

October 31, 2018

QOZ Guidance Analysis – A Baker’s Dozen of Important Points and Insights

Internal Revenue Code Sections 1400Z-1 and 1400Z-2, created by the tax reform legislation that became effective December 22, 2017, Public Law No: 115-97 (also known as the Tax Cuts and Jobs Act of 2017), incentivizes investment of capital gains in qualified opportunity zones (“**QOZs**”) by providing for the deferral and partial avoidance of tax on a current capital gain for taxpayers investing in a qualified opportunity fund (a “**QOF**”) and the complete avoidance of tax on profits from the sale of an investment in a QOF after 10 years. Guidance from the IRS on this brand-new tax incentive was critically needed in order for investors to become comfortable in participating in transactions in which the QOZ tax benefits would be significant. Our firm participates in industry working groups and with the American Bar Association Forum on Affordable Housing and Community Development Law (“**Forum**”) on these topics. We have also met with Treasury and our firm helped author and was a signatory on a July 3, 2018 Forum letter to Treasury in which we made recommendations about the forthcoming guidance.

On October 19, 2018, the IRS submitted to the Office of the Federal Register 74 pages containing four sets of proposed regulations for Internal Revenue Code Section 1400Z-2. The final version of the proposed regulations were officially published on October 29, 2018. These proposed regulations addressed various issues about QOZs, including gains that can be deferred (“**Eligible Gains**”), taxpayers who can defer gain (“**Eligible Taxpayers**”), how to qualify as a QOF, what QOFs can invest in, and how compliance is measured. In addition, on October 19, 2018 the IRS released Revenue Ruling 2018-29 which provided additional guidance on the original use and substantial improvement QOZ requirements.

This article rounds up our analysis into a “baker’s dozen” of insights and structuring considerations resulting from the proposed regulations and Revenue Ruling 2018-29. In the following discussion, we will refer to Internal Revenue Code Section 1400Z-2, which contains rules regarding the tax benefits for investing in QOZs, as the “QOZ Statute”. The 4 sets of QOZ proposed regulations will collectively be referred to as “Proposed Regulations”. The Internal Revenue Code will be referred to as the “Code” and the Treasury Regulations thereunder will be referred to as the “Regulations”.

Helpful links:

- Code Section 1400Z-1 and 1400Z-2 - <https://bit.ly/2RsbUSx>
- Proposed Regulations Sections 1.1400Z-2(a)-1, 1.1400Z-2(c)-1, 1.1400Z-2(d)-1 and 1.1400Z-2(e)-1 - <https://www.gpo.gov/fdsys/pkg/FR-2018-10-29/pdf/2018-23382.pdf>
- Revenue Ruling 2018-29 - <https://www.irs.gov/pub/irs-drop/rr-18-29.pdf>
- Draft IRS Form 8996, Qualified Opportunity Funds Form - <https://www.irs.gov/pub/irs-dft/f8996--dft.pdf>
- Draft Instructions for Form 8996 - <https://www.irs.gov/pub/irs-dft/i8996--dft.pdf>
- A&TT QOZ Quick Summary (3/15/18) - <https://bit.ly/2QcFFGs>
- A&TT QOZ Analysis (3/15/18) - <https://bit.ly/2OgR9Ho>
- A&TT QOZ Tax Credit Twinning Analysis (3/15/18) - <https://bit.ly/2Q5eNbo>
- ABA Forum Letter to Treasury (7/3/2018) - <https://bit.ly/2CPab5l>

1. **Eligible Gains Must be Capital Gains**

The Proposed Regulations provide that in order to defer tax and obtain any QOZ benefits, a taxpayer must have “Eligible Gains.” The Explanation of Provisions in the Proposed Regulations states that **Eligible Gains** “generally include capital gain from an actual, or deemed, sale or exchange, or any other gain that is required to be included in a taxpayer’s computation of capital gain.” Only gain resulting from sales to an unrelated person (applying a 20% relatedness standard) and occurring prior to December 31, 2026, is Eligible Gain.

- a. **No Gain Deferral, No QOZ Benefits** – The Proposed Regulations confirm that QOZ benefits are not available unless there is an election to defer tax on an Eligible Gain. This is consistent with the purpose of incentivizing the investment of unrealized gains in QOZs.
- b. **Debt Does Not Create a QOZ Investment** – Under federal partnership taxation rules, partnership debt is treated like a contribution of money by the partners to the partnership. Because of this rule, there was some speculation that if a QOF (or a QOF subsidiary) incurred debt, this might be a deemed QOF investment by the QOF investors resulting in QOZ benefits. The Proposed Regulations confirm that debt owed by a QOF (or its subsidiary) does not create a deemed investment in the QOF by its investors and no additional QOZ benefits are allowed. However, a QOF investor does have the flexibility to borrow funds and use the QOF interest as collateral.
- c. **Opportunity Exit Taxes from Prior LIHTC or HTC Transactions Should Generally Qualify if the Sale is Not to a Related Party** - A Low-Income Housing Tax Credit (“**LIHTC**”) or Historic Tax Credit (“**HTC**”) investor with a negative capital account will have phantom income tax when it exits a LIHTC or HTC partnership. While a portion of such gain may be ordinary income due to depreciation recapture, the capital gain portion could qualify as an Eligible Gain if the sale is not to a related person. See the discussion in Section 2(b)(i) below for structuring tips to avoid related party issues.

- d. **Opportunity** Partial Gain Deferral Rules Provide Flexibility – If a taxpayer realizing a gain elects to defer and invest only a portion of that gain, the taxpayer can later elect to defer the balance of the gain so long as it invests in the same or a different QOF within 180 days of the gain event.
- e. **Caution** Limitations on Eligible Gains - Depreciation Recapture, Section 291 Gain and Straddles Do Not Qualify; Net 1256 Gains Qualify - The sale of depreciated property can sometimes generate ordinary income. Depreciation recapture or corporate Section 291 gain are therefore not Eligible Gains. The Proposed Regulations also provide that straddles are not Eligible Gains. Finally, Eligible Gains do not include all Section 1256 Gains, but only the net 1256 gains for a year.

2. **Both Partnerships and Partners Are QOZ “Eligible Taxpayers” and Partners Can Start the 180-Day Period at the End of the Year**

Good News The QOZ Statute provides that a taxpayer with Eligible Gains must make a QOZ investment into a QOF within 180 days of the gain event in order to elect to defer taxation of the gain and obtain QOZ benefits. The QOZ Statute is unclear as to how this requirement should apply to pass-through entities, and if partners or the partnership should be considered taxpayers eligible for deferral. Consistent with the comments we submitted, the Proposed Regulations conclude that **Eligible Taxpayers** include both partnerships and their partners (as well as individuals, Regulated Investment Companies (“RICs”), Real Estate Investment Trusts (“REITs”), trusts and estates). If a partnership does not elect to defer Eligible Gain and make a QOZ investment, then the Eligible Gain is allocated up to the partners who are then able to elect to defer the gain and invest in a QOF. The Proposed Regulations also provide significant flexibility by stating that a partner’s 180-day period to invest in a QOF does not start until the end of the partnership’s tax year unless the partner chooses instead to use a 180-day period that starts when the partnership incurred the gain.

- a. **Opportunity** Investing Through Partnerships Provides Significant Flexibility to Obtain QOZ Benefits - Having a 180-day period that starts at the end a partnership’s tax year provides a significant benefit. Investors may be advised to move existing investments or put new investments into partnerships to extend the deadline for investment in a QOF.
 - i. Example 1 – 180 Days to Invest – Jim incurs a gain on January 1, 2018. Jim would need to invest that gain into a QOF by June 29, 2018 (180 days after January 1).
 - ii. Example 2 – 544 Days to Invest – Partnership A has 99% partner Jim and 1% partner Jim’s S-Corp. If Partnership A incurs a gain on January 1, 2018 and passes that gain up to Jim and Jim’s S-Corp, those partners would have until June 28, 2019 (180 days from December 31, 2018) to invest the gain. This gives the partners almost an extra year to find a desirable QOF.
- b. **Caution** Lack of Proper Structuring Creates QOZ Problems for Related Party Partnership Gains – Under the QOZ Statute, Eligible Gains must result from sales to unrelated parties (applying a 20% standard for relatedness). Accordingly, gain resulting from a partnership’s sale of property to a 20% partner would not be an Eligible Gain. Such gain would also be ineligible even if allocated to a partner unrelated to the buyer because gain must be Eligible Gain to both the partnership and partner. This result could be avoided

to negotiate for relatively more of its benefits to be from the sale of its interest in the QOF than current cash flow benefits, because the QOF structure provides greater tax benefits on exit than on current cash flow. The Proposed Regulations also clearly state that debt in a QOF does not qualify as an Eligible Interest.

- a. **Caution** Unclear How Rules Apply to Partner Promotes – QOZ benefits require that the Eligible Taxpayer “invest” in the QOF. Thus, it is unclear if QOF benefits are available to a QOF partner that does not make a substantial cash contribution to the QOF or where the IRS may conclude that some or all of a QOF interest was received in exchange for services (assuming that the service partner of the QOF had other Eligible Gain with which to elect deferral).

4. **First-In, First-Out (“FIFO”) Method Is Used to Identify Which Interest in a QOF Has Been Sold**

Where a taxpayer purchases multiple interests in a QOF with identical rights and later sells some but not all of the interests, interests that were purchased first will be deemed to be the first interests sold. Identical rights would be equivalent shares of corporate stock in a corporation or partnership interests with identical rights. A pro-rata method is used where multiple identical interests in a QOF were purchased on the same day.

- a. FIFO Can Dictate Applicable Tax Attributes – Under the Proposed Regulations, when a deferred gain is triggered, the tax attributes of that deferred gain at the time of deferral apply. For example, assume a taxpayer had a short-term capital gain in February 2018 that was invested for 100 shares in a QOF in March 2018 and then a long-term capital gain in April 2018 that was invested for another 100 identical shares in the QOF in May 2018. Further, assume that in 2019 the taxpayer sold 100 shares of the QOF. That sale would trigger the short-term capital gain that occurred in February 2018.

5. **QOF Self-Certification Is Flexible and QOF Can Pick First Month**

Good News QOFs self-certify on IRS Form 8996 and identify their first taxable year of being a QOF. The Proposed Regulations provide a very taxpayer friendly result by also allowing QOFs to choose the month that the certification is effective rather than using the default rule of the first month of the QOF’s tax year. Investments made prior to the first effective month will not qualify for QOF benefits.

- a. **Caution** Special Rules When Picking a Month that Isn’t the First Month of the Taxable Year –To avoid penalties, a QOF needs to invest 90% of its assets in Qualified Opportunity Zone Property (“**QOZP**”). This test is generally computed as the average of the results at 6 months after the start of the QOF tax year and at the end of the QOF tax year. A special rule provides that if the first month selected to be a QOF is not the first month of the QOF tax year, then the first 6-month testing date is 6 months after QOF status is effective. In addition, if the first month as a QOF occurs after the sixth month of the tax year (i.e. after June for a calendar year taxpayer), then the QOF’s first year 90% test will be based solely on the asset ratio at the end of the tax year.
 - i. **Bad News** Example - Tough Late Year QOF – A calendar year QOF selecting November 1, 2018 as its first month as a QOF must meet the 90% test by

December 31, 2018. This only gives 60 days to get the funds properly invested in QOZP. In addition, any investments in the QOF prior to November 1, 2018 would not qualify for QOF benefits.

- ii. **Good News** Example - Special First Month Rule Can Sometimes Act Like a Grace Period – Assume a calendar year QOF selects June 2018 as the effective date for QOF status. It would compute its 90% test based on the average of the ratio of assets on November 30, 2018 and December 31, 2018. This gives the QOF 6 months to get assets invested. Without the special first month rule, the QOF's first measuring date would have been June 30, 2018 (6 months from the start of the taxable year) which would have created a rush to invest.

6. **10-Year Step-Up Benefit Can Be Realized as Late as December 31, 2047**

Good News The QOZ Statute states that the definition of the Qualified Opportunity Zone is only valid for 10 years. This raised concern that an investor in a QOZ could not take advantage of the statutorily allowed step-up to fair market value of the investor's basis in its QOZ interest after holding the interest for 10 years. The Proposed Regulations provide a very investor friendly result, by allowing an investor to wait until as late as December 31, 2047 before selling its QOF investment and stepping it up to fair market value. This gives a QOF investor the ability to hold its QOF investment for nearly 20 additional years to appreciate before the QOF investor needs to sell it.

7. **LLCs Can Be Qualified Opportunity Funds**

Good News Because the statutory language required that a QOF be organized as a partnership or corporation, it was unclear if entities organized under state law as LLCs but taxed as partnerships or corporations for federal tax purposes could qualify. We had recommended that LLCs could be QOFs and the Proposed Regulations adopted this approach.

8. **70% Substantially All Standard Is a Big Relief**

Good News A QOF may meet its 90% test by investing in a subsidiary partnership or corporation that qualifies as a Qualified Opportunity Zone Business ("QOZB"). To qualify as a QOZB, substantially all of an entity's tangible property must be Qualified Opportunity Zone Business Property ("QOZBP"). How high the IRS would set the substantially standard was a huge concern. Too high of a standard (e.g. 90%) would have made it very difficult for a variety of businesses to comply with the test. Fortunately, and consistent with comments we submitted, the "substantially all" standard has been set at 70%.

- a. **Example- Old Assets** – A QOF plans to invest in a partnership on January 1, 2019. The partnership has \$3,000,000 of assets that were purchased prior to December 31, 2017 and \$7,000,000 of QOZB assets that were purchased in 2018 (and that otherwise meet the requirements to be QOZBP). The partnership assets are 70% in QOZBP on January 1, 2019 and the substantially all test is met.
- b. **Caution** Qualification of Existing Property? – The Proposed Regulations do not address whether existing property acquired by a QOZB qualifies as QOZBP while it is being

improved. However, as discussed below, reasonable working capital held to improve the property would qualify as QOZBP. We think it is reasonable to conclude that the existing building should also qualify as QOZBP while it is being improved.

9. **Reasonable Working Capital Safe Harbor for Tangible Property is Helpful**

Good News QOZBs cannot hold more than 5% of their assets as Nonqualified Financial Property (“NQFP”), which includes cash, cash equivalents and debt of less than 18-months but does not include reasonable working capital.

- a. **Requirements for Reasonable Working Capital** – Adopting an approach similar to the written plan requirements included in our comments, the Proposed Regulations provide that working capital will be considered reasonable if the following three requirements are met regarding the working capital:
 - i. **Designated in Writing** – for acquisition, construction or substantial improvement of tangible property in the QOZ;
 - ii. **Reasonable Written Schedule** – consistent with the ordinary start-up of a trade or business for the expenditure of the working capital within 31 months of receipt of the working capital; and
 - iii. **Property Consumption Consistent** – the actual use of the working capital is substantially consistent with (1) and (2) above.
- b. **Good News Reasonable Working Capital Generally Creates Good Results While Held** – The Proposed Regulations clarify that working capital held in compliance with the above safe harbor will (i) generate income that is deemed to be from the active conduct of a trade or business in the QOZ with respect to the requirement that 50% of income be generated from the active conduct of a trade or business in a QOZ, (ii) be deemed to satisfy the requirement that a substantial portion of intangible assets are used in the active conduct of a trade or business in a QOZ, and (iii) not cause tangible property fail to be QOZBP just because the working capital has not yet been used to acquire/construct/substantially improve tangible property.

10. **70% Substantially All Test Must Be Met at Time of Investment for Existing Entities**

Caution The Proposed Regulations state that an existing corporation or partnership must qualify as a QOZB at the time the QOF acquires the stock or partnership interest in such entity. This can limit the ability of existing businesses to receive staged capital for use in expansion.

- a. **Example – Staged Working Capital** - A QOF plans to invest in a partnership on January 1, 2019. On such date the partnership has \$2,000,000 of assets purchased prior to 2018 or purchased from related parties. The partnership plans to receive \$3,000,000 of funds from the QOF on January 1, 2019 and another \$3,000,000 on January 2, 2020. All such funds would be used to expand the assets that would qualify as QOZB and will meet the reasonable working capital requirements.
- b. **Analysis** – Under the working capital rules, \$3,000,000 of working capital would be treated as QOZBP on January 1, 2019. However, this is only 60% of the \$5,000,000 of assets held on that date. Therefore, the partnership would fail the 70% substantially all test and would not qualify as a QOZB at the time the QOF acquires its interest. The QOF

investment in the partnership would not qualify as QOZP, resulting in the QOF having 0% invested in QOZP and failing the 90% test. Note that it is unclear if this only would result in a penalty for failing the 90% test or if the entire investment would fail and no QOZ benefits would be available.

- c. Solution – Get all Working Capital at Once – If the partnership received all \$6,000,000 of working capital on January 1, 2019, then \$6,000,000 out of \$8,000,000 of assets would be treated as QOZBP. This represents 75% of assets with the result that the 70% substantially all test is met.

11. **QOZ Location is Important for 50% Gross Income and Intangible Use Requirements**

The QOZ Statute refers to various requirements under Code Section 1397C (which applies to Enterprise Zones). Two of the cross-referenced subsections are Code subsections 1397C(b)(2) and 1397C(b)(4), which require that 50% of gross income be derived from an active conduct of a trade or business and that a substantial portion of intangibles be used in the active conduct of a trade or business. The foregoing cross-references in the QOZ Statute did not include a requirement that the active conduct of a trade or business must occur in a QOZ. However, this requirement is included in the Proposed Regulations.

- a. **Caution** Example - Contract Manufacturing – QOF invests in a partnership which is located in a QOZ. The partnership has intellectual property for the design of widgets. The partnership receives internet orders for widgets, has the widget manufactured outside the QOZ, and has the manufactured products directly shipped from manufacturer to customer. There would be an issue as to whether the gross income is derived from the active conduct of a trade or business in a QOZ. In addition, it is unclear if the intangible property is being used in a trade or business in a QOZ.

12. **Question Remains Whether Leasing Property Is an Active Business**

Caution One of the portions of Code Section 1397C not cross-referenced by the QOZ Statute provides that the leasing of residential rental property (as well as holding or trading intangibles and farming) generally doesn't qualify under Code Section 1397C. Because this portion of 1397C is not incorporated into the QOZ Statute, most practitioners feel that residential rental property and the other referenced businesses are not prohibited. However, Code Section 1397C(b)(2) does require that 50% of gross income come from the active conduct of a trade or business. The term active conduct of a trade or business is used differently in different portions of the Internal Revenue Code. Some of those uses would imply that the leasing of residential rental of property or other classes of property in triple-net lease arrangements may not be an active trade or business. However, other uses of the term would allow residential rental of property. It is noteworthy that the conduct of a trade or business is considered "active" for New Markets Tax Credit ("NMTC") purposes if it is expected to produce revenues within 3 years of investment. We think it likely that residential rental property or other leased property owned and operated by a corporation or partnership should be considered the active conduct of a trade or business. We note that whether triple-net leased property would qualify is a more difficult question, but one that would be answered affirmatively if the NMTC position were adopted.

13. Guidance Provided on Measuring Assets for the 90% and 70% Tests, But Ambiguity Remains

The QOZ Statute provides that 90% of a QOF's assets must qualify and the Proposed Regulations state that 70% of a QOZB's tangible assets must be QOZBP. As a result, how assets are measured is very important.

- a. QOFs and Applicable Financial Statements – The Proposed Regulations provide that QOFs measure whether they meet the 90% test by using value as stated in “**Applicable Financial Statements**” if they have them. If a QOF does not have Applicable Financial Statements, then the relevant measure is the QOF's cost of the asset.
 - i. **Caution** Confusion as to What is an Applicable Financial Statement – The Proposed Regulations borrow the definition of Applicable Financial Statement from Regulation Section 1.475(a)-4. This section applies to dealers in securities and generally provides that Applicable Financial Statements are primary financial statements (i) that are filed with the SEC, or (ii) that (a) have a “Significant Business Use” including being used for “covered positions”, and (b) are filed with another government agency (other than the IRS) or are Certified Financial Statements. Certified Financial statements have to be prepared in accordance with GAAP by a Registered Public Accounting Firm (as defined in Sarbanes-Oxley Act of 2002) and given to creditors and investors for purposes of evaluating loans or investments. If the explicit requirements of Regulation Section 1.475-4 are applied, then most QOFs would not meet the requirements of Regulation Section 1.475(a)-4 and thus would not have Applicable Financial Statements. This would arrive at the more favorable result of using cost basis. However, based on informal discussions with Treasury personnel, Treasury seems to intend that certified financial statements would regularly be used by QOFs even if the QOFs are technically not complying with the requirements of Regulation Section 1.475(a)-4.
 - ii. **Bad News** Unanticipated Problems Using Financial Statements - A significant problem with using financial statements to measure assets is the use of depreciation and impairment and also forthcoming rules on leases for purposes of financial statements. Thus, a QOF with \$1,000,000 in cash and \$9,000,000 invested in depreciable property would initially meet the 90% QOF test. However, after applying depreciation, the \$9,000,000 would decrease in future years and the 90% test would no longer be satisfied. In addition, under current GAAP accounting, operating leases do not show up as assets on a financial statement. However forthcoming GAAP rules will start treating operating leases as assets. This could result in requiring a QOF that signs an operating lease would have to include that lease as an asset. This could significantly disrupt the QOF's 90% test, as well as create a valuable lease asset that normally would not exist for tax purposes.
 - iii. **Caution** How to Use Applicable Financial Statements for 6 Month Measuring Test or Penalties? - Certified Financial Statements are normally prepared on an annual basis. Thus, it is unclear how to use an Applicable Financial Statement

when measuring compliance with the 90% test at the 6-month point during the QOF's tax year. Furthermore, the penalty for failing to comply with the 90% test is calculated monthly, but Certified Financial Statements generally don't have monthly asset balances.

- iv. Proposed Commentary - For these reasons we plan on submitting comments to the IRS stating that financial statements should not be used for measuring assets. A better approach would be either to use the cost of assets without regard to depreciation and probably without including assets no longer used in the QOF's trade or business, or to not include assets beyond their depreciable lives unless affirmatively shown that such assets are still used in the entity's trade or business.

- b. QOZBs and Applicable Financial Statements – The Proposed Regulations also generally require that partnerships or corporations that are QOZBs that have Applicable Financial Statements must use them to determine if the 70% substantially all test is met. If there are no Applicable Financial Statements for such entities, then the partnership or corporation would use the compliance methodology that the QOF used in meeting its 90% test as long as no other QOF owns at least 5% of the entity. If more than one QOF has a 5% interest, then the assets would be measured using the QOF methodology that arrives at the highest amount of QOZBP.
 - i. **Bad News** Same Applicable Statement Problems – All of the issues regarding depreciation, impairment and leases discussed above with respect to QOFs also apply with respect to partnerships and corporations that are QOZBs.

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