Still Unresolved Issues in Qualified Opportunity Funds

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Sales, Exchanges & Basis Committee
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Recent Guidance

• Proposed regulations issued April 17, 2019. REG-120186-18
  • Comment deadline June 30, 2019
• Request for information on data collection and tracking
  • Comment deadline – May 31, 2019
  • New Senate bill on opportunity zone data mandates
• Possible third set of guidance?
• Possible legislative extension by 1 year?
QOZ Tax Benefits

• Recognize capital gain
  • Installment sales?

• Roll-over w/in 180 days into QOF for:
  • Deferral until December 31, 2026
  • Basis step-ups after 5-year hold and 7-year hold (prior to 12/31/26)
  • Exclusion of new gain on disposition of QOF (10-year hold) by 2048
1231 Gains and the 180 Day Period

• Controversial Proposed Reg., on which comments are requested, start 180 day investment for 1231 gains at end of year of sale.

• Inconsistent with statutory language in Sec.1400Z-2(a)(1)(A), which begins the 180 days from the “date of such sale or exchange”?

• Benefit: More time to reinvest as “eligible gain” in QOFs in the next year.

• Detriment: No time to reinvest in QOF’s as “eligible gain” in current year.

• Many, perhaps most, 2018 QOF investments, made from 2018 1231 gain, possibly retroactively disqualified from “eligible gain” treatment.

• Absent extension legislation, 2020 investments from 2019 1231 gain only have the 10%, not 15%, 2026 step-up.
Gain on Transfer to QOF

• A owns Property A, which is appreciated property, and exchanges Property A for 15% of QOF.

• Gain realized (but not recognized) on exchange for QOF interest is ineligible. Prop. Reg. 1.1400Z2(a)-1

• Ok if A has other gain
  • But note that Property A isn’t acquired by purchase
Gain on Transfer to QOF

• Alternatively, A sells Property A to QOF, then contributes the amount of gain from the sale into QOF for a 15% interest.

• Does circular cash flow doctrine apply to recharacterize A’s sale and cash contribution as an ineligible property contribution?
QOF Qualification Overview

• QOF must meet 90% asset test
  • QOZ Property = QOZBP, QOZ stock and QOZ partnership interests
  • QOZ stock or partnership interests must be acquired after 2017 for cash, the QOZ corp or partnership must be in a QOZ business, and during *substantially all* (90%) of the QOF’s holding period, the QOZ corp or partnership qualified as a QOZ business.
  • Are single member LLCs owned by the QOF or QOZB disregarded?
  • Can a second, or lower-tier, corporation or partnership interest be a qualifying opportunity zone property?
QOZ Business Requirements

- Substantially all (70%) of the tangible property owned or leased must be QOZBP, and in order to qualify as QOZBP, tangible property must be:
  - Acquired by purchase after 2017
  - Original use in the zone commences with QOF or QOZ business OR QOF or QOZ business substantially improves the property - no need to substantially improve a business itself, correct?
  - During substantially all (90%) of the QOF’s or QOZ business’s holding period, substantially all (70%) of the use of the property was in a QOZ
- At least 50% of gross income is derived from active conduct of a trade or business
- A substantial portion (40%) of the intangible property is used in the active conduct of the business
- Less than 5% of the property of the business is nonqualified financial property (by aggregate unadjusted basis)
  - Exception for certain financial property needed for working capital
1/1/2019: QOF is formed by investors A and B (both of whom recognized capital gain in December 2018). QOF forms QOZP and has an appropriate plan to use its cash as working capital.

2/1/2019, QOZP acquires land ($100X) with a warehouse ($500X) in a QOZ.

QOZP promptly begins improving the property to create a manufacturing plant on the land which costs $501X and takes 31 months.

QOZP expands by acquiring two non-QOZ distribution facilities but still holds 75% of QOZP’s assets as QOZBP.

3/1/2028, QOZP acquires a third distribution facility that results in only 65% QOZBP.

1/1/2029, assuming the balance sheet test remains the same, is the QOZP interest QOZBP?

What happens if QOF sells QOZP on 2/1/2029? 4/1/2029?
Substantially All: Potential Enforcement Issues

• Timeline/plans for issuing guidance on penalty enforcement?
  • Property must be used within a QOZ 70% of the time
    • Headquarters in zone with operations in and out of zone
    • How will this be enforced? (tracking of mobile property in and out of zones)
  • Property must be QOZBP for 90% of holding period
    • How will this be enforced?

• A question on IRS Form 1120S asks whether the S-Corp is a QOF (Question 15) for purposes of reporting the QOF-related penalties. There is no similar question on IRS Form 1065. Is this difference intentional because partners receive a distributive share of the QOF penalty by rule?
Working Capital

• October Proposed Regs provided a safe harbor for the working capital exception to 5% limit in the context of working capital needed for substantial improvement, acquisition or construction costs.

• April Proposed Regs redefined working capital safe harbor for development of a trade or business, including substantial improvement, acquisition or construction costs.

• Extension is allowed in the case of delay resulting from awaiting government actions.

• How detailed does a working capital plan need to be?
  • Are changes to the plan ok?
  • Is a blind pool inherently inconsistent?
Working Capital and Related S-I Safe Harbor

- Working capital safe harbor allows QOZP to hold cash that meets a 31-month safe harbor, and a related safe harbor treats property as if it had met the original use or substantial improvement test.
- Same facts as slide 9
- What happens if the construction can not be completed in 31 months?
- New proposed regulations allow for extensions to the working capital safe harbor if delay is attributable to government approvals requested within the 31 month period.
- If the delay is not related to government approvals, may not qualify for safe harbor, but may well still qualify as reasonable working capital under 1397C(e).
- But can the property which is being substantially improved and not yet completed (recall cost of building was $500X and improvement plans cost $501X) qualify as QOZBP?
  - Reasonable cause?
Original Use

• Original use begins when property is placed in service
  • QOF does reasonable due diligence to verify that seller has not placed property in service but it is later discovered that property was previously used in the zone.
    • Reasonable cause?
  • How will the Service treat “build-and-sell” transactions? (relevance of C of O?)
  • Property used for personal purposes was never placed in service
    • Can a QOF buy 10 owner occupied personal residences, treat as original use and rent them out?

• Property relocated into the zone meets the requirement that this be the “original use within the zone.”
  • Can a QOF qualify by acquiring business assets from one QOZ and moving them to another?

• Property becomes original use if purchased by QOF or QOZB after a 5-year vacancy
  • Would there be a certification that a QOF can rely on (similar to FIRPTA certs)?
Treatment of Land

• Land can never be original use
• Land does not need to be substantially improved
• To be QOZBP, must be used in QOZB
  • How much scrutiny for plots of land that may be somewhat bigger than the building (e.g., rental real estate) on them necessitates?
  • Is land that awaits permits and construction “used in the QOZB”? 
One-Year Safe Harbor for Asset “Churn”

• QOFs selling QOZP can reinvest into any other QOZP within one year; proceeds exempt from compliance testing

• But all federal income tax consequences apply to dispositions
  • Treasury couldn’t find any authority to exempt QOF transactions from regular income tax consequences
  • QOFs will conduct their own Section 1031 and Section 1045 exchanges
    • Section 1031 – increases importance of NSH reverse exchange format
    • Section 1045 – increases importance of C-Corp as choice of entity
Substantial Improvement – Asset-by-Asset vs Aggregation

• How does asset-by-asset substantial improvement work for the acquisition of operating businesses?

• Prior to 2023 many purchased assets are expensed
  • Does that mean there is no basis to more than double or does the purchase price serve as the starting point?

• A manufacturing facility or a science lab needs $50X of expensive new equipment but less in building improvements to the building (real estate purchased for $20X, $15X allocated to building which needs $10X of improvements). Might it qualify with all assets held in a single QOF?

• A QOF purchases a lot with an existing building and wants to construct two brand-new buildings on the same lot. OK or not OK? Fact-dependent?
Dispositions of QOF Property

• Special election for QOF partnerships and S corps to exclude gains
  • Must have held interest for at least 10 years

• Facilitates dispositions for multi-asset QOFs

• QOZB dispositions?
  • “Capital gain dividend identified with a date”
  • Shareholder 10 year holding period

• No reliance. If not retained, can we expect that there will at least be something to facilitate an exit strategy for multi-asset QOFs?
QOZ Business Safe Harbors (50% Requirement)

Businesses must derive 50% of gross income from within QOZs

1. 50% of services are performed within the/a QOZ

2. 50% of amounts paid for services were for those services performed within the/a QOZ

3. 50% of tangible property is in a QOZ and 50% of management and operations occurs within the QOZ

Otherwise, businesses can meet a “facts and circumstances” test to show they derive 50% of gross income from the QOZ
Inclusion Events

Refinance cash-out permitted, with limitations.

- Distributions that exceed basis
- Distributions based on disguised sales rules

QSST-to-ESBT and ESBT-to-QSST conversions are exceptions, yet grantor trust status changes are inclusion events.

- But with QSBT/ESBT conversions, grantor trust status also changes – what gives?

“Contributions” to grantor trusts are exceptions.

- Are sales equivalent to contributions? See Rev. Rul. 85-13
Are New Foreign Investors Welcome in QOZs?

Suppose a non-resident alien or foreign corporation has non-effectively connected, foreign source, capital gain income, in late 2019, which therefore is excluded from U.S. gross income. (See, Reg. 1.871-11(f) Example (2)(d), referring to sales proceeds excluded from gross income of a non-resident alien as “gain.”). Under Reg. 1.1400Z-2(b)(1), (2), is such foreign investor an “eligible taxpayer,” and is such gain “eligible gain,” that can fund an interest in a QOF in early 2020? When such gain reverses in 2026, does such gain maintain its tax-free character under Reg. 1.1400Z-2(b)(5)? In 10 years, does the QOF interest step-up avoid FIRPTA?
Are Existing Foreign Investors Welcome in QOZs?

Suppose an existing non-resident alien or foreign corporate investor in non-QOZ U.S. real estate has eligible FIRPTA gain in late 2019. Suppose it plans to invest this gain in a real estate–based QOF in early 2020. Will the IRS grant the seller a non-withholding certificate? (See Reg. 1.1445-3(b)(6)). Will IRS insist on security for the withholding to cover the possibility the reinvestment will not take place, or that the QOF will not remain a U.S. real property interest?
General Purpose and Anti-Abuse Rules

• Purpose of statute: “encouraging economic growth and development in QOZs” – this presumably guides the general anti-abuse rules

• What about existing business “washouts?”
  • Is it abusive for a QOF to buy an existing business in the zone and replace all tangible personal property with new property? What if the business also owns real property in the zone, and the QOF/QOZB substantially improves it?

• Cumulative losses?
Other Unanswered Questions

• Interplay between Section 1202 and Section 1400Z-2
  • What happens when the five-year holding period hits before December 31, 2026? Which statute controls? With these new regs, they come into direct conflict

• Substantial improvement issues
  • “Reverse cost segs” – will these be challenged? What about taxpayer/advisor judgment calls to capitalize certain expenses?
  • What about improving a property still operating (e.g., a hotel)? Can taxpayers make an argument to capitalize everything?
  • What if a taxpayer buys a parcel with an existing building and erects a brand new structure next to the existing building?

• No possibility of a “Section 1031 exchange bailout?”
Other Unanswered Questions

• How does Section 1014 work in the context of adjustments to outside basis of S-Corp stock and partnership interests? What if the partnership has an existing Section 754 election – does the step-up in inside basis also apply upon death?