

Treasury Issues Qualified Opportunity Fund Proposed Regulations

by Jack J. Miles



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In this article, Miles discusses salient provisions of the proposed regulations on qualified opportunity funds.

On October 19, 2018, Treasury released the highly anticipated proposed regulations (REG-115420-18) on qualified opportunity funds (QOFs). The proposed regs answer many, but not all, questions that have been raised regarding the new QOF tax regime, and therefore this article discusses some of the salient provisions of the proposed regs.

Overview of QOF Legislation

The Tax Cuts and Jobs Act (P.L. 115-97), enacted December 22, 2017, created the QOF tax regime to encourage economic development by providing investors with significant tax benefits for investments in designated low-income census tracts known as qualified Opportunity Zones (QOZs).

Under the QOF tax rules, taxpayers can generally defer the recognition of taxable gain in connection with the sale of property by investing the gain in a QOF within 180 days of the date of sale.¹ Deferred gain can be reduced by up to 15

percent if the taxpayer holds an interest in a QOF for seven years or more.² Deferred gain is generally recognized December 31, 2026, or the date on which the investment in the QOF is sold or exchanged, whichever is earlier.³ An additional incentive allows a taxpayer to permanently avoid the recognition of taxable gain on all the appreciation in the QOF if the taxpayer's investment in the QOF is held for at least 10 years.⁴

Tax Deferral Limited to Capital Gains

The proposed regulations provide that only capital gains are eligible for tax deferral.⁵ Thus, short-term capital gains and section 1231 gains could qualify for tax deferral, but depreciation recapture and ordinary income realized in connection with the sale of inventory would not.

The proposed regulations address two additional requirements that must be satisfied to qualify for tax deferral: First, the sale giving rise to the deferred gain must occur on or before December 31, 2026. Second, the gain must not be from a sale with a "related" person, as defined in section 1400Z-2(e)(2). Section 1400Z-2(e)(2) adopts the related person definition in sections 267(b) and 707(b)(1), but substitutes "20 percent" for "50 percent" in each place it appears in sections 267(b) and 707(b)(1).

The proposed regulations clarify that to qualify for tax deferral, an investment in the QOF must be an equity investment in the QOF, which

² Section 1400Z-2(b)(2)(B)(iv). If an investment in a QOF is held for five years or more, but less than seven years, the deferred gain can be increased by 10 percent of the gain initially reinvested in the QOF under section 1400Z-2(b)(2)(B)(iii).

³ Section 1400Z-2(b)(1)(A).

⁴ Section 1400Z-2(c).

⁵ Prop. reg. section 1.1400Z-2(b)(2).

¹ Section 1400Z-2(a)(1).

would include, among other things, preferred stock or a partnership interest with a special allocation.⁶

180-Day Rule for Deferring Gain

As noted above, to qualify for tax deferral, a taxpayer must generally invest in the QOF during the 180-day period beginning on the date of the sale that triggered the taxable gain.

Under a taxpayer-friendly rule, if a taxpayer initially acquires an interest in a QOF in connection with a tax-deferred transaction and later sells the QOF interest, the taxpayer can generally defer the recognition of gain in connection with the sale of its QOF interest by reinvesting in a QOF, but only if the taxpayer has completely disposed of its entire initial investment in the QOF.

Gains of Partnerships

The proposed regulations allow a partnership to elect tax deferral to the extent that it makes an eligible investment in a QOF.⁷ If a partnership makes the election, no part of the partnership's capital gain is included in the distributive share of the partners.

If a partnership does not elect to defer capital gain, the capital gain is generally taxable to its partners. A partner may, however, elect its own tax deferral regarding its distributive share of the partnership's capital gains by making an eligible investment in a QOF.⁸

The proposed regulations adopt a taxpayer-friendly 180-day rule, under which a partner's 180-day period generally commences on the last day of the partnership's tax year in which the gain is realized.⁹ A partner may elect, however, to apply the 180-day rule based on the actual date of sale by the partnership.¹⁰

Electing Tax Deferral — Self-Certification

The proposed regulations generally permit a qualifying taxpayer to self-certify as a QOF. Treasury and the IRS anticipate that taxpayers would use IRS Form 8996, "Qualified Opportunity Fund," both for initial certification and for annual compliance reporting.¹¹

Stepped-Up Basis for Investments Held 10 Years

A taxpayer that holds a QOF investment for at least 10 years may elect to step up the tax basis of the investment to its fair market value on the date that the investment is sold or exchanged.¹² Thus, a taxpayer could permanently avoid federal income taxation on any appreciation in value regarding its QOF investment.

The basis step-up election is only available for investments that are made with tax-deferred proceeds and a proper tax-deferral election under section 1400Z-2(a).¹³ The basis step-up election is not available to the extent that the QOF investment was made without tax-deferred proceeds or a tax-deferral election.

The proposed regulations recognize that a taxpayer may invest in a QOF in part with gains for which a tax-deferral election under section 1400Z-2(a) is made and in part with other funds for which no tax-deferral election is made. The tax code and the proposed regulations require that these two types of QOF investments be treated as separate investments, which are subject to different tax treatment.¹⁴

Effect of Expiration of Qualified Opportunity Zones

Under section 1400Z-1(f), designation as a QOZ remains in effect only through December 31, 2028. Treasury therefore had to consider whether investors could make the basis step-up election for QOF investments after 2028. The proposed regulations allow a basis step-up election until December 31, 2047.¹⁵

⁶ Prop. reg. section 1.1400Z-2(b)(3)(i).

⁷ Prop. reg. section 1.1400Z-2(c)(1)(i).

⁸ Prop. reg. section 1.1400Z-2(c)(2)(ii)(B).

⁹ Prop. reg. section 1.1400Z-2(c)(2)(iii)(A).

¹⁰ Prop. reg. section 1.1400Z-2(c)(2)(iii)(B).

¹¹ Prop. reg. section 1.1400Z-2(d)-(1)(a).

¹² Section 1400Z-2(c).

¹³ Prop. reg. section 1.1400Z-2(c)-1(a).

¹⁴ Section 1400Z-2(c)(1), prop. reg. section 1.1400Z-2(c)(1)(a).

¹⁵ Prop. reg. section 1.1400Z-2(c)(1)(b).

Limited Liability Companies

Before the issuance of the proposed regulations, it was not clear that a limited liability company could qualify as a QOF, because to constitute a QOF under section 1400Z-2(d), the investment vehicle must be organized as a corporation or a partnership. Although an LLC with multiple members is generally classified as a partnership for federal income tax purposes, it is arguable that it is not organized as a partnership.

Under the proposed regulations, it appears likely but far from certain that an LLC classified as a partnership for federal income tax purposes could qualify as a QOF if it otherwise satisfies the requirements of the proposed regulations.¹⁶

Designating When a QOF Begins

The proposed regulations allow a QOF to select the first month in its tax year that it would be treated as a QOF.¹⁷ This would not have to be the same month that the QOF is organized. Tax deferral is only available, however, for investments in a QOF. Accordingly, tax deferral would not be available for an investment in an entity before the date in which the entity qualifies as a QOF.¹⁸

Qualified Opportunity Zone Property

A QOF is defined as an investment vehicle organized as a corporation or partnership for investing in “qualified opportunity zone property,” defined below (other than another QOF).¹⁹ To satisfy this requirement, a QOF must generally hold at least 90 percent of its assets in QOZ property.

QOZ property is defined as “qualified opportunity zone stock,” a “qualified opportunity zone partnership interest,” or “qualified opportunity zone business property.”²⁰

Thus, a QOF could invest in QOZ business property either directly or through an equity

interest in a subsidiary partnership or corporation.

To constitute QOZ business property, tangible property must be acquired by purchase after December 31, 2017, from a person that is not related to the buyer, and either (A) the original use of the property in the QOZ must commence with the QOF, or (B) the QOF must substantially improve the tangible property.²¹ Tangible property is treated as substantially improved by the QOF only if, during any 30-month period beginning after the date of acquisition of the tangible property, additions to basis regarding the tangible property in the hands of the QOF exceed the QOF’s adjusted basis in the property at the beginning of the 30-month period.²²

QOZ stock is any stock in a domestic corporation if (1) the stock was acquired by the QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash; (2) as of the time the stock was issued, the corporation was a QOZ business (or, in the case of a new corporation, the corporation was being organized for purposes of being a QOZ business); and (3) during substantially all of the QOF’s holding period for the stock, the corporation was a QOZ business.

A QOZ partnership interest is any capital or profits interest in a domestic partnership if (1) the interest was acquired by the QOF after December 31, 2017, from the partnership solely in exchange for cash; (2) as of the time the interest was acquired, the partnership was a QOZ business (or, in the case of a new partnership, the partnership was being organized for purposes of being a QOZ business); and (3) during substantially all of the QOF’s holding period for the interest, the partnership qualified as a QOZ business.

A QOZ business is a trade or business in which (1) substantially all the tangible property owned or leased by the taxpayer is QOZ business property (determined by substituting “qualified opportunity zone business” for “qualified opportunity fund” in each place it appears); (2) at least 50 percent of its total gross income is derived

¹⁶ Prop. reg. section 1.1400Z-2(d)-(1)(a).

¹⁷ Prop. reg. section 1.1400Z-2(d)-1(a)(iii).

¹⁸ Prop. reg. section 1.1400Z-2(d)-1(a)(iii)(B).

¹⁹ Section 1400Z-2(d)(1).

²⁰ Section 1400Z-2(d)(2)(A).

²¹ Section 1400Z-2(d)(2)(D).

²² Section 1400Z-2(d)(2)(D)(ii).

from the active conduct of the business; (3) a substantial portion of its intangible property is used in the active conduct of the business; and (4) less than 5 percent of the average of the aggregate unadjusted bases of the property of the business is attributable to nonqualified financial property (that is, debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property, with an exception for reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less or accounts or notes receivable acquired in the ordinary course of a trade or business). Moreover, the business cannot be any private or commercial golf course; country club; massage parlor; hot tub facility; suntan facility; racetrack or other facility used for gambling; or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

As noted above, to qualify as a QOZ business, substantially all the tangible property owned or leased by the underlying entity must be QOZ business property. The proposed regulations provide that if at least 70 percent of the tangible property owned or leased by a trade or business is QOZ property, the trade or business is treated as satisfying the “substantially all” requirement in section 1400Z-2(d)(3)(i).²³

The 70 percent requirement will thus create an incentive for some QOFs to invest in a subsidiary partnership or corporation, rather than own QOZ business property directly. To illustrate, if a QOF holds \$10 million in assets that it plans to invest in real property, at least \$9 million (90 percent of the property) must be situated in the QOZ to satisfy the 90 percent asset test. By contrast, if the QOF invests in a subsidiary that holds real property, only \$7 million (70 percent) of the property must be located within a QOZ. Further, if the QOF only invests \$9 million in the subsidiary, which holds 70 percent of its assets within the QOZ, investors in the QOF could receive the QOF tax benefits while investing only \$6.3 million (63 percent) of its investment within the QOZ.

²³ Prop. reg. section 1.1400Z-2(d)(1)-(d)(3)(i).

90 Percent Test

The 90 percent test is applied based on the average of the percentage of QOZ property held in the QOF on the following two dates:

1. the last day of the first six-month period of the tax year of the QOF; and
2. the last day of the tax year of the QOF.²⁴

If a calendar-year QOF chooses a month after June to be its first month as a QOF, the only testing date for its first tax year is the last day of its tax year.

Preexisting Entities

The proposed regulations clarify that a preexisting entity may qualify as a QOF or as a subsidiary entity operating a QOZ business if the preexisting entity satisfies the requirements under section 1400Z-2(d).²⁵

Valuation Method of Applying the 90 Percent Test

If a taxpayer prepares financial statements that are filed with the SEC or with a federal agency other than the IRS, or if the taxpayer has certified audited financial statements prepared in accordance with U.S. generally accepted accounting principles, the values of the assets reported on the taxpayer's financial statements are applied for purposes of calculating the 90 percent asset test.²⁶ In all other cases, the proposed regulations require the QOF to use its cost basis of the assets on the date of acquisition.²⁷

Working Capital Safe Harbor

The proposed regulations adopt an important taxpayer-friendly working capital safe harbor for QOF businesses that acquire, construct, or rehabilitate tangible business property — which includes real property and other tangible property — used in a business operating in a QOZ. To qualify under this safe harbor, the following requirements must be satisfied:

1. the working capital is designated in writing for the acquisition, construction,

²⁴ Section 1400Z-1(d)(1).

²⁵ Prop. reg. section 1.1400Z-2(d)-1(a)(3).

²⁶ Prop. reg. section 1.1400Z-2(d)-1(b)(1).

²⁷ Prop. reg. section 1.1400Z-2(d)-1(b)(2).

- or substantial improvement of tangible property in a QOZ;
- 2. there is a reasonable written schedule for the expenditure of the working capital;
- 3. under the schedule, the working capital will be completely spent no later than 31 months after the amounts are invested in the QOF; and
- 4. the working capital is consumed in a manner that is consistent with the first three requirements.²⁸

The proposed regulations provide that if the working capital safe harbor applies, the tangible property subject to the written plan, which is intended to be QOZ business property once completed, will not fail to constitute QOZ business property during construction.²⁹

There is some uncertainty, however, whether this safe harbor would apply if the QOF directly owns the QOZ business property or whether it applies only to situations in which the QOF invests through a subsidiary partnership or corporation. This ambiguity arises because the proposed regulations provide for the safe harbor in connection with a QOZ business, which, by definition, applies only to a situation in which the QOF invests through a subsidiary partnership or corporation.

Despite the uncertainty, the preamble to the proposed regulations strongly suggests that Treasury did not intend to limit the working capital exception to situations in which the QOF operates through a subsidiary partnership or corporation. Moreover, there is no policy reason supporting the artificial distinction in the application of the working capital exception.

To resolve the ambiguity, Treasury and the IRS will probably have to issue additional guidance soon.

Treatment of Land

The proposed regulations and Rev. Rul. 2018-29, 2018-45 IRB 765, which was issued contemporaneously with the proposed regs, provide a taxpayer-friendly rule regarding the

treatment of land in connection with the rehabilitation of real property by a QOF.

In Rev. Rul. 2018-29, a building situated on land within a QOZ is treated as substantially improved (thus potentially qualifying as a QOF asset) if, during any 30-month period, additions to the taxpayer's basis in the building exceed an amount equal to the taxpayer's basis in the building at the beginning of the 30-month period. The guidance disregards the land in determining whether the building has been substantially improved.

In the revenue ruling, the QOF purchased a building and land for \$800x. Sixty percent (\$480x) of the purchase price was attributable to the value of the land and 40 percent (\$320x) of the purchase price was attributable to the value of the building. Within 24 months after the date of the acquisition of the property, the QOF invested an additional \$400x to convert the building to residential rental property. According to the revenue ruling, the QOF substantially improved the property because its additions to the basis of the building (\$400x) exceeded its adjusted basis in the building at the beginning of the 30-month period (\$320x).³⁰ The IRS further concludes in the guidance that the underlying land also constitutes QOZ business property.

Although the proposed regulations and Rev. Rul. 2018-29 address the treatment of land when it is purchased together with an existing building, they do not address how the purchase of unimproved land would be treated for QOF purposes.

Effective Date

In general, a taxpayer can rely on the proposed regulations if it applies the rules in their entirety and in a consistent manner. ■

²⁸ Prop. reg. section 1.1400Z-2(d)-1(d)(5)(iv).

²⁹ Prop. reg. section 1.1400Z-2(d)(5)(vii).

³⁰ See also prop. reg. section 1.1400Z-2(d)-1(d)(4)(ii).