The Recent Qualified Opportunity Zone Guidance: What We Know, What We Don't and What It All Means

By: Jenny H. Connors

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On Friday, October 19, 2018, the U.S. Treasury Department issued its first tranche of qualified opportunity zone (?OZ?) proposed regulations.[1]

Simultaneously, the IRS released Revenue Ruling 2018-29, which addresses the meanings of ?original use? and ?substantial improvement? under 1400Z-2(d)(2)(D). Both the proposed regulations and the ruling provide answers to many questions that were impediments to the utilization of the OZ incentive, and, with the incentive?s ?window of opportunity? narrowing, [2] this highly-anticipated guidance is a welcome relief for qualified opportunity funds (?QOFs?) and investors looking to optimize OZ benefits.

This article summarizes the OZ guidance from Treasury and the IRS and analyzes the impact of the guidance on OZ transactions. In addition, this article considers the questions left unanswered by the proposed regulations and the ruling and contemplates the issues that may (or may not) be covered by subsequent regulations and other guidance.

A Summary of the Recent Guidance

<u>The Proposed Regulations</u>

Gain Deferral

Eligible Gains ? Any gain that is recognized before January 1, 2027 and that is treated as a capital gain for federal income tax purposes is eligible for deferral. However, gains arising from a sale or exchange with a ?related person? are not eligible gains.

Preservation of Gain Attributes ? The tax attributes of deferred eligible gains are preserved during the deferral period. A taxpayer must take those attributes into account when the deferral period ends.

FIFO Gain Recognition ? If separate investments in the same QOF result in indistinguishable property

rights in that QOF, any sales or exchanges of the QOF?s interests must be identified on a first-in, first-out (?FIFO?) basis. Where the FIFO method is inapplicable (e.g., when different gains are used to purchase a single QOF interest), a taxpayer must include the attributes of any recognized gain on a proportionate basis.

Eligible Investments ? To qualify for deferral, an investment in a QOF must be an equity investment. Such equity investments may include preferred stock or partnership interests with special allocations. Debt investments, however, are not eligible investments.

The Investment Period ? A taxpayer?s 180-day period to invest in a QOF begins on the date on which its capital gain would be recognized for federal income tax purposes. See below for a discussion on the investment period applicable to capital gains otherwise recognized in partnerships or other flow-through entities.

Flow-Through Elections ? A partnership may make a deferral election for its eligible gain. If it makes the deferral election, no part of the deferred gain is included in the distributive shares of its partners. If the partnership does not elect to defer its eligible gain, such gain is included in the distributive shares of its partners. Each partner, in turn, may make its own deferral election with respect to its share of such gain. To the extent that a partnership forgoes a deferral election, its partners have 180 days to make the deferral election. This 180-day period begins on the last day of the partnership?s taxable year. If, however, a partner knows or has information regarding the date of the partnership?s gain recognition event, such partner may choose to begin its 180-day period as of that date.[3]

The Deferral Election Form ? Taxpayers will make deferral elections on Form 8949, which will be attached to the applicable federal income tax return for the year of deferral.

Subsequent Deferral Election ? If a taxpayer sells or exchanges a QOF investment, and that sale or exchange triggers the inclusion of deferred gain, the taxpayer may make a new qualifying investment in a QOF to defer the inclusion of the previously deferred gain. This reinvestment option is only available if the taxpayer disposes of its entire initial QOF investment. The same 180-day investment window applicable to the taxpayer?s initial QOF investment also applies to any subsequent QOF investment.

Basis Step-Up

The Basis Step-Up Election ? The basis step-up election for investments held at least ten years is dependent upon the deferral election. A taxpayer must make the deferral election to be permitted to make the basis step-up election after ten years.

The Expiration of OZ Designations ? The expiration of the OZ designations in 2028 does not affect a taxpayer?s ability to make the basis step-up election. A taxpayer?s ability to make the basis step-up election is preserved until December 31, 2047, giving taxpayers up to 20 ½ years after the last possible QOF investment date to sell their QOF investment and step up their basis to fair market value[4]

QOF Certification and Compliance

Eligible Entities ? A QOF must be an entity that is classified as a U.S. corporation or a partnership for federal income tax purposes (e.g., a limited liability company that is treated as a partnership for federal income tax purposes). Pre-existing entities may certify as QOFs so long as they meet all other requirements for QOFs.

QOF Certification ? It is anticipated that QOFs will use Form 8996 to both certify their QOF status and to file annual reports relating to their compliance with the 90% asset test. QOFs will file Form 8996 with their federal income tax return for the relevant tax year.

Commencement of QOF Status ? QOFs may identify both the taxable year and the month in which their QOF status began. If no month is identified, the first month of a QOF?s taxable year will be treated as the entity?s first month of QOF eligibility.

QOF Testing Dates ? If a QOF identifies a month other than the first month of the taxable year, the applicable date for the 90% net asset test shift based on the first 6-month period of the QOF?s taxable year (e.g., a March identification will give rise to an October testing date). To the extent that a QOF identifies a month that is 6 months after the start of its taxable year (e.g., June for a calendar-year taxpayer), the last day of the QOF?s taxable year will be the only testing date of the QOF?s first year.

Measuring Net Assets ? In calculating their net assets for purposes of the 90% net asset test, QOFs will be required to use the asset values set forth on their applicable financial statement for the taxable year. To the extent that a QOF does not have such financial statements, the QOF must use the cost of its assets.

Mixed-Use QOFs ? A taxpayer?s deemed contribution of cash to a partnership under Code Section 752(a) will not constitute an investment in a QOF that gives rise to a mixed-use fund.

OZ Businesses

Reasonable Working Capital ? QOF investments in OZ businesses may utilize a 31-month working capital safe harbor for deploying financial property to start a new business or construct or rehabilitate property. Under the safe harbor, the QOF must develop a written plan that identifies the financial property, provides a plan for the financial property and includes a written schedule for the deployment of such property that is consistent with ordinary business operations.

Substantially all ? ?Substantially all,? or at least 70%, of an OZ business?s tangible property (whether owned or leased) must be OZ business property.

Revenue Ruling 2018-29

?Original Use?

With respect to the ?original use? requirement in Code Section 1400Z-2(d)(2)(D), a QOF will never be treated as the original user of land in an OZ. As such, a QOF must substantially improve land for it to qualify as OZ business property.

?Substantial Improvement?

To substantially improve a building within an OZ, a QOF, or an OZ business, must, over a 30-month period, make additions to its basis in the building that exceed an amount equal to its adjusted basis of the building at the beginning of that 30-month period. The cost of the underlying land is not included in the QOF?s or OZ business?s adjusted basis of the building, and the land does not need to be substantially improved to qualify as OZ business property.

An Analysis of the Guidance

Once again, the OZ Incentive is the gift that keeps giving. The guidance in both the proposed regulations and the ruling is highly favorable to taxpayers. In nearly every instance, the proposed regulations provide for flexibility and inclusiveness. Similarly, the ruling, which arguably includes the most beneficial new guideline for those with real estate, may bring additional OZ opportunists into the fold.

For many developers and business owners seeking OZ investors, the substantial improvement hurdle was a high one. Based on the ruling, though, a QOF or OZ business with real estate need only improve a building to the extent of its adjusted basis in that building, not including the underlying land. This ruling may lower the substantial improvement threshold significantly, depending on the cost basis that a QOF or OZ business allocates to land.

The clarification of eligible gains is much more inclusive than some were anticipating. While eligible gains are limited to capital gains, there is no limitation as to the type of capital gain that may be invested in QOFs, so short-term capital gains should qualify. In addition, Section 1231 gains, unrecaptured 1250 gains, REIT capital gain dividends, collectibles gains and certain Section 1256 contract gains should be eligible gains. The attributes of those gains are preserved throughout the deferral period, which ends December 31, 2026.

The proposed regulations relating to partner elections also are very beneficial, providing partners with significant time to defer the recognition of their distributive shares of flow-through capital gains[5] To the extent a partner has knowledge of a capital gain event at the partnership level, it may begin its 180-day period as of that date, but it is not required to do so. Thus, a partner with knowledge of a capital gain event at the partnership level may have well over 180 days to identify and invest in a QOF.

The proposed regulations clarify that taxpayers may make subsequent deferral elections through June 2027. To the extent a taxpayer sells or exchanges its QOF investment prior to December 31, 2026, and that sale or exchange would trigger gain recognition, the taxpayer may make a subsequent deferral election to avoid the recognition of that gain. Though the holding period for the subsequent QOF investment would be less than that of the initial QOF investment, the taxpayer would have the

opportunity to reinvest its deferred gains and take advantage of the basis step-up election.

Some feared that the expiration of the OZ designations in 2028 would mean that only those QOF investments made on or before December 31, 2018 would reap the benefit of the basis step-up election. Nevertheless, the proposed regulations favorably preserve the availability of the basis step-up election through December 31, 2047 for QOF investments made as late as June 2027. While a delayed investment could lose out on temporary deferral or the basis increases in years 5 and/or 7, the investment still would be eligible for the basis step-up election after December 31, 2036. The optimal time to invest in a QOF continues until December 31, 2019, but, this extension of the basis step-up election likely means that QOF investments may continue even after the deferral period ends.

The reasonable working capital safe harbor for OZ businesses is very generous. It provides OZ businesses with a period of up to 31 months to deploy their investments without triggering a violation of the nonqualified financial property limitation. QOFs requiring more than six months to utilize their investments likely will hold OZ business property through an OZ business to take advantage of this ?grace? period.[6]

At 70%, the ?substantially all? threshold applicable to tangible property used by an OZ business in the active conduct of its trade or business is very lenient. Applying the 90% net asset test and the 70% substantially all test, OZ businesses need only hold 63% of their tangible property in OZ business property. That said, if a QOF wishes to hold tangible property outside of an OZ, it has much greater flexibility in an ?indirect-hold structure? (i.e., where a QOF holds OZ business property through an OZ business), as opposed to a ?direct-hold structure? (i.e., where a QOF holds OZ business property directly), which must meet the 90% test. Similarly, if it will not meet the substantial improvement test, an indirect-hold structure permits a lower threshold.

The proposed regulations also permit QOFs to employ preferred stock or special allocations for their investors. While many similar tax incentives and credits prohibit non-pro-rata distributions to investors, the OZ incentive is likely to be more attractive given that investors may receive a preferred return for their investments.

Unanswered Questions

One of the more confounding provisions of the proposed regulations is the reasonable working capital safe harbor for OZ businesses, as no similar safe harbor was included for QOFs that hold OZ business property directly.[7] An open item that, hopefully, will be addressed in subsequent regulations is whether a similar deployment period applies to QOFs. Nevertheless, without definitive guidance on this point, QOFs that hold OZ business property must spend their cash investments in advance of the measuring dates to ensure compliance with the 90% net asset test.

The OZ statute gives Treasury the authority to issue rules relating to a QOFs redeployment of returns of capital from the sale of OZ property. Specifically, the statute permits Treasury to determine a QOF?s ?reasonable period of time? to reinvest a return of capital from such a sale. This set of regulations did not address the meaning of ?reasonable period of time,? but it did indicate that such guidance would be forthcoming in the second tranche of OZ regulations. Treasury also put off answering questions

regarding gains from such sales and whether those gains could be deferred recycled into new OZ property.

Another significant matter that was not addressed by the proposed regulations was the treatment of losses in a QOF taxed as a partnership for federal income tax purposes. To the extent that a QOF or an OZ business is generating deductions, many investors are interested in whether their shares of such losses or deductions have to be suspended as a result of the $0 basis rule, or, in the alternative, whether they can utilize debt to take losses and deductions of the partnership.[8] Absent OZ regulations to the contrary, the general debt allocation and basis rules of subchapter K presumably apply.

One question that was not answered is what constitutes a ?trade or business.? Pursuant to the OZ statute, OZ business property is tangible property that is used in a ?trade or business? of a QOF. This first set of regulations was silent as to the meaning of ?trade or business.? Similarly, Treasury did not address the meaning of the phrase ?active conduct,? which relates to the level of activity required of an OZ business engaged in a ?trade or business.? In an example under the regulations, Treasury did indicate that commercial construction activities of an OZ business would constitute the active conduct of a trade or business for purposes of the OZ statute. Since the regulations only address construction activities in the context of an OZ business, QOFs may opt to engage in such activities indirectly through an OZ business.[9]

Finally, though Treasury addressed the meaning of ?substantially all? in the context of tangible property owned or leased by an OZ business in an OZ, it did not address the meaning of that term in other parts of the statute. Per the regulations, the meaning of ?substantially all? in other portions of the statute will be addressed in subsequent regulations.

Thoughts Going Forward

The proposed regulations and the ruling should provide QOFs, developers, investors and their advisors with sufficient information to finalize fund documents, pursue and make investments and close on property or business acquisitions. Given the generosity of Treasury and the IRS in this recent round of guidance, the OZ playing field is apt to be crowded. Nevertheless, all parties should be cognizant of the unanswered questions, giving particular attention to QOF structuring considerations.

Williams Mullen will continue to update you on OZ guidance as it is released. In the meantime, if you have any OZ questions, please contact a member of our OZ team, or visit our OZ resource page.

[1] In its ?Explanation of Provisions? to the OZ proposed regulations, Treasury indicated that another set of ?soon-to-be-released? regulations are forthcoming.

[2] The optimal benefits of the incentive are realizable through

December 31, 2019. QOF investments made before that date take advantage of maximum deferral (until December 31, 2026) as well as a 15% basis increase.

[3] Analogous rules apply in the case of other flow-through entities, such as S corporations or trusts.

[4] The last possible date for an investor to make a QOF investment would be in June 2027, which is 180 days after December 31, 2026.

[5] Note, however, that a partner may only make a deferral election to the extent that the partnership forgoes its deferral election. Tax partnerships and their partners should take care to address partnership OZ elections and whether a partnership?s managers have a duty to inform its partners of a capital gain event.

[6] The six-month period references the measuring dates for the 90% net asset test. A QOF must test its compliance with this test as of the last day of the first six-month period of its taxable year and again on the last day of its taxable year. Absent this safe harbor, an OZ business with undeployed investor cash could cause its upper-tier QOF to fail the 90% net asset test. Notably, this safe harbor is not extended to QOFs that hold OZ business property directly. See below for a further discussion of this point.

[7] This safe harbor goes on a long list of differences between a direct-hold structure versus an indirect-hold structure.

[8] Taxpayers who invest deferred capital gains in a QOF and make a qualifying deferral election take a $0 basis attributable to that investment. This $0 basis preserves the taxpayer?s unrecognized capital gain.

[9] A big question is whether rental activities, alone, will constitute a ?trade or business? and/or the ?active conduct? of such a trade or

business. If Treasury remains silent on these points, QOFs and their advisors should consider the meanings applied to those terms under analogous tax incentives.

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- Jenny H. Connors ? 804.420.6582 ? jconnors@williamsmullen.com

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