IRS Issues Highly-Anticipated Guidance on Qualified Opportunity Zones

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Significant tax incentives for investments by “qualified opportunity funds” in low-income communities designated as “qualified opportunity zones” were signed into law as part of the December 2017 legislation commonly known as the Tax Cuts and Jobs Act. Many investors have been hesitant to take advantage of the new program due to numerous technical issues and ambiguities presented by the legislative language. On October 19, 2018, the IRS issued the first significant wave of guidance regarding the structure and operation of qualified opportunity funds and the manner in which available tax benefits may be obtained. The guidance consists principally of proposed regulations (“**Proposed Regulations**”), Revenue Ruling 2018-29 and a draft of new IRS Form 8996 (with instructions). While the guidance still leaves several questions unanswered, it addresses many of the open issues presented by the original legislative language and may provide sufficient comfort to enable investors, developers and fund sponsors to move forward.

Overview

Qualified Opportunity Zones. Generally speaking, a qualified opportunity zone (“**QOZ**”) is a population census tract meeting certain low-income criteria that has been certified by the U.S. Treasury Department based on nominations by all 50 states, the District of Columbia and five U.S. territories. Earlier this year, the Treasury certified over 8,700 qualified opportunity zones for purposes of the new program.

Qualified Opportunity Funds. A qualified opportunity fund (“**Fund**”) is an investment vehicle organized as a partnership or corporation for purposes of investing in “qualified opportunity zone property” (“**QOZ Property**”) located in a QOZ and meeting certain business-related criteria addressed below. At least 90% of the Fund’s assets must consist of QOZ Property, generally based on the average of the applicable asset percentages on a semi-annual basis.

Manner of Obtaining QOZ Tax Benefits. Federal income tax benefits for an investment in a Fund are available on an elective basis only to an investor who (i) recognizes capital gain from the sale or exchange of property before the end of 2026 and (ii) reinvests cash *up to the amount of such gain* into a Fund within 180 days after the gain is recognized. The property that is sold is not required to bear any relationship to a QOZ – it could be real estate, art, publicly-traded stock, or virtually any other asset subject to capital gain treatment. Whether or not state income tax benefits are available will be determined on a state-by-state basis. It must be emphasized that the tax benefits of the QOZ program are not available to an investor who simply invests cash in a Fund; rather, the investor must first have a capital gain which, in effect, is “rolled over” into the Fund, with the Fund then acquiring the requisite QOZ Property and satisfying all other operational requirements of the statute. Moreover, an investor is not permitted to bypass the Fund and invest directly in the underlying QOZ Property; rather, the investor must first invest in a Fund (by rolling over capital gain as described above), and the Fund must then acquire the requisite QOZ Property and satisfy all other operational requirements.

Nature of QOZ Tax Benefits. The tax benefits of an investment in a Fund fall into three broad categories that may be described in general terms as follows:

- The capital gain that is “rolled over” into the Fund within the 180-day reinvestment period is deferred until 12/31/2026 (or, if earlier, the date on which the investment is sold or exchanged).
- The investor’s tax basis in the Fund (initially deemed to be zero) is eligible for a “step-up” that has the potential of permanently eliminating (i) 10% of the deferred gain if the investment in the Fund is held for five years, and (ii) an additional 5% of the deferred gain (for a cumulative amount of 15%) if the investment in the Fund is held for seven years, provided that these holding periods are met by 12/31/2026. As a result, taxpayers will be incentivized to invest in Funds by the end of 2019 so that they can meet the required holding periods by the end of 2026.
- Most significantly, for investments in the Fund held for at least 10 years, the basis of the investor’s interest in the Fund is “stepped up” to its fair market value when the investment is sold or exchanged, having the practical effect of excluding 100% of the capital gain attributable to any appreciation in value of the investment in the Fund. This 10-year capital gain benefit is separate and apart from the capital gain that is deferred at the time of the original rollover.

Qualified Opportunity Zone Property. For purposes of the 90/10 test applicable to a Fund, three categories of QOZ Property may be owned by the Fund: (i) “qualified opportunity zone business property” (“**QOZ Business Property**”), (ii) “qualified opportunity zone stock” (“**QOZ Stock**”) in a corporation that qualifies as a “qualified opportunity zone business” (“**QOZ Business**”), and (iii) a “qualified opportunity zone partnership interest” (“**QOZ Partnership Interest**”) in a partnership that qualifies as a QOZ Business. A key structural consideration for any Fund is that the Fund may own QOZ Business Property either directly in its own right, or indirectly through the ownership of QOZ Stock or QOZ Partnership Interests in lower-tier entities that meet the tests for a QOZ Business. Somewhat surprisingly, the QOZ Business requirements applicable to QOZ Stock and QOZ Partnership Interests do not apply to the direct ownership of QOZ Business Property by a Fund, and there are other significant differences between the direct and indirect deal structures that reinforce the need for careful advance planning.

Qualified Opportunity Zone Business Property. QOZ Business Property is tangible property used in a trade or business within a QOZ if (i) the property is acquired by the Fund after 12/31/2017 by “purchase” from an unrelated party, (ii) substantially all of the Fund’s use of the property is within a QOZ for substantially all of the Fund’s holding period for the property, and (iii) either (A) the original use of the property in the QOZ must commence with the Fund or (B) the Fund must “substantially improve” the property (defined generally as incurring capital expenditures with respect to the property in an amount at least equal to the tax basis of the property at the beginning of any 30-month period after the Fund’s acquisition of the property; i.e., effectively doubling the basis of the property within a 30-month period).

Qualified Opportunity Zone Stock; Qualified Opportunity Zone Partnership Interests. QOZ Stock and QOZ Partnership Interests are equity interests acquired by a Fund from a domestic corporation or domestic partnership for cash after 12/31/2017 (i.e., not by purchase from another stockholder or partner), provided that (i) the entity is a QOZ Businessat the time the equity interest is issued to the Fund (or, in the case of a new entity, is being organized for the purpose of becoming a QOZ Business), and (ii) the entity must qualify as a QOZ Business during "substantially all" of the Fund's holding period in the entity.

Qualified Opportunity Zone Business. In order to qualify as a QOZ Business, the underlying entity in which the Fund owns QOZ Stock or a QOZ Partnership Interest (such entity, a "**Lower-Tier Entity**") must meet the following requirements: (i) "substantially all" of the tangible property owned or leased by the Lower-Tier Entity must be QOZ Business Property; (ii) at least 50% of the Lower-Tier Entity's gross income must be from the active conduct of a trade or business within a QOZ; (iii) no more than 5% of the Lower-Tier Entity's property (measured by cost basis) may consist of specified financial assets, subject to an exception for reasonable working capital reserves; (iv) certain "sin" businesses are not permitted; and (v) a substantial portion of any intangible property owned by the Lower-Tier Entity must be used in the active conduct of a trade or business within a QOZ.

Effect of Proposed Regulations: QOZ Tax Benefits

The Proposed Regulations provide several helpful clarifications regarding the nature of QOZ tax benefits and the manner in which such benefits may be obtained, including the following:

Only Capital Gain Eligible for Rollover. Under a literal interpretation of the statute, it was at least arguable that QOZ tax benefits might have been available for investor rollovers of certain categories of ordinary income (such as depreciation recapture). The Proposed Regulations forestall any such argument, taking the position that only capital gain (whether short-term or long-term) may be rolled over by a taxpayer as an investment into a Fund.

Only Equity Interests Eligible for QOZ Tax Benefits. The statute provides that QOZ tax benefits are available for gains "invested" by a taxpayer in a Fund, without defining the word "invested". The Proposed Regulations provide that only "equity interests" in Funds are eligible for QOZ tax benefits, thereby forestalling any possible argument that QOZ tax benefits might be available for a taxpayer's loan to a Fund (such as convertible debt that might have some opportunity for participating in upside appreciation). The Proposed Regulations also make it clear that the term "equity interest" is broad enough to include preferred stock (for a Fund that is treated as a corporation) and a partnership interest with special allocations such as a preferred equity interest (for a Fund that is treated as a partnership).

Rollover for Gain Recognized by Flow-Through Entity. Mechanically, it is not clear under the statute whether capital gain recognized by a partnership can be rolled over into a Fund by the partnership or its partners or both. The Proposed Regulations provide helpful guidance on this point, by giving the partnership the "first bite" at rolling over capital gain into a Fund. To the extent that the partnership chooses to make such a rollover, the deferred gain will ultimately be recognized at the partnership level (subject to the potential 15% reduction amount) and flowed through to those persons who are partners *at the time of recognition* (meaning that anyone who purchases a partnership interest after the partnership has made a rollover into a Fund must take into account, as a matter of due diligence, the possibility that she may be stepping into the shoes of a selling partner's share of deferred gain). To the extent that a partnership's capital gain is not rolled over into a Fund at the partnership level, each partner then gets a "second bite" to roll over her allocable share of such gain into a Fund. For purposes of determining the 180-day reinvestment period at the partner level, the Proposed Regulations provide added flexibility by allowing each partner to choose to start the 180-day clock running either (i) on the last day of the partnership's taxable year in which the gain is triggered, or (ii) on the same day applicable in determining the partnership's 180-day period. The Proposed Regulations also provide that analogous rules will apply to other types of flow-through entities (such as S corporations).

Rollover of Single Gain into Multiple Funds. If a taxpayer elects rollover treatment for only a portion of the capital gain recognized upon the sale of a single property, the statute could have been read for the proposition that the balance of such capital gain would not be eligible for rollover into other Funds. The Proposed Regulations take a pro-taxpayer approach to this situation, making it clear that it is permissible for an investor's capital gain from a single property to be rolled over into multiple Funds.

Effect of Partnership Liabilities (for Fund Classified as Partnership). It is expected that many Funds will be treated as partnerships (rather than as corporations) for tax purposes. The Proposed Regulations provide that an investor's share of Fund liabilities will not be treated as a deemed contribution to the Fund for purposes of the QOZ rules (even though such liability share is treated as a deemed contribution under regular partnership tax rules). This pro-taxpayer clarification eliminates the concern expressed by some commentators that partnership-level leverage might have had the effect of reducing the portion of post-10-year appreciation eligible for the elective step-up in basis.

Preservation of Tax Attributes Upon Recognition of Deferred Gain. There are several categories of capital gain potentially eligible for deferral upon rollover into a Fund, such as (i) long-term capital gain subject to preferential rates, (ii) short-term capital gain taxed at ordinary income rates, (iii) collectibles gain subject to a special 28% rate and (iv) unrecaptured section 1250 gain subject to a special 25% rate. The Proposed Regulations make it clear that, upon ultimate recognition of the deferred gain, the gain so recognized retains the same attributes that would have applied if there had been no deferral.

“Recycling” of Deferred Gain Permitted Upon Pre-12/31/2026 Disposition of Investment. As noted earlier, the gain deferred upon rollover into a Fund is ultimately recognized (subject to possible reduction for the 10% and 5% basis adjustments) on 12/31/2026 or, if earlier, upon a sale or exchange of the investment in the Fund. The Proposed Regulations provide additional flexibility to those investors who dispose of their entire investment in the Fund before 12/31/2026 by allowing the gain recognized on such premature disposition to be rolled over into another Fund (or even into the same Fund) during the requisite 180-day period. However, it is not clear if this “second bite” at rollover treatment also applies to gain recognized by the Fund (whether directly at the Fund level or indirectly through a lower-tier partnership in which the Fund owns a partnership interest).

Disposition of Less Than All of Investor's Investment in Fund if Interests Acquired on Different Days. If an investor has acquired equity interests in a Fund having identical rights on different dates, the tax consequences of a subsequent sale of less than 100% of the investor's interest may vary depending upon which portion of the interest is deemed to be sold (for example, for purposes of determining whether the portion sold has achieved a basis step-up by reason of a five-year or seven-year holding period). The Proposed Regulations contain mechanical conventions designed to address this situation (generally through the application of a FIFO rule).

10-Year Capital Gain Rule Available Through 12/31/2047. Under the statute, all designations of QOZs automatically expire as of 12/31/2028. This provision created much uncertainty as to whether the expiration of the QOZ designation might deprive an investor of the ability to avoid capital gains tax upon a qualifying exit event after a 10-year holding period (through the statutory elective step-up in basis), if the investor's 10-year holding period was not satisfied until after 12/31/2028. The Proposed Regulations have resolved this issue in a pragmatic pro-taxpayer manner, by providing that the ability to utilize the 10-year basis step-up election is not impaired merely because QOZ designation has expired, provided that the disposition of the investment occurs no later than 12/31/2047.

Effect of Proposed Regulations: Structure and Operation of Funds

The October 19th IRS guidance also contains several significant provisions regarding the organization and operation of Funds, including the following:

Funds Organized as LLCs. Under the statute, a Fund must be "organized" as a partnership or corporation, which created uncertainty as to whether an LLC classified as a partnership for tax purposes would be eligible to be a Fund even though it is not "organized" under applicable state law as a partnership. The Proposed Regulations eliminate any uncertainty on this issue, by making it clear, in effect, that an entity organized as an LLC under state law will be eligible to be a Fund (assuming it meets the other definitional requirements for a Fund), regardless of whether the LLC (i) is classified as a partnership for tax purposes or (ii) files a "check-the-box" election to be classified as a corporation.

Self-Certification. The statute gives the Treasury authority to prescribe rules for the certification of Funds. Consistent with FAQs that had already appeared on the IRS website, the Proposed Regulations confirm that a Fund will not need to submit an application to the Treasury for advance certification. Instead, Funds will be required to self-certify their compliance with the various Fund requirements by filing new Form 8996 with their federal income tax returns on an annual basis.

Existing Entities Can Qualify as Funds. Under the Proposed Regulations, an entity can qualify as a Fund even though it was formed before the enactment of the QOZ legislation in 2017. However, assets acquired before 1/1/2018 do not qualify as QOZ Property for purposes of the 90/10 test, so owners of existing entities must proceed with caution before using those entities as Funds.

Asset Values Used in Applying 90/10 Test. The statute is silent as to whether the requirement for 90% of a Fund's assets to consist of QOZ Property is based on fair market value, adjusted tax basis, GAAP or some other metric. The Proposed Regulations resolve this issue in a bifurcated manner: If the Fund has "applicable financial statements" (consisting generally of financial statements filed with the SEC or certain other federal agencies, as well as audited financial statements prepared in accordance with GAAP), the asset values reported on those financial statements are used in applying the 90/10 test. Otherwise, the 90/10 test is applied based on the original cost of the Fund's assets.

Application of 90/10 Test in First Taxable Year. The Proposed Regulations provide much flexibility in applying the 90/10 test during an eligible entity's first taxable year as a Fund. First, an eligible entity is required to identify the initial taxable year in which it desires to be classified as a Fund. Second, the entity is then permitted to identify the first month in that initial taxable year in which it wants Fund status to commence (which would also be the beginning of the first six-month period for purposes of the 90/10 test). If an entity is treated as a Fund for fewer than 12 months during the taxable year in which it chooses to be treated as a Fund, the 90/10 test would be applied at the end of the first six-month period and on the last day of the taxable year (unless the entity becomes a Fund in the seventh or later month of a 12-month taxable year, in which case there would be only one measurement date in that taxable year). Although these conventions may enable Funds to optimize compliance with the 90/10 test, these compliance considerations must be coordinated with equity contributions by investors, bearing in mind that capital gain rollovers are eligible for QOZ tax benefits only if the recipient entity qualifies as a Fund at the time of the rollover investment.

Penalty for Noncompliance With 90/10 Test. Absent reasonable cause, noncompliance with the 90/10 test gives rise to a penalty that is calculated by first calculating the shortfall of asset value below the 90% threshold on a monthly basis, and then multiplying such shortfall by the interest rate on IRS underpayments. Based on a literal interpretation of the statute, the interest rate seems to be determined on an annualized basis, without dividing such annualized rate by 12 to arrive at a monthly equivalent, even though the penalty is calculated on a monthly basis. The draft of new Form 8996 released by the IRS concurrently with the

Proposed Regulations takes a more sensible, pro-taxpayer approach and requires the applicable interest rate to be determined on a monthly basis.

Effect of Proposed Regulations: QOZ Business and QOZ Business Property

The October 19th IRS guidance also provides very helpful provisions regarding certain aspects of (i) the QOZ Business requirement applicable to Lower-Tier Entities in which a Fund owns QOZ Stock or QOZ Partnership Interests, and (ii) the "original use" and "substantial improvement" tests applicable to QOZ Business Property (whether owned directly at the Fund level or indirectly through a Lower-Tier Entity), including the following:

70/30 Test for QOZ Business Property Owned by Lower-Tier Entity. As noted earlier, for purposes of determining whether equity interests owned by a Fund qualify as "QOZ Stock" or "QOZ Partnership Interests", the underlying Lower-Tier Entity must qualify as a "QOZ Business" which, among other requirements, requires "substantially all" of the tangible property owned or leased by the Lower-Tier Entity to consist of QOZ Business Property. The term "substantially all" is not defined in the statute. The Proposed Regulations provide clarity on this issue by requiring at least 70% of the tangible property owned or leased by the Lower-Tier Entity to consist of QOZ Business Property. This clarification highlights one of the key distinctions between a Fund's direct or indirect ownership of QOZ Business Property: Once the 70/30 test and the other requirements for a QOZ Business are met by a Lower-Tier Entity, the Fund's entire equity interest in that entity qualifies as QOZ Stock or a QOZ Partnership Interest, as the case may be, for purposes of applying the 90/10 test at the Fund level, even though the 90/10 test might not have been satisfied if the assets owned by the Lower-Tier Entity (to the extent of the Fund's share) had been owned directly by the Fund.

Valuation of Assets for Purposes of 70/30 Test. For purposes of valuing the tangible assets of a Lower-Tier Entity under the new 70/30 test, the Proposed Regulations adopt the same starting point used in applying the 90/10 test at the Fund level (i.e., by using the book values reflected in any "applicable financial statements"), except that if the Lower-Tier Entity itself does not have applicable financial statements, instead of using the original cost of its assets as would be the case under the 90/10 test at the Fund level, the Proposed Regulations require the Lower-Tier Entity to use a valuation methodology that essentially piggybacks the methodology used by the Fund(s) that own equity interests in such entity (with special rules for resolving differences in methodology if more than one Fund owns equity).

Reasonable Working Capital Safe Harbor. As previously noted, for purposes of applying the QOZ Business tests, liquid assets qualifying as "reasonable" working capital will not jeopardize the requirement that no more than 5% of a Lower-Tier Entity's property may be attributable to "nonqualified financial property". In response to concerns expressed by commentators regarding the lengthy period of time often required for the startup of a new business or the development of real estate, the Proposed Regulations adopt a safe harbor under which cash and other working capital assets held by the Lower-Tier Entity will be deemed "reasonable" for purposes of the 5% test. Under this safe harbor, working capital reserves are treated as "reasonable" if (i) the amounts are designated in writing for the acquisition, construction and/or substantial improvement of tangible property in a QOZ, (ii) there is a written schedule providing that the working capital assets must be spent within 31 months and (iii) the working capital assets are actually used in a manner that is substantially consistent with the foregoing written designations. It is not clear whether this safe harbor also applies for purposes of the 90/10 test at the Fund level.

Substantial Improvement of Real Estate. As noted earlier, in order for tangible property to qualify as QOZ Business Property, the property must satisfy an "original use" test or a "substantial improvement" test (in addition to meeting certain other requirements). The Proposed Regulations and Revenue Ruling 2018-29 provide pro-taxpayer guidance regarding the application of these tests where a Fund purchases an existing building on land located wholly within a QOZ. The guidance provides, in effect, that: (i) given the permanence of land, land can never have its original use in a QOZ; (ii) the determination of whether an existing building on land within a QOZ has been substantially improved (i.e., whether the Fund has doubled the tax basis of the property within a 30-month period) is measured by reference to the tax basis of the building, without regard to the tax basis of the land; and (iii) there is no separate requirement to substantially improve the land upon which the building is located. As a result of this guidance, purchasers of improved real estate in a QOZ will need to pay closer attention to the price allocation provisions in the applicable acquisition agreement. The guidance does not address how to apply the substantial improvement test when a Fund or Lower-Tier Entity constructs a new building on raw land.

Open Issues

The Treasury has already acknowledged that the October 19th guidance was not intended to address all aspects of the QOZ rules and that additional issues will be addressed in future regulations. Some of the open issues include the following:

Does 10-Year Capital Gain Rule Apply to Sale of Assets by Fund or Lower-Tier Entity? Under a literal interpretation of the statute, the elective step-up in basis (effectively a capital gain exclusion) for a sale after a 10-year holding period is limited to a disposition of an investor's "investment" in the Fund. It is not clear whether Treasury has the authority (or, even if it has the authority, if it will choose) to extend this significant tax benefit to a sale of assets owned by the Fund (whether directly by the Fund or indirectly through its ownership of a QOZ Partnership Interest). It remains to be seen how the marketplace will adjust if the 10-year capital gain benefit is limited to a disposition of an investment in the Fund; e.g., perhaps by creating incentives for sponsors to create single-asset Funds to facilitate an easier exit event after the 10-year holding period (to be balanced against the competing desire for greater diversification of risk offered by a multi-asset Fund).

Does Working Capital Safe Harbor Also Apply at Fund Level? Although the Proposed Regulations contain a safe harbor for reasonable working capital held by a Lower-Tier Entity, it is not clear whether this safe harbor also applies for purposes of the 90/10 test at the Fund level.

Ground Leases. It is not clear how construction or rehabilitation of buildings on ground-leased land should be treated under the various Fund and QOZ Property rules, particularly if the ground lease was entered into before 2018.

Active Conduct of Trade or Business. In order for a Lower-Tier Entity to qualify as a QOZ Business, at least 50% of the entity's gross income must be derived from the active conduct of a trade or business and a substantial portion of the entity's intangible property must be used in the active conduct of a trade or business (in each case, within a QOZ). The October 19th guidance does not define the term "active conduct of a trade or business", nor does it address the manner in which business activities would be apportioned within or without the QOZ.

Substantial Improvement of Raw Land. Although the October 19th guidance addresses the substantial improvement of an existing building when it is acquired along with the underlying land, no guidance has yet been provided regarding how to apply the substantial improvement test when a Fund or Lower-Tier Entity constructs a new building on raw land.

Other "Substantially All" Requirements. Although the October 19th guidance provides a 70/30 test for purposes of determining whether "substantially all" of the tangible property owned or leased by a Lower-Tier Entity constitutes QOZ Business Property, the Treasury has acknowledged that the 70% threshold was not intended to apply to other provisions of the statute that use the term "substantially all" (and has requested comments from interested parties on this subject).

Failure to Comply With 90/10 Test – Is Penalty the Sole Consequence? Although a Fund is subject to a penalty for flunking the 90/10 requirement (absent reasonable cause), it is not clear if such penalty will be the exclusive consequence of noncompliance. The Treasury has indicated that future regulations will address conduct that may lead to potential decertification of a Fund.

Is Recycling of Deferred Gain Permitted Upon Pre-12/31/2026 Disposition of Fund Assets? Although the Proposed Regulations permit an investor to "recycle" gain recognized upon disposition of her entire investment in the Fund before 12/31/2026 if the gain recognized on such premature disposition is rolled over into another Fund (or even into the same Fund), it is not clear if this "second bite" at rollover treatment also applies to gain recognized by the Fund (whether directly at the Fund level or indirectly through a lower-tier partnership in which the Fund owns a QOZ Partnership Interest).

Reinvestment of Return of Capital Proceeds. The statute directs the Treasury to issue regulations that would give a Fund a reasonable period of time to reinvest the return of capital from its investments in QOZ Property (presumably for purposes of avoiding noncompliance with the 90/10 test by reason of the Fund's temporary cash holdings). This reinvestment concept was not addressed in the October 19th guidance, although the Treasury has acknowledged that it will be addressed by future guidance.

Effective Date

The regulations will not be effective until they are published in final form in the Federal Register (which will probably not take place until mid-2019 or later). However, taxpayers are generally permitted to rely on the Proposed Regulations so long as they are applied in their entirety and in a consistent manner (although the precise reliance rules vary depending upon which provisions are being applied).

Summary

The Proposed Regulations and related guidance issued by the IRS on October 19th have provided much-needed clarification on many aspects of the QOZ rules. Although several questions still remain unanswered, the IRS has indicated that a second wave of Proposed Regulations is expected in the not-too-distant future. As a result, it may be feasible for investors, developers, fund sponsors and other affected parties to move forward with particular transactions. We would be happy to speak with you about the impact of the QOZ rules in your particular situation. Questions about this Alert or the QOZ rules generally can be directed to: Alan F. Kornstein, Curtis A. Johnson, Martin F. Dowd, and Jeffrey A. Petit.