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Qualified Opportunity Zone Funds

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IRS Publishes Opportunity Zone Proposed Regulations: The First Important Step in the Structuring of OZ Funds

As part of the Tax Cuts and Jobs Act (the "TCJA"), a new tax incentive program was created to spur economic growth and investment in designated distressed communities (each an "opportunity zone" or "OZ"). Not only does the OZ incentive program allow for the deferral of certain capital gains to the extent such gain is invested in a qualified opportunity fund ("QOF"), but it also allows for income exclusion for gains on investments in QOFs that are held for at least 10 years. While the OZ incentive program was well-received, both practitioners and potential investors had many questions about the program that seemed to be unanswered by the initial provisions provided for in the TCJA.

As such, on October 19, 2018, the Treasury Department issued additional guidance for the OZ incentive program. Specifically, the Treasury Department issued a set of proposed regulations and a revenue ruling, both of which can be relied on by taxpayers. In addition to the proposed regulations and the revenue ruling, the Treasury Department also provided a draft Form 8996, the self-certification form for QOFs, and corresponding instructions for the form. Although the additional guidance answers many questions that investors and practitioners have about the OZ incentive program, there are still a number of unanswered questions (some of which the Treasury Department is soliciting additional comments on), which we expect to be addressed in additional tranches of guidance issuances from the Treasury Department.

ADDITIONAL GUIDANCE PROVIDED BY THE PROPOSED REGULATIONS

A highlight of the guidance from the proposed regulations is as follows:

Eligible Taxpayers

- Taxpayers that are eligible to defer gain under the OZ incentive program are those that recognize "capital gain" for federal income tax purposes.

- As such, individuals, C corporations (including REITs and RICs), partnerships, common trust funds, qualified settlement funds, disputed ownership funds, and certain other types of entities should qualify.

Gain Issues

- The OZ incentive program provides gain deferral for only *capital* gains (however, depreciation recapture may be eligible for deferral; more IRS guidance is needed).

• The gain to be deferred must be gain that would have been recognized (assuming that deferral under the OZ incentive program were not permitted) no later than December 31, 2026.

• In the case of a taxpayer who made an election to defer with respect to some but not all eligible gains, the term "eligible gain" includes the portion of the eligible gain as to which no election has been made.

• The gain to be deferred must not arise from a sale or exchange with certain related persons. Generally, the OZ incentive program adopts the related party rules found in Sections 267(b) and Section 707(b)(1) of the Internal Revenue Code (the "Code"), except that it substitutes "20 percent" in place of "50 percent" each place it occurs in Sections 267(b) or Section 707(b)(1). For example, a partnership and a person owning, directly or indirectly, more than 20 percent of the capital interest, or the profits interest of such partnership, are considered to be related parties.

• Except as otherwise provided for in provisions of the OZ incentive program, the first day of the 180-day period by which an investment of capital gains must be made into a QOF is the date on which the gain would be recognized for federal income tax purposes.

Gains of Partnerships and Other Pass-Through Entities

• A partnership may elect to defer all or part of a capital gain to the extent that it makes an eligible investment in a QOF. If so, no part of the deferred gain is required to be included in the distributive shares of the partners.

• If the partnership does not elect to defer capital gain, a partner may elect to defer gain with respect to its distributive share under the OZ incentive regime (provided that all other requirements have been met).

• A partner's 180-day period generally begins on the last day of the partnership's taxable year. A partner may also choose to begin its own 180-day period on the same date as the start of the partnership's 180-day period (in situations in which the partner knows both the date of the partnership's gain and the partnership's decision not to elect deferral).

Inclusion in Income When Deferral Ends

• All of the deferred gain's tax attributes are preserved through the deferral period and are taken into account when the gain is included.

• If a taxpayer disposes of less than all its fungible interests in a QOF, the interests that are disposed of are identified using a first-in, first-out method.

QOF Qualification

• A QOF must be classified as a corporation or partnership for federal income tax purposes. Thus, it seems that limited liability companies also should qualify since Treasury Regulation Section 1.1400Z-2(d)-1(a) states that it is "qualified as a corporation or partnership for *federal tax purposes*."

• A QOF must be created or organized in one of the 50 states, the District of Columbia, or a U.S. possession. If organized in a U.S. possession, then an entity must be organized for the purpose of investing in qualified opportunity zone ("QOZ") property that relates to a trade or business operated in the possession in which the entity is organized.

• There is no prohibition to using a "preexisting" entity as a QOF provided that all other requirements of the OZ incentive program are satisfied, including that QOZ property is acquired after December 31, 2017.

Investment in QOF

• To qualify for the OZ incentive program, an investment in a QOF must be an equity interest in the QOF, including preferred stock or a partnership interest with special allocations (*i.e.*, such investment cannot be a debt instrument within the meaning of Section 1275(a) and Treasury Regulation Section 1.1275-1(d)). Thus, convertible debt should not qualify for the OZ incentive program, but query whether certain types of debt instruments may also qualify as some of these instruments may be classified as equity for federal tax purposes.

• Provided that the eligible taxpayer is the owner of the equity interest, status as such is not impaired by the taxpayer's use of the interest as collateral for a loan.

• Deemed contributions of money under Section 752(a) of the Code do not qualify as an investment in a QOF, which is beneficial. (Although more IRS guidance is needed relative to the treatment of debt as applied to other OZ structural issues.)

Designating When a QOF Begins

• It is expected that Form 8996, the self-certification form, will be attached to a QOF's federal income tax return for the relevant tax years. On Form 8996, it appears that the penalty for non-qualification is calculated monthly, but such penalty does not apply to any months before the first month in which an eligible entity is a QOF.

• On Form 8996, a QOF is allowed to identify both: 1) the taxable year and 2) the first month in that year in which the entity becomes a QOF. If an eligible entity fails to specify the first month it is a QOF, then the first month of its initial tax year as a QOF is designated as the first month that the eligible entity is a QOF.

• The "first six-month period of the taxable year of the fund" under the 90 percent test means the first six-month period composed entirely of months that are within the taxable year and during which the entity is a QOF. For example, if a calendar year entity was created in February and chooses April as its first month as a QOF, then the 90 percent test dates are the end of September (which is six months from April 1) and the end of December. This means if a calendar year QOF chooses a month after June as its first month as a QOF, then the only testing date for that first taxable year is the last day of the QFO's taxable year.

Valuation Method for Applying the 90 Percent Asset Test

• For purposes of the 90 percent asset test of a QOF, the QOF is required to use the asset values that are reported on the QOF's applicable financial statement for the taxable year (namely, a financial statement within the meaning of §1.475(a)-4(h), which, generally, includes a financial statement filed with the SEC or one that has significant business use).

• This may present a problem for certain QOFs if GAAP financial statements are used since GAAP accounting takes into account impairment, depreciation, etc., which could strain the 90 percent asset test.

• If there is no applicable financial statement, then the QOF should use "cost of the asset." Presumably, this means original cost basis, without regard for depreciation.

Working Capital Safe Harbor

• A new working capital safe harbor is established for QOF investments in QOZ businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in an OZ.

• The safe harbor allows QOZ businesses to hold a reasonable amount of working capital (generally, cash, cash equivalents, or debt instruments with a term of 18 months or less) for 31 months if: 1) there is a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the OZ, 2) there is a written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months, and 3) the QOZ business complies with such schedule.

• Solely for purposes of applying the 50 percent active conduct test in section 1397C(b)(2), as required by the definition of a QOZ business, if any gross income is derived from a reasonable amount of working capital, then such gross income is counted toward satisfaction of such 50 percent test.

Basis Step-Up Election

• Taxpayers may make the election for a step-up in their QOF investments after the QOZ designation expires. Specifically, such election is preserved until December 31, 2047 (essentially allowing all QOF investments to qualify for the step-up).

QOZ Business Qualification

• Generally, to qualify as a QOZ business, "substantially all" of a corporation or partnership's tangible property owned or lease must be QOZ business property. In this context, "substantially all" means at least 70 percent.

• Note this means that if $100 were invested in a QOF, and the QOF decided to invest through a partnership or corporation, the proposed regulations dictate that a minimum of $63 must be QOZ business property (90 percent x 70 percent x $100). If the QOF operates a trade or business directly and does not equity in any QOZ business, then the 90 percent asset test would apply (*i.e.*, $90 must be QOZ property). Thus, there is an incentive for QOFs to invest in a QOZ business rather than holding QOZ business property directly.

QOZ Stock

• Certain redemption transactions will cause stock acquired by a QOF not to be treated as QOZ stock.

• For example, stock issued by a corporation is not treated as QOZ stock if, at any time during the two-year period beginning on the date one year before the issuance of such stock, the corporation made one or more purchases of its stock with an aggregate value exceeding five percent of the aggregate value of all of its stock as of the beginning of the two-year period.

ADDITIONAL GUIDANCE PROVIDED BY THE REVENUE RULING

The key takeaways of the new revenue ruling (Revenue Ruling 2018-29), which primarily addresses the concept of "original use," are as follows:

• If a QOF purchases an existing building located on land that is wholly within a QOZ, the original use of the building in the QOZ is not considered to have commenced with the QOF, and the requirement that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located.

• If a QOF purchases a building wholly within a QOZ, a substantial improvement to the building is measured by the QOF's additions solely to the adjusted basis of the building.

• Measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately improve the land upon which the building is located.

• By excluding the basis of land, the rules facilitate repurposing vacant buildings in QOZs.

KEY ISSUES STILL NOT ADDRESSED BY ADDITIONAL GUIDANCE

• The term "substantially all" is used in various places of the OZ incentive program. For example, for property to qualify as QOZ business property, during *substantially all* the QOF's holding period for such property, *substantially all* the use of such property must be in a QOZ. Further, for the definitions of "qualified opportunity zone stock" and "qualified opportunity zone partnership interest," during *substantially all* the QOF's holding period for such interest, such interest qualified as a QOZ business. What does this term mean as it is used in these other places?

• How long is the "reasonable period" for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty? The OZ incentive program provides that a QOF has "a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and to reinvest proceeds received from the sale or disposition of qualified opportunity zone business property." For example, if a QOF shortly before a testing date sells QOZ property, such QOF should have a reasonable amount of time in which to bring itself into compliance with the 90 percent asset test.

• In calculating the value of a QOF's assets, Form 8996's instructions allow the use of a certified audited financial statement that is prepared in accordance with GAAP. However, the proposed regulations' requirements are a bit more complex. Additional guidance is necessary to reconcile this conflicting guidance.

• Will there be any relief for a taxpayer that fails to reinvest eligible gain into a QOF within 180 days of the transaction that produced such gain? Currently, there is no such relief.

• Do Section 1231 gains need to be aggregated with Section 1231 losses in order to be an "eligible gain?" Section 1231 gains are only capital gains to the extent they exceed Section 1231 losses.

• There does not appear to be guidance on whether a new building built on unimproved land satisfies the "original use" and "substantial improvement" requirements for QOZ business property.

• The additional guidance does not appear to address leased property. How such property is accounted for may put pressure on the 90 percent asset test.

• How are interim gains—that is, gains recognized at QOF level—treated? For example, will such gains be eligible for deferral to the extent that they are reinvested?

• Is carried interest a qualifying investment in a QOF? Currently, there is no distinction for interest received for cash versus services.

• What other information reporting requirements are necessary under the OZ incentive program? For example, what are the forms and instructions by which an eligible taxpayer may elect to defer eligible gains?

• What are some examples that will lead to an entity's decertification as a QOF?

The issuance of the new proposed regulations with the accompanying ruling, is an important first step in an ongoing process to provide guidance to enable taxpayers to structure investments in OZFs. Blank Rome will provide further updates as they are released; clients should reach out to our Qualitied Opportunity Zone Funds group with any questions.

For additional information on Blank Rome's Opportunity Zone capabilities, please visit our Qualified Opportunity Zone Funds page or contact:

Michael I. Sanders
202.772.5808 | sanders@blankrome.com

Daniel R. Blickman
215.569.5373 | blickman@blankrome.com

Richard Chou
424.239.3477 | rchou@blankrome.com