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Treasury Releases Eagerly Awaited Qualified Opportunity Fund Proposed Regulations

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On October 19, 2018, the U.S. Department of the Treasury ("Treasury") released the highly-anticipated Qualified Opportunity Fund ("QOF") proposed regulations (the "Proposed Regulations"). This Client Advisory discusses salient provisions of the Proposed Regulations.

Overview of QOF Legislation

The Tax Cuts and Jobs Act, P.L. 115-97 (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 regime, investors 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. Deferred gain can be reduced by up to 15 percent if an investor holds an interest in a QOF for seven years or more.[1] Deferred gain is recognized upon the earlier of December 31, 2026, or on the date on which the investment in the QOF is sold or exchanged. An additional incentive allows a taxpayer to permanently avoid recognizing taxable gain with respect to all of the appreciation in the QOF if the taxpayer's investment in the QOF is held for at least ten years.

Tax Deferral Limited to Capital Gains

The Proposed Regulations provide that only capital gains are eligible for tax deferral. It appears that short-term capital gains qualify for tax deferral. Depreciation recapture and ordinary income realized in connection with the sale of inventory would not qualify for tax deferral.

Investments in a QOF

The Proposed Regulations clarify that, in order to qualify for tax deferral, an investment in the QOF must be an equity interest in the QOF, which would include preferred stock or a partnership interest with a special allocation.

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 subsequently sells the QOF interest, the taxpayer can generally defer

the recognition of gain in connection with the second sale, 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. If a partnership makes the election, then 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, then the capital gain is generally taxable to its partners. A partner may, however, elect its own tax deferral with respect to its distributive share of the partnership’s capital gains, by making an eligible investment in a QOF.

The Proposed Regulations adopt a taxpayer-friendly 180-day rule here. Under the general rule, a partner’s 180-day period commences on the last day of the partnership’s taxable year in which the gain is recognized. A partner may elect, however, to apply the 180-day rule based upon the actual date of sale by the partnership.

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, both for initial certification as well as for annual compliance reporting.

Step-Up in Basis Election for Investments Held at Least Ten Years

A taxpayer that holds a QOF investment for at least ten 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. Thus, a taxpayer could permanently avoid Federal income taxation with respect to any appreciation in value with respect to its QOF investment.

The basis step-up election is only available for investments that were made with tax-deferred proceeds and a proper tax-deferral election under Section 1400Z-(2)(a).[2] 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 Internal Revenue Code of 1986, as amended, and the Proposed Regulations require that these two types of QOF investments are treated as separate investments, which are subject to different tax treatment.

Impact of Expiration of Qualified Opportunity Zones

Under Section 1400Z-(1)(f), designation as a QOZ remains in effect only through December 31, 2028. Treasury considered whether, in light of the loss of QOZ status on such date, 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.

Limited Liability Companies (“LLCs”)

Prior to the release of the Proposed Regulations, there was some uncertainty as to whether an LLC could qualify as a QOF. It appears likely, but it is not absolutely certain, that under the Proposed Regulations, an LLC classified as a partnership for Federal income tax purposes could qualify as a QOF, assuming it otherwise satisfies the requirements of the Proposed Regulations.

Designating When a QOF Begins

The Proposed Regulations allow a QOF to select the first month in its taxable year in which it would be treated as a QOF. Tax deferral is only available, however, for investments in a QOF. Accordingly, tax deferral would not be available with respect to an investment in an entity prior to the date in which the entity qualifies as a QOF.

Qualified Opportunity Zone Property

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

"Qualified opportunity zone property" is defined as "qualified opportunity zone stock," a "qualified opportunity zone partnership interest," or "qualified opportunity zone business property."

To qualify as "qualified zone business property," (i) the "original use" of the property in the QOZ must commence with the QOF or (ii) the QOF must "substantially improve" the tangible property. Tangible property is treated as "substantially improved" by the QOF only if during any 30-month period beginning after the date of acquisition of such tangible property, additions to basis with respect to 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.

If a QOF operates a trade or business through an underlying entity, the QOF can satisfy the 90 percent-asset test if the underlying entity qualifies as a qualified opportunity zone business. To qualify as a qualified opportunity zone business, "substantially all" of the tangible property owned or leased by the underlying entity must be "qualified opportunity zone 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 "qualified opportunity zone property," then the trade or business is treated as satisfying the "substantially all" requirement in Section 1400Z-(2)(d)(3)(i).

The 70-percent requirement will thus incentivize certain QOFs to invest in a subsidiary qualified opportunity zone business, rather than owning 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 in order to satisfy the 90 percent-asset test. By contrast, if the QOF invests in a subsidiary that holds real property, then only $7 million (70 percent) of the property must be located within a QOZ. Furthermore, if the QOF only invests $9 million into 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.

Ninety-Percent Test

The 90-percent test is applied based upon 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 taxable year of the QOF, and

2. The last day of the taxable year of the QOF.

If a calendar year QOF chooses a month after June as its first month as a QOF, then the only testing date for its first taxable year is the last day of the QOF's taxable year.

Pre-existing Entities

The Proposed Regulations clarify that a pre-existing entity may qualify as a QOF or as a subsidiary entity operating a qualified opportunity zone business, provided that the pre-existing entity satisfies the requirements under Section 1400Z-(2)(d).

Valuation Method of Applying the Ninety-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. GAAP, then the values of the assets reported on the taxpayer's financial statements are applied for purposes of calculating the 90 percent asset test. In all other cases, the Proposed Regulations require the QOF to use its cost-basis of the assets on the date of acquisition by the QOF.

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 and/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 actually consumed in a manner that is consistent with the requirements in items 1 through 3 above.

Treatment of Land

The Proposed Regulations and Revenue Ruling 2018-29 (the "Revenue Ruling"), which was issued contemporaneously with the Proposed Regulations, provide a taxpayer-friendly rule regarding the treatment of land in connection with the rehabilitation of real property by a QOF.

The Revenue Ruling concludes that a building located 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 Revenue Ruling thus 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 invests an additional $400x in converting the building to residential rental property. The Revenue Ruling holds that 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). The Revenue Ruling further concludes that the underlying land also constitutes qualified opportunity zone business property.

Query

Although the Proposed Regulations and Revenue Ruling address the treatment of land where it is purchased together with an existing building, they do not address how the purchase of unimproved land would be treated for QOF purposes.

If you have any questions regarding qualified opportunity zones, please contact Jack Miles at jmiles@kelleydrye.com or (212) 808-7574, or any of the following members of the Kelley Drye & Warren LLP Tax Department:

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[1] 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.

[2] All section references are to the Internal Revenue Code of 1986, as amended.