Lowenstein Sandler

Client Alert

August 28, 2018

Qualified Opportunity Funds: Answers and Questions

By Lesley P. Adamo and Michael N. Gooen

Qualified opportunity funds offer a unique opportunity for United States taxpayers who recognize gain in taxable transactions such as a business sale or liquidity event in an investment fund. Investors may defer tax on gains, and even avoid some of those taxes, by timely making an investment in one of these new vehicles. However, investors should use caution before investing in a qualified opportunity fund, as significant open questions remain as to how the law ultimately will apply. We invite you to read on and stay tuned as the rules develop.

This alert summarizes the potential tax benefits of investing gains in qualified opportunity funds ("QOFs") under recently adopted tax law. Substantial aspects of the new qualified opportunity zone ("QOZ") program remain to be addressed in administrative guidance that has not yet been published. Accordingly, significant uncertainty remains regarding the tax consequences arising from investments in QOFs. This alert reviews the provisions of Section 1400Z-2 of the Internal Revenue Code of 1986, as amended (the "Code"), and highlights open questions that affect current planning under the statute.

The IRS has released some helpful answers to frequently asked questions about the new QOZ program, available here. More detailed administrative guidance remains pending.

What is the purpose of new Code Section 1400Z-2 and the QOZ program?

QOZs are intended to spur economic development and to create jobs in distressed communities by incentivizing investment in such communities. As described further below, investors in QOFs (which, in turn, invest in QOZs) can defer taxable gain recognition and in some cases, exclude portions of such gains from taxes altogether.

What is a "qualified opportunity zone"?

A QOZ is a population census tract in a low-income community that is formally designated by the Treasury Department as a qualified opportunity zone. A list of approved qualified opportunity zones can be found here.

What type of income or gain can be deferred by investment in a QOZ?

If a taxpayer engages in a taxable sale or exchange with an unrelated person before 2027, the taxpayer may defer any gain arising from that sale or exchange by making an investment in a QOF. The property sold or exchanged can be any type of property (e.g., real estate, stock, art, bitcoin). However, the taxpayer must invest in a QOF (in an amount equal to the desired amount of gain deferral) during the 180-day period beginning on the date the property is sold or exchanged.

Once an election is made to defer some or all of the gain from a sale or exchange (such elected amount, the "Deferred Gain"), another election cannot be made with respect to the same transaction giving rise to the Deferred Gain. Accordingly, when a taxpayer has a gain recognition event, the taxpayer must make a one-time decision as to how much to invest in a QOF. For example, assume that (i) InvestCo recognizes gain of $4,000,000 from the sale of stock to an unrelated person, and (ii) 90 days after the closing of the sale, InvestCo invests $1,500,000 into a QOF for which it makes the deferral election. Although InvestCo still has 90 days left in its 180-day post-sale investment window, InvestCo cannot thereafter elect to defer any of the remaining $2,500,000 gain by investment in the same or any other QOF. Likewise, if a taxpayer later recognizes Deferred Gain by disposing of its QOF interest, the taxpayer cannot re-defer that gain by making an investment into another QOF.

Uncertainty: Who is the "taxpayer" eligible to defer gain?

One open question is who qualifies as the "taxpayer." For example, assume a pass-through entity, such as a limited liability company ("LLC") or subchapter S corporation ("S corp"), sells property to an unrelated buyer in a taxable transaction. One interpretation of Code Section 1400Z-2 is that the entity (the LLC or S corp) is the "taxpayer," so the LLC or S corp itself must reinvest the gain into a QOF to defer the taxable gain. Alternatively, it is possible that the persons ultimately taxable on the gain–the LLC members or S corp shareholders–may be treated as "taxpayers" and thus are eligible to achieve tax deferral by making investments into QOFs. Until further guidance is published addressing this point, the safest course of action may be to adhere to a literal interpretation of the statute, so that if LLC sells property, the LLC (rather than the LLC members) will invest the gain and make the deferral election. However, we recognize that there may be circumstances in which such a literal approach is not feasible (e.g., because members of an entity disagree on having the entity make the QOF investment) or impossible (e.g., where the gain is triggered by an S corp's deemed sale of assets as a result of a Code Section 338(h)(10) election). Only formal administrative guidance will provide certainty on this key point.

May a taxpayer invest more than the amount of Deferred Gain in a QOF?

Yes. If an investor makes an investment into a QOF and only a portion of such investment constitutes Deferred Gain, then the investment is treated as two separate investments: one that includes only Deferred Gain, another that does not represent Deferred Gain. The special rules of Code Section 1400Z-2 apply only to the Deferred Gain portion of the investment into the QOF.

How does a taxpayer notify the IRS that it is deferring gain by investing in a QOF?

The IRS has not yet published instructions on how to make the temporary deferral election. However, the IRS has provided that the election is made on the taxpayer's tax return on which the tax on the deferred gain would be due but for the taxpayer's QOF investment.

When is Deferred Gain recognized?

Deferred Gain is included in the taxpayer's income when the "investment" is sold or exchanged (a "<u>Sale Event</u>") or, if earlier, December 31, 2026. Accordingly, if the taxpayer does not dispose of its QOF investment in a taxable transaction before December 31, 2026, the taxpayer generally must recognize Deferred Gain on December 31, 2026. If the QOF investment continues to appreciate, the taxpayer will recognize additional gain on a subsequent taxable sale or exchange.

Uncertainty: When and how is the Deferred Gain inclusion calculated?

While we believe that the taxpayer's equity interest in the QOF should be deemed the "investment" for purposes of Code Section 1400Z-2, it remains possible that the QOF's underlying assets could be deemed "investments." Notably, there are some open questions regarding how deferral benefits will work if a QOF organized as a partnership sells property before a QOF investor sells its investment in the QOF. Absent clear guidance, it remains possible that QOF investors (particularly minority equity owners) may not be able to control the timing of their Deferred Gain recognition.

There is also uncertainty as to the applicable tax rate on recognition of the Deferred Gain. For example, assume that a 20% long-term capital gains rate would have applied to the Deferred Gain if recognized in 2018; instead, the Deferred Gain is recognized in 2023, when the tax rate applicable to long-term capital gains is 25%. Is the Deferred Gain taxed at 20% or 25%? Similarly, assume that the Deferred Gain was a short-term capital gain because the property sold was held for only six months; the taxpayer invests the Deferred Gain amount in a QOF and disposes of the QOF investment five years later. Is the Deferred Gain then taxed at long-term or short-term capital gains rates?

How much of the Deferred Gain is recognized on a Sale Event or December 31, 2026?

When there is a Sale Event, the taxpayer must include in income an amount equal to:

(A) The lesser of
   i. the Deferred Gain and
   ii. the fair market value of the investment on the date of the Inclusion Event;

<u>minus</u>

(B) The taxpayer's basis in the investment, as calculated pursuant to Code Section 1400Z-2 ("<u>Investment Basis</u>").

Initially, the taxpayer's Investment Basis is zero. However, if the investment is held for at least five years, the Investment Basis is increased by an amount equal to 10% of the Deferred Gain. If the investment is held for at least seven years, the Investment Basis is increased by another 5% of the Deferred Gain (i.e., a total basis increase of 15% of the Deferred Gain). Thus, the taxpayer can permanently exclude a portion of the Deferred Gain from taxation by holding the QOF investment for five years or longer.

If the investment is held on December 31, 2026, the taxpayer then must include in income an amount equal to the Deferred Gain, net of the basis adjustments discussed above. Going forward, the recognized gain amount is added to the taxpayer's new basis in the investment.

A special gain exclusion rule applies for investments held for at least 10 years. In such cases, the taxpayer can elect for the basis of the investment to equal the fair market value of the investment on the date of the Sale Event. This rule essentially allows the investor to exclude all appreciation in an investment (above the Deferred Gain, which must be recognized no later than 2026) if the investment is held for at least 10 years. If the investment has decreased in value, the taxpayer can choose to not elect into this regime, thus avoiding a basis "step-down" and recognizing the loss inherent in the investment.

Consider the following illustrations of the above rules:

On August 1, 2018, InvestCo sells its shares of Corp A stock for $5,000,000. InvestCo purchased the Corp A shares in 2015 for $1,000,000. InvestCo should have a gain recognition event in 2018 of $4,000,000 ($5,000,000 amount realized minus $1,000,000 basis).

InvestCo can defer the recognition of all $4,000,000 of gain in 2018 if it elects to invest $4,000,000 in a QOF by January 28, 2019 (180 days after August 1, 2018). For purposes of the following alternatives, assume that InvestCo invests all $4,000,000 in Fund A, a QOF, on September 1, 2018.

<u>Alternative 1</u>: InvestCo sells its interest in Fund A on December 1, 2021, when its Fund A interest is worth $5,000,000. InvestCo recognizes $5,000,000 of gain in 2021, consisting of the $4,000,000 of Deferred Gain (Investment Basis is $0) and the $1,000,000 of appreciation in the Fund A interest's value during InvestCo's holding period.

<u>Alternative 2</u>: InvestCo sells its interest in Fund A on December 1, 2023, when its Fund A interest is worth $5,000,000. InvestCo recognizes $4,600,000 of gain in 2023, consisting of $3,600,000 of Deferred Gain and the $1,000,000 of appreciation in the Fund A interest's value during InvestCo's holding period. Since InvestCo held its interest in Fund A for five years, its Investment Basis increases from $0 to $400,000 (10% of the $4,000,000 Deferred Gain). Accordingly, InvestCo only recognizes $3,600,000 of the Deferred Gain, permanently avoiding tax on the remaining $400,000.

<u>Alternative 3</u>: InvestCo sells its interest in Fund A on December 1, 2025, when its Fund A interest is worth $5,000,000. InvestCo recognizes $4,400,000 of gain in 2025, consisting of $3,400,000 of Deferred Gain and the $1,000,000 of appreciation in the Fund A interest's value during InvestCo's holding period. Since InvestCo held its interest in Fund A for seven years, its Investment Basis increases from $0 to $600,000 (15% of the Deferred Gain). InvestCo only recognizes $3,400,000 of the Deferred Gain, permanently avoiding tax on the remaining $600,000.

<u>Alternative 4</u>: InvestCo sells its interest in Fund A on December 1, 2027, when its Fund A interest is worth $5,000,000. In 2026, InvestCo will recognize $3,400,000, representing the original $4,000,000 Deferred Gain minus the $600,000 (15%) Investment Basis increase achieved by holding the Fund A investment for at least seven years. InvestCo's Investment Basis in its Fund A interest consequently increases from $600,000 to $4,000,000. In 2027, InvestCo will recognize an additional $1,000,000 of gain–i.e., the $5,000,000 sale proceeds minus its $4,000,000 post-2026 basis.

<u>Alternative 5</u>: InvestCo sells its interest in Fund A on December 1, 2028, when its Fund A interest is worth $5,000,000. As in Alternative 4, InvestCo will recognize $3,400,000 of Deferred Gain in 2026. However, if InvestCo elects into the special gain-exclusion regime for property held for at least 10 years, the basis of the Fund A interest will increase to its fair market value–$5,000,000–so InvestCo will not recognize any additional gain in 2028 upon sale of its interest in Fund A.

What is a QOF?

A QOF is "any investment vehicle which is organized as a corporation or a partnership" that satisfies two requirements. First, the corporation or partnership must be organized for the purpose of investing in QOZ property (other than another QOF). Second, at least 90% of the assets of the corporation or partnership must be "QOZ property." The 90% QOZ property test is based on the average of the percentage of QOZ property held in the QOF, measured on the last day of the first six-month period of the QOF's taxable year and on the last day of the QOF's taxable year. A QOF must pay a penalty for each month that it fails to meet the 90% requirement, unless the QOF can show reasonable cause for such failure.

"QOZ property" includes: (i) QOZ stock, (ii) QOZ partnership interests, and (iii) QOZ business property. QOZ property must meet the following requirements:

1. <u>Acquisition Specifications</u>. QOZ stock or QOZ partnership interests must be acquired from the issuing entity for cash after December 31, 2017. Notably, redemptions of the QOZ stock may cause the QOZ stock to lose its qualifying status. QOZ business property must be acquired in a taxable purchase after December 31, 2017; such property cannot be acquired from a related person or entity. Some examples of disqualifying relationships include: a partnership and a person owning, directly or indirectly, more than 20% of the capital or profits of such partnership; partnerships in which the same person owns, directly or indirectly, 20% of the capital or profits of such partnerships; and an individual and his or her spouse, ancestors, and lineal descendants.
2. <u>Holding Period Specifications</u>. During substantially all of the QOF's holding period for any stock or partnership interest, such corporation or partnership, as applicable, must qualify as a QOZ business. During substantially all of the QOF's holding period for any QOZ business property, substantially all of the use of such property must be in a QOZ.
3. <u>Use Specifications</u>. At the time any QOZ stock or QOZ partnership interest is acquired, the entity (corporation or partnership) must be a

“QOZ business” (defined below)–or, if a new entity, it must be organized for purposes of being a QOZ business. The original use of any QOZ business property in the QOZ must commence with the QOF, or the QOF must substantially improve the QOZ business property. Property is deemed substantially improved by the QOF only if, during any 30-month period beginning after the date the QOF acquires the property, the QOF makes improvements to the property equal in value to the property’s original value as of the QOF’s acquisition date.

A “QOZ business” is a trade or business that satisfies three requirements. First, at least 50% of the total gross income of the business must be derived from the active conduct of such business; a substantial portion of the business’s intangible property must be used in the active conduct of the business; and less than 5% of the average of the aggregate unadjusted bases of the business’s property must be attributable to nonqualified financial property (e.g., debt, stock, partnership interests, options, futures, forwards, warrants, swaps, etc.). Second, the following types of businesses cannot qualify as QOZ businesses: a 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. Third, substantially all of the tangible property owned or leased by the taxpayer must be “QOZ business property” – i.e., tangible (real or personal) property that meets the Acquisition Specifications, Holding Period Specifications, and Use Specifications outlined above (determined by substituting “QOZ business” for “QOF” where it appears above).

Uncertainty: Can a QOF be formed as an LLC?

Multiple-member LLCs are generally considered to be partnerships (or corporations, if they elect to be taxed as such) for federal income tax purposes. However, the requirement that an entity be “organized as” a partnership or corporation may indicate that only those specific entities may qualify as QOFs. Likewise, in the absence of guidance to the contrary, it appears that a single member LLC (whether or not such an LLC remains a disregarded entity or elects to be treated as a corporation for tax purposes) cannot qualify as a QOF, as it is not technically “organized as” a partnership. We do not see any policy reason for such limitations; however, until further guidance is published, we recommend forming any QOF as a state law partnership or corporation, rather than as an LLC.

How does a partnership or corporation notify the IRS that it qualifies as a QOF?

An eligible partnership or corporation must self-certify as to its status as a QOF by completing a form and attaching that form to the QOF’s federal income tax return for the taxable year. The IRS has not yet released that form.

Currently, what is the safest way to invest into a QOF?

In light of the uncertainty regarding the application of the QOZ program, if a taxpayer wanted to make an investment into a QOF today, it appears that the safest investment would be through a QOF formed as a limited partnership, invested in a QOZ partnership interest of a lower-tier partnership that owns only one investment in a QOZ. However, any such investment should be made only after careful planning (including a thorough assessment of nontax legal and business risks) and discussions with tax counsel.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

LESLEY P. ADAMO
Counsel
T: **646.414.6974**
ladamo@lowenstein.com

MICHAEL N. GOOEN
Partner
T: **973.597.2366**
mgooen@lowenstein.com