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Recent Developments & Observations

Qualified Opportunity Zones: The Good, the Better and the Not So Bad

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Introduction

One of the most exciting new areas of tax law is Qualified Opportunity Zones ("O-Zones"). As one digs into O-Zones, there are many interesting and complicated issues to consider. This column addresses provisions of the Proposed Regulations that were issued on April 17, 2019 (the "April Proposed Regulations") that pertain to some of those issues.[1]

Investing in O-Zones can lead to tax benefits created by P.L. 115-97 (commonly referred to as the "Tax Cuts and Jobs Act"). The rules governing O-Zones allow taxpayers to obtain tax benefits by investing through a "qualified opportunity fund" ("QOF"). The tax benefits offered by an investment in a QOF are threefold: (1) investors can defer recognized capital gains from other sources until the earlier of (a) the disposition of the QOF interest or (b) December 31, 2026, so long as such gains are invested within a 180-day investment period and the taxpayer makes a gain-deferral election; (2) investors that hold their QOF investment for five and seven years receive a tax basis step-up equal to 10 percent of the deferred gain and an additional five percent of the deferred gain, respectively; and (3) investors who maintain their investment in the QOF for at least 10 years (the "10-Year Period") receive a basis step-up to the fair market value of the investment on the sale or exchange date.[2]

On October 19, 2018, Treasury and the IRS issued the first set of Proposed Regulations and other guidance regarding O-Zones (the "October Proposed Regulations").[3] The October Proposed Regulations were amended and expanded by the April Proposed Regulations. Our last column focused on questions and issues that remain regarding the treatment of O-Zones after the publication of the October Proposed Regulations and the April Proposed Regulations. This column addresses certain provisions of the April Proposed Regulations that we did not have a chance to cover in our last column. Specifically, this column addresses, arguably, the most taxpayer-friendly provision of the April Proposed Regulations—the leasing rules—and certain issues relating to partnerships.

Leased Tangible Property

Qualified Opportunity Zone Business Property

Code Sec. 1400Z-2(d)(3)(A)(i) specifically references that a qualified opportunity zone business ("O-Zone Business") must have substantially all of its tangible property owned or leased as qualified opportunity zone business property ("O-Zone Business Property"), but the October Proposed Regulations did not address leased property. As a refresher, a QOF is any investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property ("O-Zone Property") and that holds at least 90 percent of its assets in O-Zone Property (the "90-percent test").[4] O-Zone Property includes qualified opportunity zone stock ("O-Zone Stock"), qualified opportunity zone partnership interests ("O-Zone Partnership Interests"), and O-Zone Business Property. O-Zone Stock and O-Zone Partnership Interests include stock and interests in a corporation or a partnership, respectively, that are (i) acquired by a QOF for cash after December 1, 2017, and (ii) acquired directly from the corporation or partnership.[5] Further, during substantially all (*i.e.*, 90 percent) of the QOF's holding period for the stock or partnership interests, the corporation or partnership must qualify as an O-Zone Business, which requires, among other things, that substantially all (*i.e.*, at least 70 percent) of the tangible property owned or leased by the business must be O-Zone Business Property.[6] O-Zone Business Property is property that meets the following requirements: (1) tangible property acquired by the O-Zone Business by purchase after December 31, 2017, (2) the original use of the property begins with the O-Zone Business or the O-Zone Business substantially improves the property (the "Original Use Requirement"), and (3) for substantially all (*i.e.*, at least 90 percent) of the O-Zone Business's holding period of the tangible property, substantially all (*i.e.*, at least 70 percent) of the use of such property is in the O-Zone.[7] Prior to the April Proposed Regulations, it was uncertain how leased property, which an O-Zone Business could have statutorily, was to fit into the definition of O-Zone Business Property.

The April Proposed Regulations provide that leased tangible property meeting certain criteria may be treated as O-Zone Business Property.[8] First, the lease must be entered into after December 31, 2017, and, second, substantially all (*i.e.*, at least 70 percent) of the use of the leased tangible property must be in an O-Zone during substantially all (*i.e.*, at least 90 percent) of the period for which the business leases the property.[9] In other words, leased tangible property is treated the same as owned tangible property and is included in both the numerator and denominator of the "substantially all" fractions.

Unlike the rules for owned tangible property, generally, the April Proposed Regulations do not impose an Original Use Requirement for tangible leased property.[10] Moreover, as explained by the IRS and Treasury in the Preamble to the April Proposed Regulations, leased tangible property may have been previously leased to other lessees or previously used in an O-Zone and taxpayers usually do not have a basis in leased property that can be depreciated.[11] As such, there is no requirement that a lessee substantially improve leased property.[12]

All leases that are intended to be treated as O-Zone Business Property must be "market rate."[13] Whether a lease is market rate is determined under the Treasury Regulations for Code Sec. 482 and includes consideration of whether the terms of the lease "reflect common, arms-length market practice" in the location that includes the O-Zone.[14]

While purchased tangible property must be acquired from an unrelated person, the April Proposed Regulations allow leased tangible property to be acquired from a related party to the QOF or the O-Zone Business, subject to certain requirements.[15] First, if the lessor and lessee are related, the QOF or the O-Zone Business cannot prepay its lease payments beyond 12 months in advance.[16] Additionally, if the lessor and lessee are related and the lease relates to personal property, then either (1) the property must have its "original use" in an O-Zone begin with the QOF or O-Zone Business (as explained below) or (2) the QOF or O-Zone Business must become the owner of tangible personal property that has a value not less than the value of the leased personal property.[17] If the lessee is required to purchase tangible property, the acquisition of such property must occur during the period that begins on the date the lessee receives possession of the leased property and ends on the earlier of either (1) the day that is 30 months later or (2) the last day of the lease.[18] Moreover, there must be substantial overlap of zones in which the QOF or O-Zone Business uses the acquired property and leased property.[19] For purposes of leased property, the "original use" of the property occurs when the property is first used in the O-Zone in a manner that would allow depreciation and amortization if the lessee owned the property.[20] If property has been unused or vacant for an uninterrupted period of at least five years, original use begins when any person first uses or places the property in service in the O-Zone.[21]

The April Proposed Regulations also include an anti-abuse rule with respect to leased tangible property. In the case of leased real property by a QOF, the property is not treated as O-Zone Business Property if, at the time the lease is entered into, there is a plan, intent, or expectation for the real property to be purchased by the QOF for an amount of consideration other than the fair market value of the property determined at the time of purchase.[22]

Lease Valuation

Having established what leased property can be O-Zone Business Property, the April Proposed Regulations provide a mechanism for valuing leased tangible property to determine whether a QOF meets the 90-percent test and an O-Zone Business meets the substantially all requirement for O-Zone Business Property. For these purposes, leased property may be valued using either an applicable financial statement valuation method (the "Financial Statement Method") or an alternative valuation method (the "Alternative Valuation Method").[23] Once a QOF selects a valuation method, it must apply that method consistently to all leased tangible property with respect to the taxable year.[24]

The Financial Statement Method can be used by a QOF if it has an applicable financial statement within the meaning of the Reg. §1.475(a)-4(h) that is prepared in accordance with U.S. generally acceptable accounting principles and recognizes the lease as tangible property.[25] Under this method, the value of leased tangible property of a QOF or O-Zone Business is the value of such property as reported on the applicable financial statement for the relevant reporting period.[26]

Under the Alternative Valuation Method, the value of the leased property is determined by calculating the present value of the leased property, which requires the determination of the present values of all payments to be made under the lease for the property using the applicable federal discount rate under Code Sec. 1274(d)(1).[27] If a QOF or an O-Zone Business uses the Alternative Valuation Method, the calculation must be made at the time the lease is entered into, and the calculated value must be used as the value for the leased property for all testing dates for purposes of the "substantially all of the use" requirement and the 90-percent test.[28]

Advantages of Leases

Tangible property that is purchased by a QOF must be purchased from an unrelated person (*i.e.*, a person who directly or indirectly owns less than 20 percent of a QOF) in order to be treated as O-Zone Business Property.[29] Thus, prior to the April Proposed Regulations, owners of property in O-Zones were unable to own more than 20 percent of a QOF that wanted to use that property. Because the tax law does not provide any clear answers as to how to determine profits interests and capital interests, there was a clear bias against a QOF or O-Zone Business utilizing property from a related (or potentially related) partner. The new leasing rules described above permit a QOF to lease property from a related party, allowing for owners of O-Zone property to participate in a QOF in which the property is used.

For example, Mr. X owns land in an O-Zone ("Blackacre") and wants to start a QOF with Mrs. Y. Prior to the April Proposed Regulations, the only way for their QOF to treat Blackacre as O-Zone Business Property was for the QOF to purchase the land from Mr. X and for Mr. X to own less than 20 percent of profits and capital interests in the QOF. Under the April Proposed Regulations, Mr. X can lease Blackacre to the QOF and own as much of the QOF as he wants.

Although the leasing rules create opportunities, they do not allow Mr. X or Mrs. Y to enjoy the 10-year benefit (*i.e.*, full fair market value basis step-up) on the sale of the fee interest in the property, as the QOF will not have that interest if it just leases the property. With a bit of forward thinking, however, it may be possible to capture some of that benefit.

Assume Mr. X and Mrs. Y set up a QOF by each contributing $100 of eligible deferred capital gain. The QOF leases Blackacre from Mr. X in a lease meeting the requirements mentioned above and borrows money to build an apartment building. Thus, the QOF can include the value of the lease as O-Zone Business Property in its calculation of whether it meets the 90-percent test or the "substantially all" requirement for an O-Zone Business and, as the apartment building will be new, it will also be O-Zone Business Property. After the apartment building is constructed, the QOF might buy the land from Mr. X. While the land is disqualified (because it is acquired from a related person), if the land is worth less than 3/7th of the apartment building, the O-Zone Business will still meet its requirement that substantially all of its tangible property be O-Zone Business Property. Any appreciation in the land after such an acquisition would belong to the QOF and could be eligible for the 10-year benefit.

Certain Partnership Provisions

Inclusion Events

In general, a QOF investor's deferred qualified gain is not subject to tax until the earlier of (i) the date the investor sells or exchanges the qualifying investment or (ii) December 31, 2026.[30] The April Proposed Regulations provide useful guidance on what constitutes a "sale or exchange" for this purpose by establishing what is an "inclusion event."[31] An inclusion event occurs if and to the extent that a taxpayer transfers its qualifying investment in a transfer which reduces its QOF interest or the QOF makes a distribution of property to the taxpayer that has the effect of reducing its interest in the QOF.[32] The April Proposed Regulations provide a non-exclusive list of inclusion events. While non-exclusive, the list is also extensive and this column only focuses on the partnership aspects of that list.

Generally, a transfer in a transaction governed by Code Sec. 721 does not create an inclusion event so long as the transaction does not cause a termination of a QOF partnership or the direct or indirect owner of the QOF under Code Sec. 708(b)(1).[33] Additionally, the transferee partnership must allocate and report gain with respect to the contributed QOF interest to the contributing partner.[34] The transfer rules are important as they allow investors to consolidate their QOF interests into a single holding entity.

Similarly, the April Proposed Regulations provide that Code Sec. 708(b)(2)(A) mergers or consolidations are not inclusion events.[35] The resulting partnership or new partnership becomes subject to the O-Zone rules to the same extent that the original partnership was subject.[36] Additionally, the resulting or new partnership must allocate and report any eligible gain to the same extent and to the same partners as the original partnership allocated such gain.[37] While the April Proposed Regulations did not address partnership divisions, some have commented that the final regulations should clarify that *pro-rata* divisions of QOF partnerships do not create inclusion events.[38]

On the other hand, the April Proposed Regulations treat certain distributions as inclusion events. A distribution of property by a QOF partnership to a partner is an inclusion event if the distributed property has a fair market value in excess of the partner's basis in its qualifying investment in the QOF.[39] This seemingly simple rule becomes particularly complicated in the context of "mixed funds" (as discussed below).

The April Proposed Regulations also include a "catch-all" or anti-abuse provision for inclusion events in partnerships. If a transaction has the effect of reducing either (1) the amount of remaining deferred gain of a direct or indirect partner or (2) "the amount of gain that would be recognized by a partner [due to an inclusion event] to the extent that such amount would reduce such gain to an amount that is less than the remaining deferred gain."[40] The first portion of this rule is fairly straightforward, even if its application is unclear, as it captures any transaction where a partner is avoiding paying the tax on the deferred gain when the deferral is otherwise required to end. The second portion is somewhat of a mystery, as it is unclear what "such amount" references and appears to be circular.

Disguised Sales and Debt Financed Distributions

The April Proposed Regulations allow an investor to make an eligible investment in a QOF partnership by transferring cash or other property to a QOF.[41] However, if the transfer is characterized as anything other than a tax-free contribution under Code Sec. 721, including a disguised sale under Code Sec. 707, the transfer will not result in a qualified investment.[42] Additionally, reductions in QOF investments that would otherwise be treated as contributions (including investments of cash) are not treated as eligible investments to the extent that (1) the QOF partnership makes a distribution to the partner, and (2) the transfer to the partnership and the distribution would be recharacterized as a disguised sale under Code Sec. 707 if (A) any cash contributed were non-cash property; and (B) in the case of a debt-financed distribution by the partnership under Reg. §1.707-5(b), the partner's share of liabilities is zero.[43]

The April Proposed Regulations provide the following example as an illustration of this rule. A and B each realize $100 of eligible gain and transfer $100 cash to a QOF partnership. Later, the QOF borrows $120 from an unrelated lender and distributes it equally to A and B. If the contributions had been of property other than cash, the contributions and distributions would have been tested under the disguised sale rules of Reg. §1.707-5(b) by, among other things, determining the timing of the distribution and amount of the debt allocated to each partner. Under the April Proposed Regulations, the $100 of cash from A and $100 of cash from B is treated as property that could be sold in a disguised sale transaction and each partner's share of the debt is zero for purposes of determining the amount of the investment.[44] To the extent there would have been a disguised sale, the amount of partner A's and partner B's investments would be reduced by the amount of the contribution recharacterized as a disguised sale.

Although the April Proposed Regulations provide that a contribution of property to a QOF partnership followed by a distribution of property, which together is treated as a disguised sale, is not treated as an eligible investment, the regulations also provide that an investor's basis in its QOF partnership interest is increased by its share of liabilities.[45] Thus, so long as a debt-financed distribution is not otherwise treated as a disguised sale, a QOF partnership should be able to make tax-free debt-financed distributions, which will likely become important as partners in QOF partnerships look for cash to pay the tax on their deferred but invested gains when the deferral ends.

Mixed Fund Investments

The April Proposed Regulations provide special rules to address situations in which a partner in a QOF partnership has both an investment that qualifies for QOF treatment and one that does not (referred to as a "Mixed-Fund Investment").[46] For example, if a partner contributes cash in the amount of its eligible deferred capital gain in exchange for a qualifying QOF interest and also receives an interest in exchange for services, the interest received in exchange for the partner's eligible deferred capital gain is "qualifying" under Code Sec. 1400Z-2(a) and the one received in exchange for services (*i.e.*, the carried interest) is not.[47] Thus, the QOF partner has a Mixed-Funds Investment.

The Preamble to the April Proposed Regulations confirms that a Mixed-Fund Investment is treated for all purposes of the Code other than Code Sec. 1400Z-2 as a single partnership interest with a single basis and capital account.[48] However, for purposes of the O-Zone rules, a partner holding a Mixed-Funds Investment is treated as holding two separate partnership interests—one that is a qualifying investment and one that is not.[49] Partnership items, such as income, losses and debt allocations, are allocated to the separate interests based on their "allocation percentages" for purposes of the O-Zone rules (*i.e.*, with respect to determining whether an inclusion event has occurred).[50] Additionally, Code Sec. 704(c) principles apply to account for any value-basis disparities attributable to either the qualifying or non-qualifying investment.[51]

For a Mixed-Fund Investment that is not a carried interest, *e.g.*, an interest received for cash in excess of a partner's eligible capital gain, allocation percentages are generally based on relative capital contributions.[52] For example, if a partner contributes $1,000 to a QOF partnership, but only has $700 of recognized eligible capital gain to invest, 70 percent of its interest in the QOF would be a qualifying interest and 30 percent would be a non-qualifying investment. As such, the partner's QOF partnership items would be allocated 70 percent to the qualifying interest and 30 percent to the non-qualifying interest.

Determining allocation percentages is more complicated for profits interests received in exchange for services. The April Proposed Regulations provide that the allocation percentage attributable to a profits interest received in exchange for services is equal to the "highest share of residual profits the mixed-funds partner would receive with respect to that interest."[53] Presumably, this means that if the percentage in residual QOF profits for a service provider varies based on the performance of a QOF, the service provider would still be required to use the highest potential percentage for purposes of allocations under the QOF rules.

Continuing the prior example (where the partner contributed $1,000 to a QOF partnership, with $700 of eligible gain), let's assume that the partner also receives a profits interest in exchange for providing management services to the QOF. The distribution waterfall for the QOF partnership provides that cash is distributed, first, to the capital interests to return their capital and provide a preferred return, second, 80 percent to the capital interests and 20 percent to the profits interests until an internal rate of return of 15 percent is achieved for the capital interests, and thereafter, 70 percent to the capital interests and 30 percent to the profits interests. What is the "applicable percentage" with respect to the profits interest? The rule would require it to be 30 percent since this is the highest share of residual profits to be distributed on the profits interest. But, what if the QOF never achieves an internal rate of return of 15 percent? If 30 percent is the partner's applicable percentage for his profits interest, partnership items allocated to the partner would be allocated 30 percent to the non-qualified profits interest, 21 percent to the non-qualified capital interest (*i.e.*, 30 percent times 70 percent), for a total of 51 percent to the non-qualified interest, and 49 percent to the qualified investment (*i.e.*, 70 percent times 70 percent).

These rules present a double-edge sword. On the one hand, 51 percent of all distributions will be treated as made to the non-qualified interests, which is advantageous to help limit inclusion events. However, the same advantage is reversed after the partner has held its QOF investment for 10 years, as only 49 percent is eligible for the full fair market value basis step up.

Conclusion

In general, the April Proposed Regulations are a welcome addition to the O-Zone rules and include many taxpayer friendly provisions, specifically with respect to leases. However, as we discussed in our last column and here, there are still unresolved issues. While investors do appear to be making O-Zone investments, these unresolved issues will hamper development in O-Zones. Treasury and the IRS should be commended for their efforts in releasing guidance thus far, but, unfortunately, time is still of the essence to publish rules in final form and to address as many unresolved issues as possible.

ENDNOTES

[1] REG-1201860-18, 84 FR 18652.
[2] Code Sec. 1400Z-2.
[3] REG-115420-18, 83 FR 54279.
[4] Code Sec. 1400Z-2(d)(1).
[5] Code Sec. 1400Z-2(d)(2)(B) and (C). Additionally, a rule similar to Code Sec. 1202(c)(3) applies to O-Zone Stock. Code Sec. 1400Z-2(d)(B)(ii).
[6] Code Sec. 1400Z-2(d)(2)(B)(i)(III) and (C)(iii); Code Sec. 1400Z-2(d)(3)(A)(i).
[7] Code Sec. 1400Z-2(d)(2)(D).
[8] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(B).
[9] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(B)(1).
[10] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(B)(6).
[11] 84 FR at 18,656.
[12] *Id*.
[13] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(B)(2).
[14] *Id*.
[15] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(B)(3).
[16] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(B)(4).
[17] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(B)(5).
[18] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(B)(7).
[19] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(B)(5).
[20] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(B)(6).
[21] *Id*.
[22] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(E). Note, any prior lease payments under the lease are disregarded.
[23] Proposed Reg. §1.1400Z2(d)-1(b)(1).
[24] *Id*.
[25] Proposed Reg. §1.1400Z2(d)-1(b)(2)(ii).
[26] *Id*.
[27] Proposed Reg. §1.1400Z2(d)-1(b)(3).
[28] Proposed Reg. §1.1400Z2(d)-1(b)(3)(iii)(C).
[29] Proposed Reg. §1.1400Z2(d)-1(c)(4)(i)(A).
[30] Code Sec. 1400Z-2(b)(1) and Proposed Reg. §1.1400Z2(b)-1(b).
[31] Proposed Reg. §1.1400Z2(b)-1(c)(1).
[32] Proposed Reg. §1.1400Z2(b)-1(c)(1)(i) and (ii).
[33] Proposed Reg. §1.1400Z2(b)-1(c)(6)(ii)(B). However, if the QOF has made an election under Code Sec. 754, such a transfer may inadvertently cause a negative basis adjustment under Code Sec. 743 that may be unwanted.
[34] *Id*.
[35] Proposed Reg. §1.1400Z2(b)-1(c)(6)(ii)(C).
[36] *Id*.
[37] *Id*.
[38] American Bar Association, Section of Taxation, "Comments on Proposed Regulations Regarding Investments in Qualified Opportunity Funds Under Section 1400Z-2," July 1, 2019.
[39] Proposed Reg. §1.1400Z2(b)-1(c)(6)(iii).
[40] Proposed Reg. §1.1400Z2(b)-1(c)(6)(v).
[41] Proposed Reg. §1.1400Z2(a)-1(b)(9)(i).
[42] Proposed Reg. §1.1400Z2(a)-1(b)(10)(ii)(A)(1).
[43] Proposed Reg. §1.1400Z2(a)-1(b)(10)(ii)(A)(2).
[44] *Id*.
[45] Proposed Reg. §1.1400Z2(b)-1(g)(3).
[46] Proposed Reg. §1.1400Z2(b)-1(c)(6)(iv).
[47] Proposed Reg. §1.1400Z2(a)-1(b)(9)(ii).
[48] 84 FR at 18,663; *see also* Rev. Rul. 84-53, 1984-1 CB 159.
[49] Proposed Reg. §1.1400Z2(b)-1(c)(6)(iv)(A).
[50] Proposed Reg. §1.1400Z2(b)-1(c)(6)(iv)(B).
[51] *Id*.
[52] Proposed Reg. §1.1400Z2(b)-1(c)(6)(iv)(D).
[53] *Id*.