Still Unresolved Issues in Qualified Opportunity Funds

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Substantial Improvement Requirement: Land Exception

• Substantial improvement of an asset: more than double basis.
• Exception for land

• *Exception to exception* for land: “(f) *** a QOF may not rely on the proposed [waiver of the requirement to improve substantially land] rules in paragraphs (c)(8)(ii)(B) and (d)(4)(ii)(B) of this section (which concern the qualification of land as QOZBP) if the land is unimproved or minimally improved and the QOF or the QOZB purchases the land with an expectation, an intention, or a view not to improve the land by more than an insubstantial amount within 30 months after the date of purchase.
Hypothetical 1

Multiple related QOZBs. QOZB1 (land owner) will not improve the land.
Substantial Improvement

• If QOZB tenants will improve the land, does QOZB1 still qualify?
  o Does it matter that the QOZBs are commonly owned?
• What is “more than an insubstantial amount”?
• What if QOZB1
  o clears the land?
  o environmentally remediates land?
  o constructs roads and utility infrastructure?
More Than Insubstantial Improvement

• What is needed from land lessor to more than “insubstantially” improve the land?

• Will putting in street lights, sewers, and roads be considered substantial?

• Does Reg. §1.1237-1(c)(3)(ii) and its case law offer analogous guidance? (“If [road, sewer, utility lines and similar] improvements increase the value of a lot by 10 percent or less, such increase will not be considered as substantial, but if the value of the lot is increased by more than 10 percent, then all relevant factors must be considered to determine whether, under such circumstances, the increase is substantial.”)

• Must the street lights, sewers and roads be finished within 30 months to be deemed substantial?
Active Trade or Business

• Real estate rental activity qualifies.
• Triple net leases do not qualify.
• The ground leases aren’t denominated as triple net leases. The property owner pays the real estate taxes. The tenants maintain and pay insurance on the buildings they construct. But economically the tenants cover the cost, because of both the rent and the common ownership.
• Is it an active trade or business?
Property Leases & Purchases at FMV

• “In the case of real property (other than unimproved land) that is leased by a QOF, if, at the time the lease is entered into, there was a plan, intent, or expectation for the real property to be purchased by the QOF for an amount of consideration other than the fair market value of the real property determined at the time of purchase without regard to any prior lease payments, the leased real property is not QOZBP at any time.” Prop. Reg. §1.1400Z2(d)-1(c)(4)(i)(E).
QOZB1 acquires and leases to QOZB2-5 warehouses that QOZB2-5 will gut and rehab. QOZB1 improves and maintains infrastructure of the overall tract of land. As anticipated, in year 11, QOZB1 is ready to sell. QOZB2-5 want to acquire the relevant leased property.
Potential Burden of Fair Market Value Requirement

• What is the fair market value of the leased property after tenants have made improvements? Can tenant not benefit from its own improvements in the calculation of the fair market value of the leased property?

• Different result under Prop. Reg. §1.1400Z2(d)-1(c)(4)(i)(E) if lease is merely raw land. In this scenario, should there really be such a difference to QOZB tenants if we had a lease of raw land?
Inclusion Events

• Certain events occurring prior to 12/31/2026 trigger inclusion in income of deferred gain
  o QOF partnership distributions in excess of basis are an inclusion event.
  o Basis in a QOF interest is $0 + 752 basis (debt) + income recognized – loss recognized – distributions
Excess Cash

Hypothetical 3

• QOF and QOZB have no debt.
• QOZB has begun operations and has positive cash flow in excess of its working capital needs.
• QOZB has no income because of depreciation deductions.
Excess Cash

• What should QOZB and QOF do with the excess cash before the next asset testing date?
• QOZB can hold up to 5% NQFP.
• QOF can hold up to 10% non-QOZBP assets.
• Can pay liabilities, e.g., pay trade liabilities rather than wait customary 30-60 days.
• Can invest in QOZBP, including through the QOZB 31 month safe harbor.
Excess Cash

• Anything beyond that must generally be distributed to avoid §1400Z-2(f) penalty.

• Inclusion event ends deferral with respect to that distributed amount, since it exceeds the pre-distribution basis in the QOF interest. *Prop. Reg. §1.1400Z2(b)-1(c)(6)(iii).*
  
  o Distributee’s reinvestment in the same or another QOF seems impermissible to defer gain, since the inclusion would seem to relate to a sale or exchange that occurred more than 180 days previously.
Excess Cash

• However, *Prop. Reg. §1.1400Z2(b)-1(f) Example 6* favorably allows step-up due to inclusion to be taken into account to eliminate §731(a)(1) gain.

• Does distribution impact 1400Z-2(c) exclusion?
QOZB Requirements- “Substantially All” the Assets and Other Tests

• A qualified opportunity zone business (QOZB) is a trade or business in which “substantially all” of the tangible property owned or leased by the QOZB is qualified opportunity zone business property (QOZBP). Section 1400Z-2(d)(3)(A)(i).
  o Substantially all is defined under the proposed regulations as 70%. Prop. Reg. §1.1400Z2(d)-1(d)(3)(i).

• Additional QOZB requirements include the 1397C(b) cross-references (50% gross income, etc.) and the prohibition on sin businesses.
QOZBP Requirements – Purchase Requirement

• Qualified opportunity zone business property (QOZBP) means tangible property used in a trade or business of the QOZB if:
  o The property was **acquired by purchase after 12/31/2017**;
  o The original use test or the substantial improvement test is satisfied; and
  o The holding period test is met. *Section 1400Z-2(d)(2)(D)(i).*

• If property is **contributed** to a QOZB, then it cannot be QOZBP because it was not acquired by purchase.
Testing “Substantially All” of a QOZB’s Assets

Hypothetical 4:

• Assume an existing property owner contributes raw land with a basis of $20 to a QOZB partnership, and a QOF simultaneously contributes $80 cash to build improvements.
  o The land cannot be QOZBP.

• Putting timing issues aside, if the QOZB constructs a new building worth $80 (assume the building qualifies as QOZBP), then the QOZB should meet the 70% substantially all test even though the land was contributed.
QOZB Working Capital Safe Harbor

- Under the Proposed Regulations, a QOZB can treat working capital assets as reasonable in amount if:
  - Certain documentation requirements are met:
    - A written plan designating the working capital assets for the development of a trade or business in an opportunity zone, including the acquisition, construction and/or substantial improvement of tangible property in a zone, and
    - A written schedule to spend the cash within 31 months
  - The working capital assets are used in a manner that is substantially consistent with the written plan and schedule. Prop. Reg. §1.1400Z2(d)-1(d)(5)(iv).
QOZB Working Capital Safe Harbor

• Under the Proposed Regulations, if:
  - Financial property of the QOZB is treated as being reasonable in amount because of compliance with the WCSH, and
  - The **tangible property** referred to in the written plan is expected to qualify as QOZBP as a result of the planned expenditure of the working capital assets, then..
  - That **tangible property** is not treated as failing to be QOZBP solely because the working capital assets have not yet been spent. *Prop. Reg. §1.1400Z2(d)-1(d)(5)(vii).*

• During the 31-month period, does the **work in process** qualify as QOZBP?
• During the 31-month period, does the **cash** on hand that the QOZB is planning on spending qualify as QOZBP?
Timing of Testing “Substantially All” of a QOZB’s Assets?

Hypothetical 5:

• An existing property owner contributes raw land with a basis of $20 to a QOZB partnership, and a QOF simultaneously contributes $80 cash to build improvements.
  o The land cannot be QOZBP.

• Assume that when the cash was contributed in Year 1, the QOZB complied with the documentation requirements for the 31-month working capital safe harbor.

• If construction started immediately and the $80 was used in compliance with the WCSH, when is the substantially all test met?
Timing of Testing “Substantially All” of a QOZB’s Assets?

**Hypothetical 6:**

- In Year 1, assume an existing property owner contributes raw land with a basis of $20 to a QOZB partnership, and a QOF simultaneously contributes $10 cash for pre-development.
  - The land cannot be QOZBP.
- Assume that when the cash was contributed in Year 1, the QOZB complied with the documentation requirements for the 31-month working capital safe harbor.
- In Year 3, the QOF contributes $70 cash to build new improvements, and the QOZB starts a new 31-month WCSH for the construction period.
- In Year 5, the building is completed.
- When is the substantially all test met?
Another Topic- QOF Requirements – “Substantially All” the QOF’s Holding Period in QOZB

• In order for a partnership interest to be qualified opportunity zone property (QOZP) to a QOF for purposes of the QOF 90% asset test, the partnership must qualify as a QOZB during substantially all of the QOF’s holding period for the interest. Section 1400Z-2(d)(2)(C)(iii).

• For purposes of the holding period requirement, “substantially all” means at least 90%. Prop. Reg. §1.1400Z2(d)-1(c)(5).
Hypothetical 7:

• In Year 1, an existing property owner contributes raw land with a basis of $20 to a QOZB partnership, and a QOF simultaneously contributes $10 cash for pre-development.

• In Year 3, the QOF contributes $100 cash to build new improvements. (Assume the QOZB meets the 70% test in Year 3.)

• If the QOZB does not meet the 70% test in Year 1, the QOF does not meet its 90% asset test in Year 1.

• If the QOZB meets the 70% test in Year 3, does the QOF meet its 90% test beginning in Year 3?

• If the QOZB meets the 70% test in Year 3, does the QOF fail the 90% test until Year 20 (when the QOZB will have been a good QOZB for 18 years, i.e. 90% of the 20-year holding period)?
QOF Requirements – “Substantially All” the QOF’s Holding Period in QOZB

• *Reg. § .1223-3(a)(1)*, promulgated in 2000, well before the QOF rules were enacted, states that a partner can have a *divided holding period* in its partnership interest if the partner acquired portions of an interest at different times.

• However, the holding period concept applied in construing §1400Z-2 in the April Proposed QOF Regs. sometimes, but not always, differs from the pre-QOF general holding period rules. For example, solely for applying the 5 year, 7 year, and 10 year step-up rules, the holding period of a QOF partnership interest obtained for contributed property does not include the holding period of property contributed to the QOF in exchange for the QOF interest, per Prop. Reg. §1.1400Z2(b)-1(d)(1)(i).
QOF – Split Holding Periods?

Hypothetical 8:

• Same facts as Hypothetical 7:
  o In Year 1, an existing property owner contributes raw land with a basis of $20 to a QOZB partnership, and a QOF simultaneously contributes $10 cash for pre-development.
  o In Year 3, the QOF contributes $100 cash to build new improvements.

• Under Reg §1.1223-3, does the QOF have a split holding period?
  • 9% ($10/$110) of the holding period begins in Year 1.
  • 91% ($100/$110) of the holding period begins in Year 3.

• If Reg. §1.1223-3 applies, maybe 91% of the QOF’s interest in the QOZB is QOZP beginning in Year 3, and 9% is not QOZP until Year 20.
Turning Back to 31-Month Safe Harbor

• The April proposed regulations expand the 31-month WCSH with two helpful provisions.
  o A QOZB does not fail to meet the safe harbor requirement to spend the cash consistent with its written schedule if it has not been able to spend the cash because it is waiting for government action. Prop. Reg. §1.1400Z2(d)-1(d)(5)(iv)(C).
  o A QOZB can have multiple sequential or overlapping 31-month WCSHs. Prop. Reg. §1.1400Z2(d)-1(d)(5)(iv)(D).
Timing of Tolling Rules

Hypothetical 9:

• The QOZB receives cash contributions from one or more QOFs and complies with the documentation requirements of the 31-month WCSH.

• In month 6, the QOZB files for a zoning change and does not receive approval for the zoning change until month 30.

• Does the QOZB get an automatic extension of the 31-month WCSH (and the QOZBP safe harbor) for the 24 months it was waiting, or does it get the extension only if it is waiting at the end of month 31?
Timing of Tolling Rules

Hypothetical 10:

• The QOZB receives cash contributions in Year 1 and complies with the 31-month WCSH, so it also qualifies for the QOZBP safe harbor. The initial cash is all spent within the first 31 months.

• There is a long pre-development process and at the beginning of Year 3, the QOZB receives additional cash to finally begin construction, so it complies with the documentation and other requirements for a second 31-month WCSH.
  o Does the QOZB get the benefit of the QOZBP safe harbor as well?
  o Does it matter if the cash is additional QOF equity contributions or loan proceeds?

• The QOZB needs additional capital in Year 5, and it complies with the safe harbor requirements again for new cash.
  o Is there a concern for abuse if the project is not fully complete until Year 7 and up and running until Year 8?
Insufficient Eligible Gain – Can QOF Pro-Rata Debt Be Used?

- Some investors, such as high-earning tax lawyers with six figure balances in certificates of deposit earning 1% after tax, would be very interested in investing, say, $100k in a family-owned or syndicated QOF, with the prospect of a far higher return.

- However, they may not have $100k in unrealized capital gains outside their 401(k) and IRA, and even if they do have some individual unrealized gains, they wouldn’t want to have to pay 85% x 24% x $100,000 in 2026 capital gains tax as a tax cost of buying a QOF for $100,000 in 2019.

- A practical question is whether a QOF can use pro-rata debt to mitigate this problem of desired cash investment in excess of capital gains.
Insufficient Eligible Gain – Can Pro-Rata QOF Debt Be Used

Hypothetical 11:

• A QOF needs to raise $1,000,000. The QOF issues to ten investors, who have $40,000 each in eligible gains and $100,000 each in cash, a QOF equity interest for $40,000 and a QOF note for $60,000. Suppose that, for federal tax purposes, the QOF notes are treated as true debt, and are worth their face.

• At the end of 11 years, the QOF equity interest is highly valuable, and the debt, then outstanding, is only worth its original, now relatively small, face.

• The investors sell the QOF equity interest in year 11 at a large gain.

• Is the full step-up available?
Insufficient Eligible Gain – Can Pro-Rata QOF Debt Be Used

• *Prop. Reg. §1.1400Z2(c)-1* provides a 10 year step-up on a “qualifying investment.”

• A “qualifying investment” include “eligible interests.” *Prop. Reg. §1.1400Z2(a)-1(b)(3)(i)* provides that an “eligible interest” in a QOF includes equity, including preferred stock, and includes a preferred partnership interest, but does not include debt as determined under general federal tax principles.

• But *Prop. Reg. §1.1400Z2(a)-1(b)(10)* states “If the amount of the taxpayer's investment . . . exceeds the amount of gain to be deferred . . . the amount of the excess is treated as an investment to which [the 10 year step-up is denied].”
Insufficient Eligible Gain - Can Pro-Rata QOF Debt Be Used?

• Can one conclude that the $40,000 designated QOF equity receives the full 10 year step-up because it is an “eligible interest” and a “qualifying investment” and the amount invested does not exceed the $40,000 eligible gain?

• Further, the investors might have a successful factual argument that unrelated third party creditors could have loaned the QOF the $600,000; in that case the issue as to pro-rata debt issuance would not arise.

• Or can the IRS state, e.g., there has been an abuse, because the QOF could hypothetically have issued $100,000 in equity to each investor, in which case only 40% of the step-up would have been available under the §1400Z-2(e) mixed fund rules?
Insufficient Eligible Gain – Can Pro-Rata QOF Debt Be Used

• Does §7701(o) have any application, particularly since the debt and equity are in the same proportions? Cf. H.R. Rep. No. 111-443, at 296 (2010) — §7701(o) does not apply to alter the tax treatment of "certain basic business transactions . . . merely because the choice between meaningful economic alternatives is largely or entirely based on comparative tax advantages, including the choice between capitalizing a business enterprise with debt or equity.”
Insufficient Eligible Gain - Can Pro-Rata QOF Debt Be Used?

• The Preamble to the 2019 Proposed Regulations states that “Sections 1400Z-1 and 1400Z-2 seek to encourage economic growth and investment . . . by providing Federal income tax benefits to taxpayers who invest new capital in businesses located within qualified opportunity zones through a QOF.”

• Does the QOF anti-abuse not apply to use of debt, because the investor is investing the debt capital, as well as equity capital, in QOZBs through a QOF?

• Prop. Reg. §1.1400Z2(f)-1, where the (c) anti-abuse rule is located, is titled “Penalty for Failure to Maintain 90% [QOF Assets] Test,” irrelevant to this issue.
Insufficient Eligible Gain - Can Pro-Rata QOF Debt Be Used?

• But, although not mentioned in the 2018 Preamble, §1400Z-2 can be viewed as having the purpose of unlocking built-in eligible gains, and the use of pro-rata debt arguably is inconsistent with that purpose.
Insufficient Eligible Gain – IRS Debt-to-Equity Recharacterization

Hypothetical 12:

• Investor has recognized capital gain equal to 1/7 of the funds needed to start her private QOF. (That may be because her unrealized capital gain was only 1/7 of the funds needed, or simply because she did not want to pay 2026 gains tax on 85% of the remaining 6/7 of unrealized gains needed). Suppose the investor contributes 1/7 of the needed funds for all the equity in the QOF, for which she makes a gain deferral election. She herself loans 6/7 of the funds to the QOF.
IRS Debt-to-Equity Recharacterization

• At the end of 11 years, the QOF stock is highly valuable, and the debt, then outstanding, is only worth its original, relatively small, face.

• The investor sells the QOF stock in year 11 at a large gain.

• Question presented: If the IRS successfully recharacterizes the 6/7 of funds advanced as equity under the traditional debt-equity factors analysis, is the QOF stock stepped up, or is only 1/7 of the QOF stock stepped up?
IRS Debt-to-Equity Recharacterization

• Must the non-qualified portion of the investment be pro-rated to the common stock? Or, if 6/7 of the investment is treated as a non-qualified preferred stock QOF investment under debt-equity principles, can the gain be traced to the common equity, which then benefits from the Prop. Reg. §1.1400Z2(c)-1 step-up? Since the gain deferral election is made only with respect to the designated common equity, arguably §1400Z-2(e)(1)(A)(i) allows that to be treated as a separate investment.

• The Preamble states that “the share of gain attributable to the excess investment . . . is not eligible for the various benefits afforded qualifying investments.” For QOF partnerships, Prop. Reg. §1.1400Z2(b)-1(c)(6)(iv)(D) refers to allocation percentages for some purposes, based on capital contributions, not profits. But even this has been criticized. And what about QOF S and C corporations?
IRS Debt-to-Equity Recharacterization

• What if the QOF is an S corporation and, like here, the straight-debt safe harbor applies? See Reg. §1.1361-1(l)(5)(i) (“even if it is considered equity under general principles of Federal tax law [such] an obligation is generally treated as debt and when so treated is subject to the applicable rules governing indebtedness for other purposes of the Code”); PLRs 9746038, 9342019.

• However, where the S corporation has cumulative losses, any reductions of S QOF debt basis, like reductions of ineligible QOF stock basis, but unlike reductions of eligible QOF S stock basis, do not benefit from the 10 year QOF step-up under Section 1400Z-2(c).

• What if the QOF equity is purchased within the 180 day gain period, and the loan is made later, e.g. in the next year, or staggered over 2 years?
Gain Delayed

**Hypothetical 13:**
Investor has enough cash to fund the equity immediately needed by her QOF in late 2019, but will not recognize enough gain to cover 1/2 of the funding until early 2020.

1. Can investor loan 1/2 of the money to the QOF in late 2019, and then, when the gain is recognized in 2020, either (a) exchange in 2020 the debt for equity; or (b) contribute in 2020 cash in the amount of the 2019 loan for equity and then have the QOF use that cash to repay the investor’s loan?

2. If the 1/2 is true debt under a traditional-debt equity analysis, is this fine?

3. Is this an abuse? It promotes QOZ business, but locked-in gains are not freed until shortly after the investment.
Master Lease

Hypothetical 14:

• Non-QOF Partnership owns QOZ rental land and building in 2019.
• Partnership master leases the land and building to a sister (or subsidiary) QOF with the same partners for 50 years.
• The lease satisfies the QOZBP related party lease test in Prop. Reg. §1.1400Z2(d)- 1(c)(4)(i)(B).
Master Lease

• After 11 years, the master lessee QOF sells (i.e. assigns for a lump-sum cash payment) the master lease to an unrelated third party.

• Since the master lease has no pretax significance (rent is paid to an identically owned entity), and brings in no new investment, is the 11 year step-up denied under the anti-abuse rule or economic substance doctrine?

• What percent of new investors in the master lessee would be needed to provide sufficient economic substance or non-abuse?
Purchase Before QOZ Designation

**Hypothetical 15**

- An aspiring QOF or QOZBP purchased an existing rental building in early February 2018, with a view to substantially renovating it.
- The census tract within which the real estate is located was certified by the Treasury as a QOZ 5 months later.
- That tract was then listed in IRS Notice 2018-48 (July 9, 2018).
Purchase Before QOZ Designation

• Thus, for 4 months of Buyer’s holding period, the rental building was not used in a census tract that was then designated as a QOZ.

• Section 1400Z-2(d)(2)(D)(iii) disqualifies property as QOZBP if for more than an insubstantial period (10%) of the holding period, the property was not used in a QOZ.

• Question: Does the §1400Z-1(b)(1)(A)(ii) QOZ certification relate back to December 22, 2017? Or is the property doomed to non-QOZBP status for 50 months, even if substantially renovated?

• Since §1400Z-2(d)(3)(D)(i)(I) seems only to require a post-2017 purchase, an argument exists that the QOZ certification is retroactive.
Forming a QOF

Hypothetical 16:
• A large real estate company “Developer” bought, through a single member LLC, a tract of land in late 2018 located in a census tract already designated a QOZ. The company itself cannot qualify as a QOF or QOZB because most of its other properties are located outside QOZs.
• The company, first becoming aware of the QOF benefits, seeks to develop the property in a QOF.
Forming a QOF

Developer

SMLLC

Real Estate in QOZ
Regarded Entities

• Both a QOF and a QOZB must be regarded entities (tax partnership, S corp, C corp)
• Disregarded entity cannot qualify
• What happens if we add a QOF as a second member to the LLC?
Acquired by Purchase Requirement

• In order to qualify as QOZBP, tangible property must be, among other requirements, “acquired by purchase” as described in §179(d)(2). Property acquired by an LLC through capital contribution by an LLC member is not acquired by purchase.

• Rev. Rul. 99-5
  o If QOF buys LLC interests from Developer, QOF is treated as buying an equivalent ownership percentage of the real estate and QOF and Developer each contribute their interest in the real estate to the LLC
  o If QOF contributes cash to the LLC, Developer is treated as contributing the real estate and QOF is treated as contributing cash.
  o In either case, the real estate is not “purchased” by the LLC.
Acquired by Purchase Requirement

• Can anything else be done?
  o Spin-off of all Developer’s other properties, coupled with an election by Developer, which does meet the 2018 purchase requirement, to prospectively be a QOF?
  o A master lease of the property to a QOF or QOZB?