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Update on Qualified Opportunity Zones: First Set of Guidance Issued: Ballard Spahr

Ballard Spahr to hold webinar on November 1, 2018

The Tax Cuts and Jobs Act introduced a new tax-incentive program known as Qualified Opportunity Zones (QOZs). In 2018, governors of all 50 states, the District of Columbia, and the five U.S. possessions designated more than 8,700 QOZs. The program's benefits include gain deferral and gain elimination for taxpayers who roll over capital gain into a Qualified Opportunity Fund (QOF).

Specifically, if an investor (1) recognizes capital gain, (2) invests cash in an amount equal to the capital gain in a QOF within 180 days of the date the gain is recognized, and (3) makes an election (on IRS Form 8949) to treat the investment as a QOZ investment, the investor is eligible for the QOZ tax benefits. These benefits include (1) deferral of tax on the rolled-over gain until the earlier of the date the investor sells its interest in the QOF or December 31, 2026, (2) 10% of the investor's roll-over gain is eliminated if on or before December 31, 2026, the investor holds its interest in the QOF for at least five years and another 5% of the roll-over gain is eliminated if the investor holds its interest in the QOF on or before December 31, 2026, for a total of seven years (for a total gain elimination of 15%), and (3) if the investor holds its QOF interest for at least 10 years, the investor will pay no tax on any gain recognized when such QOF interest is sold. There is no tracing of funds to the proceeds of a sale that produces capital gain; the investor may obtain the cash from any source to invest an amount equal to the roll-over gain in a QOF. There are a variety of technical requirements a fund must satisfy to be a QOF. (See below and see our March 1, 2018, e-alert on qualified opportunity zones.)

Investors and promoters of QOFs have been anxiously awaiting guidance from the U.S. Department of the Treasury and the IRS on the issues raised by the statutory language creating this incentive program. On October 19, 2018, the first set of proposed regulations (Proposed Regulations) and a Revenue Ruling were released providing initial guidance on QOFs. At least two more proposed regulations packages are expected, one this year and one in the spring of 2019. The Proposed Regulations and Revenue Ruling address some of the important uncertainties necessary to implement this program, which is expected to stimulate a great deal of investment. Taxpayers may rely on the Revenue Ruling and taxpayers may rely on the Proposed Regulations—with certain limitations—before they are finalized.

INITIAL GUIDANCE

What type of gain may be rolled-over?

The Proposed Regulations clarify that only gain treated as capital gain may be rolled over into a QOF to obtain QOZ benefits. This includes long-term and short-term capital gain from the sale or exchange of a capital asset, gain that is treated as capital gain from the sale of a Section 1231 asset (depreciable property used in a trade or business held for more than one year and real property used in a trade or business held for more than one year other than dealer property, inventory and certain

other exceptions), and "unrecaptured section 1250 gain" (the gain on real estate currently subject to tax at a 25% rate). To be eligible for QOZ benefits, cash (not property) in an amount equal to the gain must be contributed to a QOF within 180 days of when the capital gain is recognized. The Proposed Regulations also provide that, subject to certain rules, eligible capital gain will include capital gain a QOF investor recognizes on the sale of a QOF interest on or before December 31, 2026.

What types of taxpayers may roll over cash equal to capital gains they recognize into a QOF?

Individuals, partnerships, corporations (including S corporations, REITs, and RICs), trusts, and estates may roll over gain into a QOF and obtain the tax benefits of investing in a QOF with respect to gains realized on or before December 31, 2026. The Proposed Regulations clarify that either a partnership or its partners may roll over gain realized by the partnership. If the partnership rolls over the gain, the partnership has 180 days from the sale that produces the gain to roll over the gain. If the partnership opts not to roll over the gain, one or more of the partners may roll over their share of the gain. If a partner rolls over gain, the partner's 180-day period starts from the last day of the partnership's tax year or, if the partnership notifies the partners of the date of the sale, at the election of a partner rolling over the gain, the partner's 180-day period may start on the date of the partnership's sale. Similar rules apply to S corporations, trusts and estates, and their shareholders and beneficiaries.

When does the ability of an investor to take advantage of the 10-year benefit expire?

Once a QOF investor has held its QOF interest for at least 10 years, the QOF investor can sell that interest and pay no tax on any gain. But, to be a QOF, a fund—among other things—must be invested directly or indirectly in a QOZ, and all QOZs expire on December 31, 2028. Therefore, there was concern that a fund no longer could qualify as a QOF when the QOZs expire. The Proposed Regulations solve this problem by providing that a QOF investor pays no tax on the sale of a QOF interest if (1) the QOF investor rolls over capital gain into a QOF in a timely manner, (2) the investor holds its QOF interest for at least 10 years, and (3) the QOF investor disposes of its QOF interest no later than December 31, 2047.

How does a fund qualify as a QOF?

To be a QOF, an entity must be certified and must satisfy three tests: (1) it is organized as a corporation or partnership (the Organization Test), (2) it is an investment vehicle formed for the purpose of investing in QOZ Property (the Purpose Test), and (3) at least 90% of the entity's assets are invested in QOZ Property (the 90% Asset Test). QOZ Property is (a) an entity interest in a subsidiary partnership or corporation [1] that is a QOZ Business, or (b) QOZ Business Property. For each month that a QOF does not satisfy the 90% Asset Test, it would owe a penalty. The Proposed Regulations provide clarification about the certification process and each of the three elements required to qualify an entity as a QOF.

FAQs published by the IRS in July 2018 indicated that an entity could self-certify as to QOF status. The Proposed Regulations state that self-certification will be accomplished by filing Form 8996 with the tax return filed for the first taxable year the entity "wants" to be a QOF. A draft of Form 8996 and accompanying instructions were released simultaneously with the Proposed Regulations.

With respect to the requirement that a QOF be organized as a corporation or partnership, the Proposed Regulations state that a QOF must be a corporation or partnership for federal income tax purposes, thus clarifying that an entity formed as a limited liability company under state law but

taxed as a partnership for federal income tax purposes is eligible for QOF status. Neither a QOF nor its subsidiary partnership can be a disregarded entity.

The Proposed Regulations place a special limitation on the Organization Test for a QOF formed under the laws of any one of the U.S. possessions (Puerto Rico, U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Marianas). Those entities may be a QOF only if organized for the purpose of investing in QOZ Property relating to a trade or business operated in that particular possession in which the entity is organized. This requirement is carried over to the definition of what investments in stock or partnership interests will be QOZ Property. A QOF formed under the laws of one of the 50 states or District of Columbia cannot treat as QOZ Property the acquisition of corporate stock or a partnership interest in a corporation or partnership formed under the laws of a possession. This limitation apparently reflects the IRS interpretation of the definition of "domestic" corporation or partnership for purposes of the Opportunity Zone benefits. The possession limitations are highlighted in the draft instructions to Form 8996.

With respect to the Purpose Test, Form 8996 requires that the entity certify that, by the end of the first tax year of the QOF, its organizing documents include (1) a statement that the entity's purpose is to invest in QOZ property, and (2) a description of the qualified opportunity zone business or businesses in which the QOF expects to directly or indirectly engage. It is not clear how much detail is required as to the description of businesses in the organizing documents, but the draft Form 8996 seems to expand the statutory requirement.

The Proposed Regulations state that there is no legal barrier to an existing entity filing Form 8996 to become a QOF—as long as the other requirements are met. Thus, an existing partnership or corporation could seek new cash equity infusions that would qualify for QOZ benefits, which likely would require amending the existing entity's organizing documents to substantiate the Purpose Test. This would mean that the existing entity would need to bifurcate the new qualifying investments from any prior investments for purposes of measuring the 90% Asset Test and for purposes of passing on the capital gains relief.

In self-certifying, the QOF also will specify on Form 8996 the first month of the initial year in which it wants to be a QOF. This date will be relevant not only for purposes of determining whether a qualifying investment has been made, but also for purposes of measuring the 90% Asset Test. Failure to identify the first month on Form 8996 will result in the IRS treating the first month of the entity's taxable year as the first month the entity intends to be a QOF.

As to the third requirement, the Initial Guidance describes how to establish the dates for measuring the 90% Asset Test and how QOZ investments are valued. The 90% Asset Test is based on the average of the QOF's assets on two snapshot dates: the last day of the first six months of a QOF's tax year and the last day of a QOF's tax year. (If a QOF has less than six months in its initial tax year, the only relevant date is the last day of its tax year.) The Proposed Regulations provide that—for purposes of determining if a QOF satisfies the 90% Asset Test—if the QOF prepares financial statements filed with the Securities and Exchange Commission or with a federal agency other than the IRS—or has certified audited financial statements that are prepared in accordance with Generally Accepted Accounting Principles (U.S. GAAP)—then the value of the assets reported on such financial statements are to be used for valuation of the QOF's assets. In other cases, the QOF's cost basis of the assets on the date of acquisition by the QOF is to be used. The Proposed Regulations also include special rules to permit a QOF to use the most favorable valuation method for a subsidiary that is a QOZ Business that is owned by multiple QOFs.

How are the terms QOZ Business Property and QOZ Business defined?

There are different requirements regarding the types of assets a QOF can own and operate directly and the types of assets a QOF's subsidiary can own and operate. The Proposed Regulations provide relatively little guidance on this aspect, reserving these issues for subsequent guidance. As discussed above, to be a QOF, 90% of a fund's assets must be composed of (1) interests in one or more corporate or partnership subsidiaries that qualify as QOZ Businesses and/or (2) QOZ Business Property. For a QOF's subsidiary to be a QOZ Business, substantially all (at least 70%, as defined in the Proposed Regulations) of its tangible property must be QOZ Business Property, it must not be a "sin business" (golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, or other facility used for gambling, or any store the principal purpose of which is the sale of alcoholic beverages for off-premises consumption), no more than 5% of its assets can be nonqualified financial assets (e.g. cash, stock, bonds, partnership interests, and options etc.), a substantial portion of its intangible assets must be used in the active conduct of its trade or business, and at least 50% of its gross income must be from the active conduct of a trade or business within the QOZ.

QOZ Business Property is property (1) purchased by a QOF or a subsidiary of a QOF (that is a QOZ Business) from an unrelated person (related means more than 20% common ownership) after December 31, 2017, [2] (2)(i) the original use of which in the QOZ commences with the QOF or its subsidiary (that is a QOZ Business) or (ii) the QOF or its subsidiary (that is a QOZ Business) substantially improves such property, and (3) substantially all of the use of such property is in a QOZ during substantially all of the time it is held by the QOF or the QOF's subsidiary (that is a QOZ Business).

Property is substantially improved if during any 30-month period during which it is owned by a QOF or its subsidiary, the QOF or its subsidiary essentially spends at least as much to improve the property as it spent to buy the property. The Revenue Ruling provides a taxpayer friendly rule applicable to a QOF or subsidiary of a QOF that buys land and improvements—that is for purposes of determining whether such land and improvements are substantially improved, the cost of the land is not included. For example, if a QOF's subsidiary buys land and a building for $100—$60 of which is allocable to the land and $40 of which is allocable to the building—the subsidiary is only required to spend $40 to satisfy the substantial improvement test. But, the land nevertheless remains in the numerator (assuming it was acquired from an unrelated person after 2017) to determine if substantially all (at least 70%) of the subsidiary's assets are QOZ Business Property. As a result, to determine if at least 70% of the QOF subsidiary's assets are QOZ Business Property in the prior example, the $60 allocable to the land is treated as QOZ Business Property. The Revenue Ruling does not address what constitutes a substantial improvement if the purchased asset is vacant land.

There are advantages and disadvantages if a QOF invests in a QOZ through a subsidiary QOZ Business, as opposed to investing directly. The advantages include that only 70% of the tangible assets of a QOZ Business must be QOZ Business Property, whereas a greater percentage (up to 90%) may be required if the QOF invests directly in QOZ Business Property. Also, a subsidiary QOZ Business can hold more working capital than can a QOF (see below). There also are certain disadvantages if a QOF invests in a QOZ through a subsidiary QOZ Business as opposed to directly. In contrast to a business conducted by a QOF itself, a subsidiary QOZ Business cannot be a sin business, 50% of such subsidiary QOZ Business' gross income must be from the active conduct of a trade or business, a substantial portion of the subsidiary QOZ Business' intangible assets must be used in the active conduct of its trade or business, and less than 5% of its assets can be nonqualified financial assets.

What does "substantially all" mean?

There are a variety of places where the QOZ rules use the term "substantially all." One such place is

in one of the requirements that a partnership or corporate subsidiary of a QOF must satisfy to qualify as a QOZ Business—i.e., that "substantially all" of the subsidiary's tangible assets (owned or leased) must be QOZ Business Property. The Proposed Regulations explain that substantially all for this purpose means 70%. The meaning of substantially all for other QOZ purposes remains undefined.

Can a QOF or its subsidiary hold working capital and for how long?

Unfortunately, the Proposed Regulations do not provide that a QOF can hold working capital as part of the assets that meet the 90% Asset Test. However, the Proposed Regulations establish a safe harbor for reasonable amounts of working capital that a QOF's Subsidiary (a QOZ Business) can hold. This safe harbor provides a QOF's subsidiary with greater flexibility to qualify as a QOZ Business as its property or business is being developed. In fact, the Proposed Regulations specify that reasonable working capital may be held by a QOF's subsidiary (a QOZ Business) if (1) the working capital amount is designated in writing for the acquisition, construction and/or substantial improvement of tangible property in a QOZ, (2) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital, (3) the working capital is spent within 31 months of receipt of such funds, and (4) the working capital actually is used in a manner that is "substantially consistent" with the first three requirements. It is unclear how much specificity must be included on the written schedule as to the actual property or business to be conducted by the QOZ Business.

Likewise, the Proposed Regulations provide that working capital that fits within the safe harbor also counts toward satisfying the 50% gross income test and the intangible property test that the QOZ Business must meet and clarifies that tangible property satisfies the QOZ Business requirements even while working capital is still being expended.

What are other interesting aspects of the Proposed Regulations?

Carried Interest

The Proposed Regulations make clear that an interest in a QOF may include any equity interest in the QOF, including preferred stock and a partnership interest with special allocations. As a result, it appears that if a promoter timely invests an amount equal to all or a portion of capital gain it recognized in a QOF that is a partnership and acquires an interest in the QOF, including its carried interest, its entire interest in the QOF (including the carried interest) may be eligible for QOZ benefits.

Borrowing

The Proposed Regulations make clear that an investor can borrow against its QOF interest without interfering with the investor's QOZ benefits. However, the Proposed Regulations do not address whether a QOF that is a partnership can make debt financed distributions to a partner without the partner recognizing gain. The Proposed Regulations also clarify that debt incurred by a QOF that is a partnership or its subsidiary partnership that is a QOZ Business is not treated as an investment by the QOF's investors for purposes of determining how much capital gain has been rolled over or for purposes of determining if other than capital gains have been invested in the QOF.

Installment Sales

The QOZ law permits a taxpayer to obtain QOZ benefits if the taxpayer rolls over capital gain from a sale of property to an unrelated person and cash equal to the gain is invested in a QOF within 180

days of the sale. The Proposed Regulations explain that the 180 days begins on the day on which the gain would be recognized if the taxpayer did not make an election to defer the gain under the QOZ rules. This provision in the Proposed Regulations might open the door for a taxpayer who recognizes gain after December 31, 2017, from an installment sale that occurred before 2018 to roll over post-2017 gain from that installment sale into a QOF.

Attributes when roll-over gain is recognized

When all or a portion of the roll-over gain is recognized on the earlier of December 31, 2026, or when the investor disposes of its interest in the QOF, the gain will have the same attributes as the gain rolled over. For example, if the rolled-over gain is short-term capital gain, it will be short-term capital gain when it is recognized and, if all or a portion of the gain rolled over is "unrecaptured section 1250 gain" from the sale of real estate (gain currently subject to tax at a 25% rate), such gain will retain its character as unrecaptured section 1250 gain. The tax rates applicable at the time the roll-over gain ultimately is recognized will apply to that gain, not the rates applicable when such gain was realized and deferred. This presents additional return risk, as the applicable tax rates may be higher when the gain ultimately is recognized.

Issues not yet answered

Among the issues requiring further guidance:

- What constitutes the active conduct of a trade or business, particularly in the context of a QOF's subsidiary QOZ Business that owns real estate?
- What does original use in the QOZ mean?
- What transactions cause the deferral to end?
- What are the administrative rules and applicable penalties if a QOF fails to satisfy the 90% Asset Test?

The Proposed Regulations state that soon to be released proposed regulations will provide guidance on how long a QOF has to reinvest proceeds from a sale of one or more of its assets to continue the qualify as a QOF.

If you have any questions about investing in or forming and operating a QOF, please contact any member of Ballard Spahr's QOZ team.

Members of Ballard Spahr's QOZ Team will be presenting a seminar/webinar on QOZs addressing the Initial Guidance on **November 1, 2018, at 3:00 pm ET**.

[1] For this purpose, we are using the term subsidiary to mean an entity treated as a partnership or corporation in which the QOF has any direct ownership interest.

[2] Property will not qualify as a QOZ Business Property if it is contributed to—as opposed to purchased by—a QOF or a subsidiary of a QOF.

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