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Recent Developments & Observations

Qualified Opportunity Zones: Some Answers; More Questions

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Introduction

Qualified Opportunity Zones ("O-Zones") currently are one of the most discussed, praised and uncertain areas of tax law. Thus, although we discussed O-Zones in our column published in the September/October edition of this JOURNAL, we believe they are worth revisiting. As a refresher, O-Zones are a new tax incentive created by P.L. 115-97 (commonly referred to as the "Tax Cuts and Jobs Act") that allows investors to reinvest capital gains from other sources in O-Zones through a "qualified opportunity fund" ("QOF") in exchange for deferred and, potentially, exempt tax treatment on historic and future capital gains. O-Zones provide three major tax incentives. The first is that they allow recognized capital gains to be deferred if invested into a QOF until the earlier of (1) the disposition of the QOF interest or (2) December 31, 2026, so long as such gains are invested within a 180-day investment period and the taxpayer makes a gain-deferral election.[1] The second benefit provides taxpayers with a step-up in tax basis equal to 10 percent of the deferred gain, if the investment in the QOF is maintained for five years, and an additional five percent step-up in tax basis, if the investment is maintained in the QOF for seven years.[2] Lastly, taxpayers who maintain their investment in the QOF for at least 10 years (the "10-Year Period") receive a basis step-up equal to the fair market value of the investment on the sale or exchange date.[3]

Since we last wrote about O-Zones, on October 19, 2018, Treasury and the IRS issued proposed regulations (the "Proposed Regulations") and other guidance.[4] The Proposed Regulations were recently amended by further proposed regulations (the "Revised Proposed Regulations").[5] The Proposed Regulations and Revised Proposed Regulations address some of the questions raised in our September–October column. However, many questions remain, specifically regarding how the O-Zone rules interact with Subchapter K of the Code. This column provides a summary of certain provisions of the Proposed Regulations, as revised by the Revised Proposed Regulations, and raises some of those unanswered questions.

This column does not summarize the Revised Proposed Regulations generally, which we may address in a future column.

Proposed Regulations—Investor Level Guidance

Eligible Gains and Investors

The Proposed Regulations confirm that only recognized capital gains are eligible gains for purposes of O-Zone tax benefits.[6] Ordinary income items, such as depreciation recapture or income due to Code Sec. 751, may not be deferred using O-Zones. So long as the gain is capital gain that is recognized before December 31, 2026, and does not arise from a sale with a related party, it is eligible to be invested in a QOF.[7] Further, if a taxpayer recognizes a single capital gain, it may bifurcate the gain and invest different parts of such gain into different QOFs (or not in any QOF).[8] Additionally, tracing of funds is not required, *i.e.*, an investor is not required to use the same cash from the recognized capital gain transaction to fund the O-Zone investment.

Any "eligible taxpayer" that recognizes capital gain can take advantage of O-Zone benefits, including partnerships.[9] As such, a partnership that recognizes a capital gain can elect to defer the gain by investing in a QOF within 180 days of the recognition transaction.[10] If the partnership makes the election, then the deferred gain is not included in the distributive shares of the partners under Code Sec. 702.[11] If the partnership does not make such an election, the gains are included in the partners' distributive shares, and the partners themselves are permitted to invest their allocable share of the recognized capital gain in a QOF.[12] Generally, the 180-day period during which the partner is required to invest in a QOF begins on the last day of the partnership's taxable year.[13] However, if the partner knows (or receives information) regarding both the date of the partnership's gain and the partnership's decision not to elect deferral under the O-Zone regime, the partner may choose to begin the 180-day period on the date of the disposition by the partnership.[14]

The 180-day period raises logistical issues in the context of partnerships. Namely, unless the partnership is closely held, most partners will not be aware that the partnership has recognized capital gain that can be invested in a QOF until they receive their Schedules K-1. Thus, the earliest that many partners will learn of the disposition (and thus, that capital gain has been recognized that can be invested in a new QOF) is the date the partnership distributes the Schedules K-1, which typically is at least 75 days after the partnership's taxable year ends (if not significantly later). Additionally, partnerships are eligible to receive a six-month extension in which to file their tax returns. In this case, most partners will not receive their Schedules K-1 reporting the share of eligible gain until after the 180-day period to make an investment in a QOF has expired.

A further logistical issue arises because of the mechanism of Code Sec. 1231. If section 1231 gains for a taxable year exceed the section 1231 losses for that year, those gains and losses are long-term capital gain and losses.[15] On the other hand, if section 1231 losses exceed section 1231 gains for the year, the gains and losses are not capital gains or losses.[16] The Revised Proposed Regulations deal with the issue arising from Code Sec. 1231 itself by providing that the 180-day period for investing section 1231 gains will not commence until the last day of the taxable year.[17] However, a taxpayer that is a partner in a partnership does not know if the taxpayer's own section 1231 gains are capital gains until the taxpayer knows whether the partnership will allocate section 1231 losses to the taxpayer.

Separate issues arise if the partnership elects to invest in a QOF. For example, how are the basis adjustments allocated and capital accounts calculated by the investing partnership at the following times: (a) the disposition giving rise to the gain, (b) the QOF investment, (c) the basis step-ups in year five and year seven, and (d) the disposition of the interest in the QOF? The Revised Proposed Regulations address some of these questions by providing that the basis adjustments in year five and year seven and upon a disposition after year 10 is treated as an item of income described in Code Sec. 705(a)(1), thus increasing basis for upper-tier partners.[18] Additionally, as described below, the Revised Proposed Regulations allow for a basis step-up in the QOF's assets upon the disposition of a QOF partnership interest after the 10-Year Period.[19] Alternatively, if the partnership elects not to invest in the QOF, but the partner does, presumably the electing partner still increases its basis in its partnership interest by operation of Code Sec. 705 for the gain allocated to it that is deferred (and sees its capital account increased under Code Sec. 704 and the regulations promulgated under Code Sec. 704).

The Proposed Regulations also allow investors, including partnerships, to roll gain from one QOF to another QOF.[20] They provide that, if an investor makes an election to defer gain by investing into a QOF and later sells its interest in the QOF, the investor can make another deferral election with respect to gain from the sale of the QOF interest to the extent the investor makes a new QOF investment within 180 days.[21] Presumably, if a partnership investor chooses not to make a subsequent investment in a new QOF, the same rules as described above apply that allow a partner to reinvest the QOF gain. As discussed below, however, while the Proposed Regulations did not address how sales of QOF assets are treated if sold prior to the end of the 10-Year Period and the QOF reinvests the proceeds, the preamble to the Revised Proposed Regulations clarifies that such sales are taxable (or not) under the other provisions of the Code.[22] A QOF taxed as a partnership can allocate the gains from any such sales to its partners and, presumably, those partners can then invest such gains into a new QOF. However, any investor that takes gains from one QOF investment and invests them in another QOF will have to restart its holding period for purposes of the five-year, seven-year and 10-year benefits.[23]

Helpfully, the Revised Proposed Regulations clarify that a taxable disposition of property by a QOF does not restart an investor's holding period in their QOF investment and does not trigger inclusion of the investor's deferred gain.[24] The Revised Proposed Regulations also allow the QOF to maintain qualification after such a disposition, by allowing cash, cash equivalents and certain debt instruments to be treated as qualified opportunity zone property ("O-Zone Property") if the proceeds of the disposition are reinvested within 12 months.[25]

Eligible Investments

The statute provides that the O-Zone designations are set to expire in December 2028. Prior to the Proposed Regulations, there was uncertainty regarding whether, in order to take advantage of the 10-year basis step-up rule, QOF investments had to be made by December 31, 2018. The Proposed Regulations provide that the expiration of the Q-Zone designations will not affect the basis step-up rule provided the taxpayer disposes of its QOF investment by December 31, 2047.[26] This rule, however, raises the spectre of taxpayers being forced to dispose of QOF investments by this deadline and raises questions regarding what will occur if they do not. For example, if a taxpayer that has a QOF investment causes the QOF to make a distribution on December 31, 2047, that triggers gain under Code Sec. 731, will that be sufficient to trigger the step-up at the then fair market value and avoid losing the O-Zone benefit?

Debt Allocations, Distributions and Basis Step-Up

Because the statute provides for capital gain deferral on the original sale, an investor's QOF investment initially will have a zero basis. Before the Proposed Regulations were issued, it was unclear whether a deemed contribution of money resulting from an allocation of QOF liabilities under Code Sec. 752(a) would result in a separate non-qualifying investment in the QOF. The Proposed Regulations clarify that liability allocations under Code Sec. 752 do not constitute a separate investment in the QOF.[27]

As previously described, the first benefit of the statute is gain deferral on the original capital gain until the later of when the QOF interest is disposed of or December 31, 2026. The third benefit, however, requires that the QOF interest be held for 10 years in order to obtain a full gain exclusion on QOF appreciation. Ultimately, this means that the original deferred gain will be required to be recognized prior to the end of the 10-Year Period, leaving investors with a tax bill and no cash. Given this quandary, can a QOF that is taxed as a partnership borrow money and distribute it to its partners at the end of the initial gain deferral period (or before) for purposes of, for example, covering their taxes? The statute and Proposed Regulations are silent on whether debt-financed distributions from a partnership prior to the end of the 10-Year Period will be considered a "disposition" of a QOF interest violating the 10-year holding requirement. The Proposed Regulations do not prevent the operation of Code Secs. 752(a) and 722, and Code Sec. 731 generally provides that no gain is recognized upon a distribution by a partnership unless it exceeds the partner's adjusted basis in its partnership interest. The Revised Proposed Regulations now answer this question by providing that distributions by a QOF that is a partnership will not accelerate gain deferral if the investor has basis (whether from debt, income allocations or otherwise) at least equal to the amount of the distribution.[28] However, distributions in excess of basis will accelerate the gain deferral. One complicating factor is that, if a partner has an interest that qualifies for opportunity zone benefits and an interest that does not, the partner must separately track basis in each such interest and, while the partner may not have gain from a distribution under Code Sec. 731, the partner may accelerate deferred gain if the distribution as to the qualifying investment exceeds the separately calculated basis in that investment.[29]

Likewise, what if a QOF distributes current earnings? Does this trigger the gain deferral or violate the O-Zone holding requirements? The provision in the Revised Proposed Regulations that limits deferred gain acceleration to distributions in excess of basis should permit current earnings (assuming that they represent taxable income of the partnership that increase basis under Code Sec. 705) to be distributed without affecting the O-Zone benefits.

Similarly, what if after an allocation of debt-financed deductions or losses, the partnership pays off the liability, triggering minimum gain? Is this treated as a disposition of all or part of a QOF interest that triggers the deferred gain or violates the O-Zone holding requirement? Because minimum gain is an allocation of partnership income, absent a disposition of the QOF's directly or indirectly held property, certainly one would not expect the investors in the QOF to be treated as having disposed of (or otherwise ceasing to hold) any portion of their QOF interests.

Another issue that arises in the context of partnership borrowings is how the borrowing is treated at the end of the 10-Year Period. Neither the Code nor the Proposed Regulations clarify whether the basis step-up to "fair market value" at the end of the 10-Year Period is calculated gross of partnership debt or not.[30] For example, Investor A invests $500 of eligible capital gain into a QOF. The QOF then makes a non-recourse borrowing, $100 of which is allocated to Investor A under Code Sec. 752. Investor A is allocated $100 of depreciation from the QOF over the next 10 years, at the end of which time Investor A's QOF interest is worth $1,000 (*i.e.*, taking into account the $100 liability and any applicable discounts, an unrelated third party with complete information and no compulsion to buy would pay Investor A $1,000 for the QOF interest). If Investor A sold its interest, Investor A would have an amount realized of $1,100, inclusive of the liabilities. Under Code Sec. 1400Z-2 and Proposed Regulations, it is unclear whether Investor A's step-up to fair market value, if Investor A were to sell, would be to net fair market value (which is $1,000) or gross fair market value (which is $1,100). The Revised Proposed Regulations answer this question by stating that, upon a disposition of an interest in a QOF after the end of the 10-Year Period, the fair market value of the interest includes debt.[31] However, the workings of that rule appear relevant in one example in the Revised Proposed Regulations, but the example does not specifically address it.[32]

Proposed Regulations—QOF Level Guidance

Working Capital Exception

A QOF is any investment vehicle organized as a corporation or a partnership for the purpose of investing in O-Zone Property and that holds at least 90 percent of its assets in O-Zone Property (the "90-percent test").[33] The Proposed Regulations clarify that the 90-percent test is based on the value of the QOF's assets per the QOF's financial statements or, if the QOF does not have financial statements, the cost of the QOF's assets.[34] The 90-percent test is determined on a semi-annual basis, by measuring the percentage of the QOF's O-Zone Property at the end of each six-month period of the QOF's taxable year and averaging these two amounts.[35] The Proposed Regulations provide that the 90-percent test does not apply to any portion of an entity's taxable year before it becomes a QOF.[36] Thus, if a calendar-year QOF elects its status as of March, its testing dates for the first year would be August 30 and December 31; whereas, if a calendar-year QOF elects its status as of August, it would have only one testing date for the first year on December 31.

O-Zone Property includes O-Zone stock, O-Zone partnership interests, and qualified opportunity zone business property ("O-Zone Business Property").[37] O-Zone Business Property is tangible property used in a trade or business of a QOF if, among other things, either the original use of the property commences with the QOF or the QOF "substantially improves" the property.[38] Code Sec. 1400Z-2(d)(2)(D)(ii) indicates that property will be treated as "substantially improved" by a QOF only if, during any 30-month period beginning after the date of the acquisition of the property, additions to basis with respect to such property exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period. The Proposed Regulations provide that, in determining whether a building has been substantially improved, improvements are measured by the QOF's additions to the adjusted basis of the building itself, and not the land on which the building is located.[39] Additionally, contemporaneously with issuing the Proposed Regulations, the IRS issued Rev. Rul. 2018-29, which provides guidance regarding the application of the "original use" and "substantial improvement" requirements to land and structures that are acquired together by a QOF.[40]

If a QOF holds O-Zone stock or partnership interests, during substantially all of the QOF's holding period for such stock or interests, the corporation or partnership must qualify as a qualified opportunity zone business ("O-Zone Business").[41] There are a number of tests that an O-Zone Business must meet, one of which requires that "substantially all" of the tangible property owned or leased by the business must be O-Zone Business Property.[42] The Proposed Regulations provide that this "substantially all" requirement is met if at least 70 percent of the tangible property owned or leased by an O-Zone Business is O-Zone Business Property.[43] Another requirement for an O-Zone Business is that less than five percent of the average of the aggregate unadjusted bases of the property of such business may be attributable to certain "financial assets," including stock and partnership interests, but excluding "reasonable" amounts of working capital.[44]

The Proposed Regulations create a special rule that provides for a 31-month safe harbor for QOF investments in O-Zone Businesses that acquire, construct, or rehabilitate business property in an O-Zone.[45] The safe harbor allows an O-Zone Business, in which a QOF has invested, to treat the trade or business's cash, cash equivalents, and debt instruments with a term of 18 months or less as "reasonable" working capital so long as (a) the amounts are designated in writing for development of a trade or business in a O-Zone, including (when appropriate) the acquisition, construction, and/or substantial improvement of tangible property in an opportunity zone; (b) there is a written schedule, consistent with the ordinary start-up of a trade or business for the expenditure of the working capital, pursuant to which the working capital will be spent within 31 months of receipt by the O-Zone Business; and (c) the working capital is actually used in a manner substantially consistent with (a) and (b) (the "Working Capital Exception").[46] The Revised Proposed Regulations also add that failure to use the working capital consistent with the designation and schedule will not be considered inconsistent due to government inaction, if the application for government action was completed.[47]

The Working Capital Exception described above is a welcome addition to the O-Zone rules, but its usefulness is limited. It only applies to O-Zone Businesses and not QOFs. Recall that QOFs must meet the 90-percent test, which requires the QOF to hold 90 percent of its assets in O-Zone stock, O-Zone partnership interests, or O-Zone Business Property. If the QOF holds O-Zone stock or partnership interests, this is where the O-Zone Business tests become relevant, *i.e.*, that the corporation or partnership must qualify as an O-Zone Business. Thus, the Working Capital Exception is only applicable in a two-tier structure (*i.e.*, a structure in which a QOF holds interests in either a corporation or a partnership).

Sale of QOF Assets at the End of the 10-Year Period

Code Sec. 1400Z-2(c) provides that, if a taxpayer holds "any investment" for at least 10 years and if the taxpayer makes an election, the basis of "such property" will be stepped up to the fair market value of "such investment" on the date that "the investment" is sold or exchanged. Given this is a subsection of the O-Zone statute (and the legislative history), it is reasonable to interpret "any investment" as an investment in the QOF by the taxpayer that deferred the original gain by making the investment in the QOF. Thus, this provision appears to require a taxpayer to dispose of its interest in a QOF in order to obtain the benefits of the basis step-up following the 10-Year Period. As such, it would be difficult to consider the QOF or the O-Zone Business to be "the taxpayer" referenced in Code Sec. 1400Z-2 and it would be difficult, if the "investment" is the interest in the QOF, to construe "such property" as referring to anything other than the interest in the QOF. Given that reading, the basis step-up and consequent gain exclusion would not appear to apply if the QOF or the O-Zone Business sold assets, instead of the investors selling their interests in the QOF.[48] In practice, this would prevent a QOF from having multiple unrelated business holdings and require a separate QOF to be maintained for each group of related O-Zone Business Property. That model is very different than a typical fund structure in which an investors' capital is diversified among multiple assets. It would also require buyers of the interests in the QOF to take on any number of liabilities that the QOF or the O-Zone Business may have, which could be specifically avoided if the buyer were able to acquire assets. Ultimately, it could reduce the capital interested in buying the QOF interests.

Presumably, one way to solve the liquidity issue might be to have all of the investors in a QOF sell their interests to an intermediary that would then sell the underlying QOF assets to the ultimate buyer. This structure, however, raises questions as to whether the IRS would challenge the purported tax avoidance as a tax shelter using an intermediary.[49] Generally, intermediary tax shelters attempt to avoid the corporate income tax from a sale of assets and involve transactions in which corporate shareholders dispose of their shares, one or more persons purchase the corporation's assets in one or more taxable transactions, and at least some of the gain or tax that would otherwise result to the corporation from a sale of assets is avoided through the use of an intermediary. Through a series of Notices, the IRS has indicated that it will challenge these types of transactions.[50] Presumably, then, there is a risk that the IRS would disregard the use of an intermediary and treat the O-Zone Business as selling its assets directly to the buyer, which, as described above, would prevent the QOF investors from meeting the basis step-up requirements.

The Revised Proposed Regulations provide a special election to address this issue, at least in part. Under the Revised Proposed Regulations, if an investor has completed the 10-Year Period and receives an allocation of capital gain from a QOF attributable to the qualifying investment and the disposition by the QOF of qualifying opportunity zone property, the investor can elect to exclude some or all of that capital gain from income.[51] In a sale of the interest in the QOF, the investor receives a full step-up in basis in the QOF interest and, according to the Revised Proposed Regulations, immediately before the disposition, a basis adjustment (as if an election had been made under Code Sec. 754) in the QOF's assets.[52] Thus, on a sale of a qualifying interest in a QOF, one can eliminate capital gain and ordinary income from the sale, but, upon the sale by the QOF of qualifying opportunity zone property, one can only eliminate capital gain from the sale. Also noteworthy is that the Revised Proposed Regulations did not apply this special election to dispositions of qualifying opportunity zone business property by a lower-tier entity.

Additional Issues Involving Partnerships

Timing of Allocations in Year of Sale

An uncertain, yet not often discussed, issue is how partnership allocations affect a partner's gain or loss on the sale of its QOF interest at the end of the 10-Year Period. Code Sec. 1400Z-2(c) provides that the basis step-up at the end of the 10-Year Period is equal to the "fair market value … *on the date that the investment is sold or exchanged* (emphasis added)." If the basis step-up occurs as of a date certain, how do partnership allocations from the year of sale factor into the basis step-up? For example, assume that a partner with a basis of zero holds an interest in a QOF taxed as a partnership (which has no liabilities) and that the partner has held the interest in the QOF for at least 10 years. Further, assume that the QOF has ordinary taxable income for the year of $20,000 (which, regardless of whether a closing of the books or a proration method is used, would be $10,000 for the first half of the year and $10,000 for the second half of the year). The partner sells its interest in the QOF for $100,000 on June 30. Thus, the partner will have a step-up in the basis of its interest on June 30 to $100,000 and will have no gain on the sale but will still receive a Schedule K-1 in the next calendar year showing $10,000 of ordinary income from the year of sale. Will the selling partner have $10,000 of ordinary income and $10,000 of capital loss for the year of the sale? If the selling partner is a corporation, it will be unable to deduct any of that capital loss against that ordinary income. If the selling partner is an individual (or if the tax results flow to an individual), the selling partner will be able to deduct only a limited portion of the capital loss against the ordinary income. This seems unfair. Perhaps the step-up in basis should take into account any adjustments that the selling partner will have from its allocable share for the year of sale.

Conclusion

In many aspects, O-Zones still offer a huge potential. However, there are several unresolved issues that affect the economic viability of QOF investments. Until these issues are resolved, many investors will hold off on making investments in QOFs. However, for those investors whose gains have already been recognized, the 180-day clock is ticking and they may be unable to wait for answers to these and other questions under the new O-Zone provisions.

ENDNOTES

1 Code Sec. 1400Z-2(a).
2 Code Sec. 1400Z-2(b)(2)(B).
3 Code Sec. 1400Z-2(c).
4 REG-115420-18, 83 FR 54279.
5 REG-120186-18, 84 FR 18652.
6 Proposed Reg. §1.1400Z2(a)-1(b)(2); 83 FR at 54279.
7 *Id.*
8 Proposed Reg. §1.1400Z2(a)-1(b)(2)(ii).
9 Proposed Reg. §§1.1400Z2(a)-1(b)(1) and (c)(1).
10 Proposed Reg. §1.1400Z2(a)-1(c)(1).
11 Proposed Reg. §1.1400Z2(a)-1(c)(1)(i)(B).
12 Proposed Reg. §1.1400Z2(a)-1(c)(2)(ii).
13 Proposed Reg. §1.1400Z2(a)-1(c)(2)(iii)(A).
14 Proposed Reg. §1.1400Z2(a)-1(c)(2)(iii)(B).
15 Code Sec. 1231(a)(1).
16 Code Sec. 1231(a)(2).
17 Proposed Reg. §1.1400Z2(a)-1(b)(2)(iii).
18 Proposed Reg. §§1.1400Z2(b)-1(g)(3)(ii) and 1.1400Z2(c)-1(b)(2)(ii)(C).
19 Proposed Reg. §1.1400Z2(c)-1(b)(2)(i).
20 Proposed Reg. §1.1400Z2(a)-1(b)(4)(ii)(D), Ex. 4.
21 *Id.*
22 84 FR 18660.
23 84 FR 18672.
24 Proposed Reg. §1.1400Z2(f)-1(b). *See also* 84 FR 18660.
25 Proposed Reg. §1.1400Z2(f)-1(b). Note that this reinvestment test appears to require the proceeds to be held directly by the QOF and not by a lower-tier partnership that may have issued a qualified opportunity zone partnership interest.
26 Proposed Reg. §1.1400Z2(c)-1(b).
27 Proposed Reg. §1.1400Z2(a)-1(b)(3)(iii).
28 Proposed Reg. §1.1400Z2(b)-1(c)(6)(iii).
29 Proposed Reg. §1.1400Z2(b)-1(c)(6)(iv).
30 *See* Code Sec. 1400Z-2(c).
31 Proposed Reg. §1.1400Z2(c)-1(b)(2)(i).
32 Proposed Reg. §1.1400Z2(b)-1(f), Example 5(iii).
33 Code Sec. 1400Z-2(d)(1).
34 Proposed Reg. §1.1400Z2(d)-1(b). A QOF will use financial statements only if the financial statements are used for certain non-tax purposes. It is unclear whether, in using such financial statements, the value is or is not adjusted for accumulated depreciation, impairments or similar adjustments.
35 Code Sec. 1400Z-2(d)(1).
36 Proposed Reg. §1.1400Z2(d)-1(a)(2).
37 Code Sec. 1400Z-2(d)(2).
38 Code Sec. 1400Z-2(d)(2)(D).
39 Proposed Reg. §1.1400Z2(d)-1(c)(8)(ii).
40 Rev. Rul. 2018-29, 2018-45 IRB 765. However, the Proposed Regulations and this ruling define neither "building" nor upon which land the building will be considered to be located. This leads to inevitable questions regarding whether there is a maximum amount of land that can be treated

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