnership's taxable year (not the actual date of the sale of the capital asset), so the partners may have a second bite at the apple to plan.

The tax on the gain from the sale of the capital gain property is not due in the year that the sale is completed if the gain is rolled over into a QOF and the investor elects the QOZ tax benefits on the investor's federal income tax return. Once the investor contributes the capital gain to a QOF, the investor's income tax basis in the QOF investment is zero.[10] An investor can transfer property other than cash as an investment to a QOF. However, a transfer of non-cash property may result in only part of the investment being eligible for QOZ tax benefits, so that not all of the investor's capital gain is able to be deferred.

Stepped-up basis after five-year holding period

If an investor invested the capital gain into a QOF before December 31, 2021, and holds the QOF interest for five years, then the investor's basis will receive an additional 10% step-up in basis.

Stepped-up basis after seven-year holding period

If an investor invested the capital gain into a QOF before December 31, 2019, and holds the QOF interest for seven years, then the investor's basis will receive an additional 5% step-up in basis. Thus, the investor will potentially enjoy a 15% basis step-up on any pre-2020 investment in a QOF.

Tax deferral

The tax on the earnings from the sale of the capital gains property is not due in the year that the sale is completed if it is rolled over into a QOF. The deferral of recognition of capital gains tax continues until the earlier of:

- The date that the QOF investment is sold or exchanged; or
- December 31, 2026.

As a result, the tax is not eliminated or deferred indefinitely—capital gains tax is paid in the first to occur of the tax year of the sale or disposition of the QOF investment and the 2026 tax year.

Upon its recognition, the gain has the same attributes as it would have had if it hadn't been deferred.[11] If, for example, an investor had invested short-term capital gains in a QOF, then the gain would be treated as short-term capital gain upon its recognition.[12] The tax rate on the deferred gain will be the tax rate in effect at the time the tax is owed (e.g., capital gains and net investment tax rates in effect in 2026). At the time the tax is owed, however, the basis in the investment is increased to include the amount of gain recognized on the income tax return.

If an investor holds the investment in the QOF such that tax is due for tax year 2026, the investor must plan to have enough liquidity to actually pay the capital gains tax at that time. It may make sense to use other outside assets to pay the tax as early distributions from a QOF will trigger income tax to the extent the distribution exceeds basis.

Tax-free appreciation

If an investor holds a QOF investment for at least 10 years, the investor generally can exclude from income any gains from the sale of the QOF investment and any gains from the sale of assets by the QOF or a lower-tier partnership or S corporation that is a QOZ business. The investors generally recognizes losses associated with a QOF investment in accordance with current law. The investor may elect this basis step-up until December 31, 2047, so long as the investor sells or disposes of the QOF investment on or before that date.

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[9] IRC § 1400Z-2(a)(1)(A).
[10] IRC § 1400Z-2(b)(2)(A).
[11] Treas. Reg. § 1.1400Z2(a)-1(c)(1)(i).
[12] Treas. Reg. § 1.1400Z2(a)-1(c)(4)(i).

Holding period / tax due	Potential result
After five years	10% increase in basis in investment (original basis is zero).
After seven years	An additional 5% increase in basis in investment (15% total basis increase), but only if the investment was made on or before December 31, 2019.
Earlier of (i) sale or exchange of investment or (ii) December 31, 2026	Recognize capital gain on 2026 federal income tax return on the difference between the amount of the deferred capital gains and adjusted basis (either $0, 10%, or 15%). After payment of capital gains tax, new basis in investment is increased to include recognized gain.
After 10 years	Post-acquisition appreciation excluded from income. New basis is fair market value on the date of sale or exchange until December 31, 2047.

If an investor disposes of less than all of the investor's QOF investment, the investments that are disposed of are identified using the first-in, first-out method.

EXAMPLE[13]

Let's review a hypothetical example that further explains how tax deferral under Section 1400Z-2 operates.

Assumptions

On January 1, 2019, Avery, who is an unmarried individual, sold shares of a privately held company to an unrelated private equity firm for $10 million. Avery's basis in those shares was $1 million. At the time of the sale, Avery had a realized capital gain of $9 million, which would have resulted in $2.142 million of capital gains tax at the 23.8% rate.

Avery creates a corporation called FundCo, which qualified as a QOF. On February 1, 2019 (within 180 days of January 1, 2019), Avery contributed the $9 million of gain to FundCo in exchange for shares. FundCo purchased an affordable housing complex (which qualified as QOZ business property) in a QOZ.

On a timely filed income tax return for tax year 2019, Avery elected to defer the capital gain tax until the earlier of the sale of their interest in the FundCo or December 31, 2026. Avery's initial basis in the interest in FundCo is zero.

Avery's tax consequences

Five-year holding period

If Avery holds the interest in FundCo until February 1, 2024 (five years), then Avery's basis in the FundCo shares will increase to 10% of the amount of the deferred gain, so Avery's new basis in the investment will be $900,000.

Seven-year holding period

If Avery holds the interest in FundCo until February 1, 2026 (seven years), then Avery's basis in the FundCo shares will increase by an additional 5% of the deferred gain, so Avery's new basis in the investment will be $1.35 million.

[13] The hypothetical example is provided as an illustration only and may not be representative of the experience of other clients. There is no guarantee of the future success of any of the strategies discussed. This example assumes that Avery does not qualify for an exception to the additional 3.8% net investment income tax, so the total capital gains tax rate applied in this scenario is 23.8%. Any prospective investor should consult with an attorney or accountant to determine whether the investor would be subject to the additional net investment income tax upon the sale or exchange of a capital asset.

Payment of tax on 2026 income tax return

As described above, because the payment of the capital gains tax has to be paid no later than December 31, 2026, Avery still has to pay capital gains tax in that tax year even if Avery holds the investment for a longer period. On the 2026 federal income tax return, Avery would report a $9 million capital gain but that gain is offset by their new basis in their interest in FundCo of $1.35 million. Avery's capital gains tax due is roughly $1.82 million, and Avery's basis in FundCo is increased by the recognized capital gains. After the payment of tax, Avery's new basis in the interest in FundCo is $9 million. (Of course, in 2026, the capital gains tax rate could differ from the tax rate in 2019.)

Ten-year holding period

If, after paying the tax, Avery holds the investment until February 1, 2029 (10 years), then Avery's basis in the interest in FundCo is stepped-up to its fair market value on the date that it is sold or exchanged, so Avery would not recognize any post-acquisition capital gains on the investment—so the appreciation in the interest in FundCo grows tax free. If Avery holds the interest for 10 years and sells it on March 1, 2029, for $20 million, Avery's basis is $20 million on the date of sale, and no additional tax would be due. If Avery decides not to sell the interest in FundCo immediately after holding the interest for 10 years, then Avery has until December 31, 2047, to sell or exit the investment to step-up her income tax basis to fair market value.

Selling the interest before the five-, seven-, or 10-year holding period

What if Avery sells the interest in FundCo before holding it for five, seven, or 10 years? If Avery sells the interest in FundCo before holding it for five years, Avery will pay the entire deferred gain and tax on any of the appreciation on the interest in FundCo. If Avery sells her interest in FundCo after five years but before seven years, Avery recognizes only 90% of the original gain. If Avery sells the interest in FundCo after seven years, Avery recognizes only 85% of the original capital gain. If Avery holds the property so that Avery must pay the tax on her 2026 tax return, Avery's basis is increased by the amount of capital gain recognized.

ESTATE PLANNING TREATMENT AND OPPORTUNITIES

Planning with an asset subject to holding periods often requires thorough review and attention. When planning with a QOF investment, certain transfers (such as gifts) made by an investor are inclusion events that require some or all of the investor's previously deferred gain to be immediately subject to income tax. An inclusion event either (1) reduces the investor's QOF investment or (2) results in the investor receiving property from the QOF as a distribution for federal income tax purposes. These inclusion events are narrowly defined.

Gifts during life

If an investor gives a QOF investment to a non-charitable *or* charitable donee before the tax deferral period ends, the deferral period terminates at the time of the gift. This inclusion event triggers income tax, so it is not advantageous from a tax standpoint to make gifts of a QOF investment in this manner. The investor must then include the deferred gain when filing the investor's income tax return, reporting the gain on Form 8949. There is an exception, though, if the investor transfers a QOF investment to a grantor trust that is owned by the investor, as discussed below.

Transfer on death

Upon the investor's death, the deceased investor's QOF investment transfers to the investor's beneficiaries with the tax incentives and holding period intact. This is not considered as an inclusion event. Transfers on death may occur through the investor's will or revocable trust, through a state's intestacy statute, or to a joint owner of an account such as an account held as joint tenants with rights of survivorship. However, the gain required to be recognized on the initial investment in the QOF will be treated as income with respect to the decedent (IRD) under Section 691 and will not be eligible for a stepped-up income tax basis on death. The long-term benefit of non-recognition of gain on investments held longer than 10 years still applies; the IRD applies only to the original deferred gain. IRD may affect other estate planning.

Grantor trusts

As stated above, grantor trusts are eligible to invest in QOFs, and transfers by gift to grantor trusts are not considered inclusion events for tax purposes. When an investor gives a QOF investment to a grantor trust, the investor's holding period will be tacked to the grantor trust. A grantor trust is a trust in which the creator of the trust retains certain powers over the trust so that they are the owner for income tax purposes. This differs from a nongrantor trust where the trust pays its own income tax liability. In short, the investor would be the grantor of the trust and be personally responsible for the payment of any the trust's income tax liability.

Investors may create a variety of different types of grantor trusts to hold QOF investment. Some examples are trusts where they are the beneficiary such as revocable trusts, trusts that pay the grantor an annuity stream during the initial term such as grantor retained annuity trusts (GRATs) or trusts simply for the benefit of other third-party loved ones such as dynasty trusts or spousal lifetime access trusts (SLATs). It also may make sense to have any continuing trust (such as follow-on trusts for GRATs) also be taxed as grantor trusts so that the trust may continue to hold a QOF investment without triggering gain. It is possible to transfer QOF investment to a charitable lead trust for clients who are charitably inclined yet are prevented from making a direct transfer to a charity without triggering an inclusion event for tax purposes.

If a grantor trust that holds a QOF investment ceases to be classified as a grantor trust (other than on account of the grantor's death), the trust will recognize the deferred gain. For example, some grantor trusts permit the grantor to turn off grantor trust status by giving up some or all powers over the trust. This would result in the recognition of the deferred gain because the trust itself would then own the QOF investment on behalf of the beneficiaries. If the grantor dies, however, then the transfer of the QOF investment held in the grantor trust may pass to the trust's beneficiaries without triggering recognition of the deferred gain.

Marital trust and credit shelter trust planning

In a typical transfer tax-efficient estate plan, on a spouse's death, the deceased spouse's assets are divided into a marital trust (which qualifies for the marital deduction) and a credit shelter trust (which typically holds the decedent's unused estate and generation-skipping transfer tax exemption amount). On the death of the second spouse, the trust assets will pass to trusts for the couple's descendants. The deceased spouse's QOF investment may pass to the surviving spouse to be held in these trusts without triggering tax. The regulations, however, fail to address expressly whether the subsequent distribution to a trust for the couple's descendants is an inclusion event that triggers tax.

OTHER FUND REQUIREMENTS

Like many income tax minimization strategies provided under the Internal Revenue Code, an investor must comply with several stringent requirements to qualify for the capital gains deferral and potential tax-free appreciation that Section 1400Z-2 may offer.

90% test

A QOF is required to hold at least 90% of its assets in QOZ property, with such threshold to be measured every six months. If the QOF does not meet the 90% requirement, it must pay a penalty for each month it fails to do so.[14] QOFs may exclude new cash received from investors in the preceding six months though it must be held in cash, cash equivalents, or debt instruments with terms of 18 months or less. Additionally, proceeds from the sale of qualifying assets will be treated as QOZ property so long as those proceeds are reinvested within 12 months from the date of sale and, pending reinvestment, are held in cash, cash equivalents, or debt

[14] The penalty is calculated on a monthly basis and is equal to the excess of (1) the amount equal to 90% of the aggregate assets over (2) the aggregate amount of QOZ property held by the QOF multiplied by the Section 6621(A)(2) underpayment rate. This will be taken from each partner's proportionate distributive share if a partnership. Finally, there is a reasonable cause exception that may be available. IRC § 1400Z-2(f)(3).

instruments with terms of 18 months or less. In a situation like this, an investor should determine whether a sale or other disposition could result in taxable gain to the taxpayer.

Original use requirement

The original use of QOZ business property must begin with the creation of the QOF, or the QOF must substantially improve the property (described below). Previously depreciated or amortized tangible property does not satisfy the original use requirement, though previously used property may satisfy the requirement so long as that property has not be used in a QOZ in a way that would have led to the property being depreciated or amortized by the then-owner. Vacant real property will satisfy the original use requirement if it has been vacant for at least one year before its purchase by a QOF or QOZ business and the vacancy began before the area was designated as a QOZ. Vacant real property also will satisfy the original use requirement if it has been vacant for at least five years before its purchase by a QOF or QOZ business and the vacancy began after the area was designated as a QOZ.

Substantially improvement requirement

Section 1400Z-2(d) provides that the property will only be treated as substantially improved by a QOF if during the 30-month period, which begins after the date of acquisition, the additions to the income tax basis of the property in the QOF exceed the adjusted basis of the property at the beginning of that 30-month period. Substantial improvements to real estate, such as a building, will be measured by the QOF's additions solely to the adjusted basis of the building. It does not require separate additions to the land upon which the building is located.

Safe harbor

The regulations contain a working capital safe harbor, which permits a QOZ business to hold a reasonable amount of working capital (cash, cash equivalents, or debt instruments with terms of less than 18 months) for 31 months, so long as the business has a written financial plan that relates to the qualified usage, has a schedule for deploying the capital within 31 months, and complies with that schedule.

Existing entities

There is no prohibition to using an entity already in existence as a QOF, so long as all of the other requirements of the QOF rules are met, including the rule that the QOZ property was acquired after December 31, 2017.

Debt financing

A QOF can generally borrow money to purchase or develop property without jeopardizing QOZ tax benefits.

STATE INCOME TAX

Certain states levy their own separate state income tax and may have their own rules and regulations that may affect rolling over capital gains into a QOF. Therefore, a state's congruity with Section 1400Z-2 is yet another factor to consider. Investors in states that follow the federal QOZ tax incentives may receive state tax incentives similar to those available at the federal level. On the other hand, investors in states that do not conform may be unable to defer and reduce state taxation on the initial gains invested in a QOF. They may also be required to recognize gain for state tax purposes on the ultimate sale of the QOF investment.

OVERALL FINANCIAL PLAN

As noted, this whitepaper focuses solely on the known mechanics and federal tax implications of investing in a QOF. Though investing in a QOF may potentially solve a capital gains tax issue for an investor, any new investment must be carefully considered, taking the investor's entire financial plan into account.

For example, an investment in a QOF most likely will be an illiquid investment for quite some time and may change the dynamic of the investor's overall portfolio by increasing the illiquid allocation. To maximize the benefits of Section 1400Z-2, the capital must be committed for several years, yet the investor must have the liquidity to pay the deferred tax when the investor sells or disposes of the QOZ investment or December 31, 2026, whichever occurs first. Therefore, it is imperative that an investor speak with the investor's advisor and carefully consider

all issues and concerns so that these types of investments can be reviewed for suitability and properly planned for.

OTHER CONSIDERATIONS

There are several other considerations to be aware of when contemplating an investment in a QOF. Here are a few key considerations that a potential investor should consider:

- There is no limit on the amount of investments in any one or more QOFs.
- To defer gain there is no requirement to invest in like-kind property.
- In order to qualify for QOZ tax deferral, the taxable gains cannot result from a sale to a related party, which includes any of the investor's siblings, spouse, ancestors, lineal descendants, and related trusts or business entities.
- As with other investments, there can be a loss of value with any QOF (or a QOF's property or business), and the value of the QOF may fluctuate over the holding period.

CONCLUSION

For some investors, an investment in a QOF may offer attractive tax benefits. This type of investment, however, is not without complexity and uncertainty. Investors should carefully evaluate the risks and implications of investing in these types of funds. They should also be mindful that future legislation could modify or eliminate the tax benefits associated with investments in QOFs.

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