THE SECOND SET OF OPPORTUNITY ZONE PROPOSED REGULATIONS

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Agenda

• Qualified Opportunity Zone ("QOZ") Background
• Proposed regulations
  • Section 1231 Considerations
  • Debt Financed Distributions (disguised sales coordination)
  • Clarification on Initial Investments in a Qualified Opportunity Fund ("QOF")
  • Mixed-Use Funds and Bifurcated Interests (including Carried Interests)
  • Post 10-year Holding Period Considerations
  • Tiered Partnerships
**QOZ Framework**

At least 90% of $600 invested as equity in Qualified Opportunity Zone ("QOZ") Property (reduced to 70% in qualified lower-tier entity).

**Timing:** 90% tested twice a year (6 month point and end of year).

**Effect:** Failure to satisfy QOF status results in penalty. Any shortfall on the 90% is penalized at the tax underpayment rate. Broader QOF disqualification risk if shortfall continues.

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**Tax Benefits**

- **Deferral of unrelated tax gain:** the $600 is deferred until up to 12/31/26 (or earlier sale)
- **Up to 15% exclusion of unrelated gain:** after a 5-year hold investor increases basis by 10% of the $600, or $60; at 7-year point basis increases another 5% or $30.
- **Potential complete exemption of post-contribution QOZ Property gain:** If Investor has not sold within 10 years after Step 1, no tax on post-contribution appreciation in QOF interests.

**QOZ Property** is tangible property used in a trade or business of the QOF that is (1) acquired by the QOF for cash or property in a taxable transaction from an unrelated party and (2) either (i) the original use of the property commenced by the QOF or (ii) the QOF "substantially improves" the property (building improvements exceed basis).
In general, Section 1231 gains are treated as capital gains even though technically not arising from the sale or exchange of capital assets.

Only net-Section 1231 gains eligible for deferral and investment in the QOZ, and 180-day period begins as of the end of the taxpayer’s taxable year.

Contrasts with non-Section 1231 capital gains that can be deferred within 180 days of sale of capital assets associated with such gain.

Why the difference?

Partner level Section 1231 determination seemingly precludes a partnership from being an investor in a QOF.
Inclusion Events – Disguised Sales Coordination

• Assume:
  • A contributes $100 of cash consisting of eligible gain.
  • B contributes in-kind property with basis of $40 and value of $100, and has $100 of eligible gain.
  • QOF borrows $100
  • All items split evenly.

• A has zero basis in its QOF interest with respect to the cash and $50 from the debt.
• QOF distributes $10 to A.
• **Inclusion Event**
  • A debt financed distribution is not an inclusion event for QOZ purposes, and should be tax free for sub-k purposes.

• **Disguised Sale**
  • For d/s purposes, two points:
    • DFD disabled.
    • Cash contribution by A treated as a property contribution.

• What if property value increases in a year e.g., Whole Foods moves into a QOZ?
Initial Investments in a QOF

• The new Proposed Regulations provide additional guidance on the form and manner of initial QOF investments, including:

  • Clarity on capital gains (as noted previously)

  • Ability to acquire an eligible interest as a secondary purchaser

  • Exclusion of later investments from next 6-month testing period

  • Contributions of non-cash property

  • Exclusion of interests received in exchange for services (e.g., no carried interest)
Mixed-Funds and Bifurcated Interests

• The new Proposed Regulations provide rules for so-called “mixed-fund investments”
  • An investor who acquires a QOF interest for both qualifying capital (i.e., rolled over cap gains) and non-qualifying capital (e.g., services) is considered to own two separate interests in the QOF
  • If an investor contributes appreciated property to a QOF the amount of the qualifying investment is equal to the investor’s basis in the property and the investor will have a non-qualifying investment equal to the amount of the unrealized appreciation in the property
    • Note, if the FMV of contributed property is less that the taxpayer’s basis in the property, the amount of the qualifying investment is such FMV
  • If an investor rolls over qualifying capital gains and also invests additional non-eligible gain, only the eligible gain is a qualifying investment
Mixed-Funds and Bifurcated Interests (cont’d)

• The Proposed Regulations provide that with respect to mixed-fund investments:
  • A QOF partner will be treated as holding a single partnership interest with a single basis account for all Subchapter-K purposes, and
  • Solely for purposes of Section 1400Z-2, the partner will be treated as holding TWO interests
    • All partnership items (e.g., income, debt allocations, distribution) would affect these two interests proportionately (based on relative capital contributions)
      • Section 704(c) rules would apply to prevent inappropriate shifting
      • Special rules apply in the case of mixed-fund investments attributable to profits interests received for services
Post 10-year holding period considerations

• Under the statute and the first set of Proposed Regulations, a QOF investor needed to sell its interest in the QOF in order to claim the gain exclusion on its QOF’s appreciation

• The new Proposed Regulations provide additional flexibility in terms of exiting investments after achieving the required 10-year holding period
  • If a QOF sells directly held QOZ property the capital gain on such property will be tax-free to the QOF investor
    • This is achieved with respect to partnership QOF or S corp QOF by excluding the gain from gross income (REIT QOF’s are provided a special 0% rate to achieve the result)
  • This rule is only applicable at the QOF level, and so in a two-tier structure in which a QOF owns a QOZB, the exclusion is not available for sales or dispositions of QOZ property by the QOZB
  • Note, these 10-year gain exclusion rules do not provide the same effective date reliance as the other provisions in the new regulations
Up to 15% of a taxpayer’s deferred eligible gains can be permanently excluded from tax if the taxpayer meets certain holding periods.

- First, if a QOF investment is held for 5 years prior to December 31, 2026, the taxpayer gets a 10% step up in their QOF basis.
- Second, if a QOF investment is held for 7 years prior to December 31, 2026, the taxpayer gets an additional 5% basis step up.

In a QOF partnership, these basis adjustments are treated as an item of income described in Section 705(a)(1) and are allocated to the owners of the QOF.

- They must be further allocated to the owners of any upper-tier partnership that directly or indirectly (solely through one or more partnerships) owns such QOF interest, and must track to such owners’ interests, based on their shares of the remaining deferred gain to which such amounts relate.
Deferred eligible gains generally must be recognized the earlier of (i) the date the qualified investment is sold or exchanged or (ii) December 31, 2026.

The new Proposed Regulations clarify that inclusion events include both taxable dispositions and certain non-taxable dispositions that trigger a reduction in a taxpayer’s share of deferred gains.

For tiered partnerships, if an upper-tier partnership sells a portion of its partnership interest in a transaction that is treated as an inclusion event, the indirect owner must provide the QOF owner notification and information sufficient to enable the QOF owner, in a timely manner, to recognize an appropriate amount of deferred gain.
Contributions to Upper-Tier Partnerships

• The Proposed Regulations do not permit an eligible taxpayer to contribute eligible gains to a non-QOF partnership for further contribution to a QOF (i.e., non-QOF aggregator or feeder fund structures are not permitted from the outset).

• In contrast, an eligible taxpayer that initially contributes rollover dollars to a QOF can subsequently contribute its interest in the QOF to an upper-tier partnership that is not a QOF. That upper-tier partnership will then become subject to the QOZ rules (i.e., stepping into the shoes of the contributing partner).
Contributions to Upper-Tier Partnerships (cont’d)

• The upper-tier partnership receiving the contributed qualifying investment must allocate and report gain associated with the contributed qualifying investment to the contributing partner to the same extent that the gain would have been allocated and reported to the contributing partner in the absence of the contribution (similar to a Section 704(c) approach).

• Query – what is the policy reason for permitting a qualifying investment to an upper-tier partnership after making the initial investment in a QOF but not allowing taxpayers to structure an arrangement this way through a feeder fund initially? Is it simply due to statutory constraints?
Contributions to Upper-Tier Partnerships (cont’d)

• The Proposed Regulations generally do not treat a Section 721 contribution as an inclusion event, as long as it does not cause a termination of the QOF partnership.

• Can taxpayers ever restructure a QOF partnership that directly owns and operates a trade or business in an Opportunity Zone into a two-tier structure in which the trade or business is operated by a Qualified Opportunity Zone Business Partnership or Corporation without triggering an inclusion event or failing to meet the requirements of Section 1400Z-2(d)(2)?