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IRS and Treasury Issue Long-Awaited Proposed Guidance on Qualified Opportunity Fund Rules

On October 19, 2018, the Department of the Treasury and the Internal Revenue Service (the "IRS") issued proposed regulations (the "Proposed Regulations") under new section 1400Z-2 of the Internal Revenue Code (the "Code"),[1] relating to the highly publicized "qualified opportunity zone" ("QOZ") tax incentive program enacted as part of the 2017 tax reform bill. The QOZ regime provides taxpayers with the ability to defer recognition of investment gains by timely investing such gains in a qualified opportunity fund ("QOF"). The potential tax benefits of a properly structured QOF investment include deferral of tax (until 2026) on eligible gains invested in a QOF, partial exclusion of such gains if certain holding periods are achieved, and the elimination of all post-investment gain (attributable to appreciation in the QOF investment) so long as a ten year holding period requirement is met.

Along with the Proposed Regulations, the IRS issued Rev. Rul. 2018-29 (the "Revenue Ruling"), which addresses the "original use" and "substantial improvement" requirements under section 1400Z-2(d)(2)(D)(i). The IRS also released a draft of a new tax form, Form 8996, for QOF self-certification and annual reporting. The Proposed Regulations and Revenue Ruling provide long-awaited guidance for numerous stakeholders, including QOF investors, fund sponsors and developers, but a good degree of uncertainty remains in the application of section 1400Z-2, which further administrative guidance should address.

The significant points addressed by the Proposed Regulations and Revenue Ruling include:

- *Only Capital Gains Eligible for Deferral*: The statute itself is unclear regarding the types of gain eligible for deferral. The Proposed Regulations clarify that only gain treated as capital gain for U.S. federal income tax purposes is eligible. Thus, in addition to capital gains under section 1221, the Proposed Regulations would seem to allow deferral of section 1231 gain, which is treated as capital gain under the Code.

Conversely, gain that is treated as ordinary income under the depreciation recapture rules of sections 1245 and 1250 presumably is ineligible for deferral.

- *Eligible Taxpayers/Passthrough Entities*: The Proposed Regulations provide guidance on the application of the QOZ rules to passthrough entities. Importantly, where eligible gain is realized by a partnership, either the partnership itself or any of its partners may elect to defer the gain by reinvesting in a QOF. Prior to the Proposed Regulations, taxpayers were concerned that a literal interpretation of the statute required the same "taxpayer" that realized the eligible gain to make the QOF investment, a constraint that still applies in the section 1031 context. The Proposed Regulations also set forth timing rules for deferral elections by partners. The IRS has requested comments regarding analogous rules for passthrough entities other than partnerships, such as S corporations. Notably, the Proposed Regulations should permit "blocker" entities through which foreign and tax-exempt investors commonly hold interests, to defer any capital gains realized when the underlying investments are sold by the blockers. Furthermore, although foreign investors themselves are not excluded from the benefits of the QOZ rules with respect to otherwise eligible gains, the application of the rules in these circumstances, including the interaction with the FIRPTA regime, will likely require further clarification and guidance.
- *180-Day Deferral Window*: To defer gain through a QOF investment, a taxpayer must generally invest in the QOF during the 180-day period beginning on the date of the sale or exchange giving rise to the gain. In order to address certain categories of gain that are *deemed* to occur under tax principles, the Proposed Regulations logically provide that the 180-day period begins on the date on which the gain would be recognized for tax purposes (without regard to the deferral available under section 1400Z-2). For example, the 180-day period for a capital gain dividend received by a shareholder of a REIT begins on the day the dividend was paid to the shareholder.[2] In the case of a partnership that does not elect to defer recognition of capital gain realized by the partnership, a partner of that partnership may do so, in which case the 180-day period begins on the last day of the partnership's taxable year, as that is the day on which the partner would be required to recognize the capital gain if it were not deferred. The Proposed Regulations also provide that in the partnership scenario, a partner may choose to utilize the 180-day period applicable to the partnership (for example, if the partner wants to make a qualifying QOF investment prior to the end of the partnership's tax year).
- *Rollover of QOF Investments*: The Proposed Regulations permit a taxpayer that invests in a QOF and then disposes of that investment through a sale or exchange that would trigger recognition of the deferred gain to make a new QOF investment with that deferred gain, thereby further deferring the gain. In that case, to comply with the precise wording of the statute on this point, the Proposed Regulations require that the taxpayer dispose of its *entire* initial QOF investment in order to roll into the new QOF investment. The general rules governing the 180-day period apply to such rollovers. This tax deferred reinvestment flexibility at the investor level should provide considerable tax benefits to investors in QOFs structured as liquid vehicles, such as open ended real estate funds.
- *Preservation of Attributes of Deferred Gain*: The Proposed Regulations provide that the tax attributes of deferred gain are preserved through the deferral period and are taken into account when the gain is eventually recognized. In cases where a taxpayer disposes of part, but not all, of its interests in a QOF, the Proposed Regulations provide that the QOF interests are identified based on a first-in, first-out (FIFO) method. A pro-rata method is employed where the FIFO method does not provide a complete answer, for example where gains with differing attributes are invested in identical QOF interests at the same time.
- *Gains Realized in Straddle Transactions:* The Proposed Regulations provide that gain resulting from a position that is or has been part of an offsetting-position transaction, such as a straddle, is not eligible for deferral under section 1400Z-2.

- *Basis Step-Up for QOF Investments Held for 10 Years:* The most significant tax benefit associated with the QOZ rules is the complete exclusion of post-investment appreciation in a qualifying QOF investment that is held for at least ten years. This tax relief is provided through a basis step-up election made in connection with an eventual sale or exchange of the QOF investment. Because all QOZ designations are set to expire on December 31, 2028, there has been some uncertainty as to whether investors may make this basis step-up election for QOF investments made after 2018 (for which the eligible disposition would occur in 2029 or later). The Proposed Regulations clarify that the election may be made in connection with a disposition that occurs following the expiration of the QOZ designations. However, the Proposed Regulations preserve the election only through December 31, 2047, which is 20 1/2 years after the latest possible time at which an investor may make a QOF investment eligible for gain deferral.[3] The IRS has requested comment on the 2047 termination date, including as to whether taxpayers should automatically be granted a step-up immediately prior to the expiration of the election period if the investment has not been disposed of by such time.
- *QOF Status and Timing of the 90% Asset Test:* To maintain QOF status, a fund must hold at least 90% of its assets in "qualified opportunity zone property" on certain testing dates that occur generally every six months. The Proposed Regulations allow taxpayers to identify the taxable year in which an entity becomes a QOF and to choose the month during such year that it wishes its QOF status to become effective. Furthermore, with regard to the QOF's first taxable year, the 90% determination is made at the end of the first 6-month period of the fund's elected QOF status, and then again on the last day of the taxable year. If a QOF elects to commence its QOF status more than halfway through the taxable year, the only testing date for that year is the last day of the taxable year.
- *Reinvestment in Compliance with the 90% Asset Test:* If a QOF sells qualified opportunity zone property shortly before a testing date with respect to the 90% asset test described above, then it risks failing the test and losing its status as a QOF. To alleviate this, the Code authorizes regulations affording a QOF a "reasonable amount of time" to reinvest such proceeds in order to bring itself into compliance with the 90% asset test. In the preamble to the Proposed Regulations (the "Preamble"), the IRS has stated that forthcoming proposed regulations will provide guidance on such reinvestments.
- *"Substantially All" Requirement for QOZ Business Entities:* The Proposed Regulations generally preserved the somewhat puzzling distinction between QOZ property held directly by a QOF and one held by a partnership or corporate subsidiary of the QOF (in which case the governing asset test is the "substantially all" test further described below). More specifically, QOFs that hold QOZ property directly must meet the 90% asset test described above. For these purposes, only tangible property purchased from unrelated persons may qualify,[4] and therefore intangible assets and working capital (including cash) are not treated as qualifying assets. Where a QOF holds its property through a partnership or corporate subsidiary, the entire interest in the entity is treated as qualifying property so long as the subsidiary constitutes a "qualified opportunity zone business" ("QOZB"). QOZB qualification involves tests that relate to the gross income of the business as well as the composition of its intangible property. It also requires that "substantially all" the tangible property of the entity constitute QOZ business property. The Proposed Regulations establish a 70% threshold for these purposes. Significantly, intangible assets and working capital (taking into account the safe harbor described immediately below) may generally be held by a QOZB (contrary to a QOF holding such assets directly), creating a strong bias for QOFs in favor of holding assets through subsidiary QOZB entities.
- *Working Capital Safe Harbor:* QOZB designation also requires that less than 5% of the entity's unadjusted basis in its property is "nonqualified financial property" ("NQFP"). The Proposed Regulations provide a safe harbor which allows certain financial property (i.e., cash and other property which would otherwise be treated as NQFP) to be treated as "reasonable working capital" (and thus not as NQFP). To qualify for the safe harbor, such property must be held by the business for a period of up to 31 months and meet certain documentation requirements regarding its intended

deployment as working capital. Importantly, the Proposed Regulations do not treat the reasonable working capital as "qualifying" QOZ assets generally.[5] In other words, reasonable working capital will not cause a QOZB to fail the 5% NQFP test, but it does not help the QOZB satisfy the 70% asset requirement.

- *Eligible QOF Entities:* The Proposed Regulations clarify that any entity treated as a corporation or partnership for federal income tax purposes may certify as a QOF. While there has been uncertainty whether a state law limited liability company could qualify as a QOF, the Proposed Regulations confirm that it may.
- *Mixed Funds:* In situations where only a portion of a taxpayer's investment in a QOF represents gain rolled over under the QOF provisions, the QOZ rules bifurcate the investment into two separate components, each with its own set of federal income tax consequences. Prior to the issuance of the Proposed Regulations, commentators were unsure of whether the deemed contribution of cash occurring by reason of a partner's increase in its share of partnership liabilities under section 752 would be treated as an investment of nonqualifying capital, thereby giving rise to a mixed fund. The Proposed Regulations clarify that such deemed contributions do not constitute an investment in the QOF for these purposes.[6]
- *Treatment of Land:* The Revenue Ruling provides that while an existing building and land cannot satisfy the "original use" requirement, the basis allocated to purchased land is not taken into account for purposes of testing whether the building has been "substantially improved." Furthermore, land need not be separately improved. The Preamble asserts that these rules "facilitate repurposing vacant buildings in qualified opportunity zones." Importantly, the Revenue Ruling only addresses a situation in which a QOF purchases an existing building. It is not clear how the "substantial improvement" requirement applies to a purchase of a vacant lot acquired for development. Some commentators have expressed concern that excluding land value from this computation will allow investors to engage in "land banking" subsidized by the QOF regime. To be sure, the "trade or business" requirement provides a check on such strategies, but additional guidance on the treatment of undeveloped land would provide welcome certainty to real estate developers.

The Proposed Regulations represent a promising start to the QOZ guidance project. However, numerous uncertainties still exist and taxpayers will still be required to make certain assumptions when structuring QOF investments. Nonetheless, because of the unmistakable significance of the tax benefits involved, we expect the pace of QOZ investment activity to pick up considerably, especially as the IRS issues additional clarifying guidance in the near future.

[1] All "section" references hereunder are to the Code unless otherwise indicated.
[2] This timing rule may still present challenges for recipients of REIT capital gain dividends. The IRS and Treasury will hopefully address this and similar issues when additional guidance is published.
[3] Only gains realized by December 31, 2026 may be deferred under the QOZ rules. The end of the 180-day period for such a gain transaction would be June 30, 2027. The ten year holding period would be satisfied in June 2037, and taxpayers would then have another ten years to hold and dispose of the investment.
[4] The related party limitation creates challenges in many situations. For example, certain joint ventures may need to utilize ground lease and other structures to avoid capitalizing a QOZB with nonqualifying land that would otherwise have been contributed by a related party.
[5] The Proposed Regulations state that the reasonable working capital rule applies "solely for purposes of applying section 1397C(e)(1) to the definition of [QOZB]." Section 1397C(e)(1) contains the NQFP rule.
[6] Presumably an increase in section 752 liability share is taken into account for other purposes, including increasing the investor's outside tax basis in the QOF partnership.