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Client Alert

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Qualified Opportunity Funds: Answers and Questions (Update #1)

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On October 19, 2018, the IRS released proposed regulations that resolve some of the ambiguities in the application of the qualified opportunity fund rules. This Client Alert updates our August 28 alert on this topic.

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, including the proposed regulations ("Proposed Regulations") released on October 19, 2018. Substantial aspects of the new qualified opportunity zone ("QOZ") program still remain to be addressed. Accordingly, uncertainty remains regarding some tax consequences arising from investments in QOFs and related structuring. This alert reviews the provisions of Section 1400Z-2 of the Internal Revenue Code of 1986, as amended (the "Code") and the Proposed Regulations, highlighting 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. While the Proposed Regulations have addressed numerous questions raised by the statute, we anticipate further administrative guidance.

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 QOZ?

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 equity investment in a QOF. The Proposed Regulations clarify that the investment in the QOF must take the form of equity – e.g., a partnership interest or common or preferred stock – rather than debt. The property sold or exchanged can be any type of property (e.g., real estate, stock, art, bitcoin), but the Proposed Regulations clarify that only capital gains are eligible for deferral. 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. (We discuss the calculation of the 180-day period below.)

Once an election is made to defer some or all of the gain from a sale or exchange (such elected amount, the "Deferred Gain"), the taxpayer cannot receive benefits for multiple QOF investments for the same Deferred Gain. However, the Proposed Regulations clarify that if a taxpayer recognizes gain (e.g., $100) and elects to defer only a portion of the gain (e.g., $30 of the $100), the taxpayer can still elect to defer the remaining gain (any or all of the remaining $70) as long as the taxpayer satisfies the original 180-day investment period requirement. The Proposed Regulations also provide that if a taxpayer disposes of the entire QOF interest investment with respect to a

Deferred Gain, the taxpayer can make another QOF investment and effectively "re-defer" the Deferred Gain.

Who is the "taxpayer" eligible to defer gain?

The Proposed Regulations clarify that the "taxpayer" eligible to defer gain is "a person that may recognize gains" for tax purposes. Thus, individuals, C corporations (including regulated investment companies and real estate investment trusts), partnerships, and certain other pass-through entities all may enjoy tax benefits associated with QOF investments. If a partnership, S corporation, or other pass-through entity recognizes capital gain and passes that gain through to its owner(s), the owner(s), instead of the entity, may elect to defer gain by making a QOF investment.

How is the 180-day investment period calculated in the partnership context?

The Proposed Regulations explain that the 180-day period begins on the day on which the gain would be recognized for federal income tax purposes absent a QOF deferral election. The partnership itself may elect to defer some or all of an eligible capital gain. To the extent a partnership opts not to defer eligible capital gains, any partner of that partnership may elect to defer some or all of such eligible gains included in that partner's distributive share as long as the partner makes a QOF investment during the 180-day period beginning on the last day of the partnership taxable year in which the partner's allocable share of the partnership's (un-deferred) eligible gain is taken into account. The partners of a partnership, however, can elect to treat their 180-day investment period as the same period as the partnership's.

> For example, assume ABC Partnership realizes a capital gain on January 17, 2019, and does not make a QOF investment. The 180-day investment period for each partner of ABC Partnership with respect to that partner's portion of the eligible gain begins on December 31, 2019, if ABC Partnership uses the calendar year. However, one or more of ABC's partners can opt to start the 180-day investment period on January 17, 2019 (if, for example, a desirable QOF investment opportunity arises during 2019).

The Proposed Regulations include some special rules for other flow-through entities in calculating the 180-day investment period.

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

Yes. If an investor makes an investment in 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 and 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 in the QOF.

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

The Proposed Regulations anticipate that taxpayers will make deferral elections on Form 8949 (Sales and Other Dispositions of Capital Assets). Taxpayers will file that form with their federal income tax returns for the year in 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 "Sale Event") 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 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.

How is the Deferred Gain inclusion calculated?

Before the release of the Proposed Regulations, there was uncertainty as to the applicable tax rate on recognition of the Deferred Gain. However, the Proposed Regulations provide that the gain's tax attributes are preserved and taken into account when the Deferred Gain is included. For example, assume that a 20% long-term capital gains rate would have applied to the Deferred Gain if it were recognized in 2018; instead, the Deferred Gain is recognized in 2023, when the tax rate applicable to long-term capital gains is 25%. The Proposed Regulations provide that in 2023, the Deferred Gain is taxed at 20%. 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. The Proposed Regulations provide that the Deferred Gain, when recognized, is taxed at the 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 or, if earlier, on December 31, 2026, 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;

minus

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

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. The special 10-year rule only applies with respect to Deferred Gain invested in a QOF.

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.

Alternative 1: 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.

Alternative 2: 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.

Alternative 3: 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.

Alternative 4: 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.

Alternative 5: 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 an entity that is classified as a corporation or partnership that satisfies two requirements. Eliminating earlier uncertainty, the Proposed Regulations clarify that a limited liability company that is classified as a corporation or partnership can be a QOF.

First, the corporation or partnership must be organized for the purpose of investing in QOZ property (other than another QOF). The Proposed Regulations provide that a pre-existing entity may qualify as a 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. The Proposed Regulations clarify that if a QOF was formed in September 2018, the end of the first 6 month period (as well as the end of the first taxable year) would be on December 31, 2018, for a calendar-year entity. 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.

What is QOZ property?

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

1. Acquisition Specifications. 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. Holding Period Specifications. 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. Use Specifications. 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.

   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 that exceed in value the property's original value as of the QOF's acquisition date. The Proposed Regulations and new Revenue Ruling 2018-29 make clear that if a QOF purchases a building that is located on land wholly within a QOZ, substantial improvement is measured by the additions to the adjusted basis of the building and does not require a separate improvement of the land upon which the building is located.

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 in a QOZ; a substantial portion of the business's intangible property must be used in the active conduct of the business in that QOZ; 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.).

> "Nonqualified financial property" does not include "reasonable amounts" of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less ("Working Capital Assets"). The Proposed Regulations establish a safe harbor: Working Capital Assets will be treated as held in "reasonable amounts" if (i) the Working Capital Assets are designated in writing for the acquisition, construction,

and/or substantial improvement of tangible property in a QOZ, (ii) there is a written spending schedule that is consistent with the ordinary start-up of a trade or business, (iii) the Working Capital Assets are spent within 31 months of the receipt by the business of such assets, and (iv) the assets are actually used in a manner consistent with the written designation and the spending schedule. In calculating whether 50% of the total gross income of the business is derived from the active conduct of a business in a QOZ, gross income derived from reasonable amounts of Working Capital Assets will be treated as income counted toward satisfaction of the 50% test. While reasonable amounts of Working Capital Assets are being expended on property, such property will not fail to be treated as QOZ business property, as long as it is expected that the property will satisfy the requirements of QOZ business property as a result of those expenditures.

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, 70 percent 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).

Open question: What does it mean for income to be derived from, and property to be used in, the active conduct of a business in a QOZ?

If, for example, a manufacturing business is located in a QOZ but substantially all of its products are delivered to locations outside the QOZ for resale to customers primarily outside the QOZ, can the business qualify as a QOZ business?

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 released Form 8996 (Qualified Opportunity Fund) in draft form, found here. Instructions for that form can be found here.

Can taxpayers rely on the Proposed Regulations?

Yes. Although the Proposed Regulations are not yet published as final regulations, a taxpayer can rely on the rules set forth in the Proposed Regulations for transactions occurring before final regulations are published, as long as the taxpayer applies the Proposed Regulations in their entirety and in a consistent manner.

In sum, the Proposed Regulations address many of the questions concerning the tax treatment of QOF investments. The rules are complex, and some uncertainty persists, so it remains essential to make QOF investments only after careful planning (including a thorough assessment of nontax legal and business risks) and discussions with tax counsel.

Contacts

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