Qualified Opportunity Zones

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Panelists

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Background

- Established under the Tax Cuts and Jobs Act of 2017 (the “Act”), IRC Section 1400Z-1 and 1400Z-2.
- Allows taxpayers to defer capital gains incurred from a sale or exchange of an asset to an unrelated third party by investing the gains in Qualified Opportunity Funds (“QOFs”) which, in turn, invest in “Qualified Opportunity Zone Property.”
- Intended to encourage investment in areas designated as Qualified Opportunity Zones (“QOZs”).
- QOZs were designated in all 50 states, the District of Columbia, and several possessions during the first half of 2018.
- Proposed Regulations were issued on October 19, 2018.
Eligible Taxpayer

- QOZ benefits are available to “eligible taxpayers” that invest “eligible gains” into one or more QOFs within a 180-day investment period.
- An eligible taxpayer is any taxpayer that recognizes capital gain for tax purposes.
- The Regulations provide that a partnership may get QOZ benefits by investing eligible gains and, to the extent that the partnership does not do so, the Regulations allow a partner to invest such partner's share of eligible gains not invested in a QOF by the partnership into a QOF.
- Rules analogous to those provided for partnerships apply to other pass-through entities (including S corporations, decedents' estates, and trusts).
Eligible Gain

• Gain is treated as “eligible gain” if:
  – the gain is treated as capital gain,
  – the gain is gain that would otherwise be recognized no later than Dec. 31, 2026, and
  – the gain is not recognized as a result of a sale or exchange engaged in by the taxpayer with a related person.

• The Regulations provide that any capital gain from a position that is or has been part of an “offsetting-positions transaction” is not eligible to receive QOZ tax benefits upon investment in a QOF.

• An “offsetting-positions transaction” means any transaction in which a taxpayer has substantially diminished its risk of loss from holding one position by holding one or more other positions, regardless of whether either of the positions is with respect to actively traded personal property.

• Eligible gains generally include gross gains, except in the case of section 1256 contracts.
180-Day Investment Period

• **General Rule.** The first day of the 180-day period generally is the date on which the gain would be recognized for tax purposes.

• **Special Rule for Partnerships.** In the case of a partner investing its distributive share of partnership gains into a QOF, the partner’s 180-day period:
  
  – generally begins on the last day of the partnership’s taxable year, but
  
  – the partner may choose to begin its own 180-day investment period on the same date as the start of the partnership’s 180-day investment period where the partner knows (or receives information) regarding both the date of the partnership’s gain and the partnership’s decision not to elect deferral under the QOZ regime.
Investments in Excess of Eligible Gain

- If an investor makes an investment in a QOF in excess of its eligible gains, its investment is treated as two separate investments:
  - one investment relating to its recent sales or exchanges, which may qualify for the QOZ tax benefits; and
  - a separate investment, consisting of the excess amount, which will not qualify for those tax benefits.
- The Regulations clarify that, where the QOF is a partnership, a deemed contribution of money resulting from an allocation of QOF-level liabilities under Section 752(a) does not constitute an investment in the QOF. As a result, such a deemed contribution does not result in the partner having a separate, non-qualifying investment in the QOF.
Overview of QOZ Tax Benefits

• There are three potential tax benefits available for QOF investments.
  – Temporary deferral of reinvested gains until the earlier of the investor’s disposition of its QOF interest or December 31, 2026.
  – Reduction of the amount of gain that will be subject to tax based on how long the investor holds its interest in the QOF.
    • 10% decrease for an interest held for 5 years or more, and
    • A further 5% decrease for an interest held for 7 years or more.
  – Appreciation in the value of the investor’s investment in the QOF is not subject to tax if the investment is held for 10 years or more and the investor exits through a sale or exchange of its investment in the QOF.
Qualification as a QOF

- A QOF is an investment vehicle organized as a corporation or a partnership for the purpose of investing in “Qualified Opportunity Zone Property.”

- A QOF must hold at least 90% of its assets in Qualified Opportunity Zone Property (tested every tax year). This percentage is calculated by taking the average of the percentage of qualified opportunity zone property held in the fund as measured (i) on the last day of the first 6-month period of the taxable year of the fund, and (ii) on the last day of the taxable year of the fund.

- An investment entity must self-certify its QOF status in its federal income tax return.
  - No approval or action by the IRS is required.
  - To self-certify, a taxpayer completes a form and attaches that form to the taxpayer’s federal income tax return for the taxable year. The return must be filed timely, taking extensions into account.
Qualified Opportunity Zone Property

- Qualified Opportunity Zone Property is either:
  1. Qualified opportunity zone stock or partnership interest – a new issuance of equity (acquired solely for cash) in a corporation or partnership that is a Qualified Opportunity Zone Business (QOZB).
  2. Qualified opportunity zone business property (QOZ Business Property) - tangible property used in a trade or business where:
     - such property was acquired by purchase from an unrelated party after December 31, 2017,
     - the *original use* of such property in the QOZ commences with the QOF or QOZB, or such property is *substantially improved* while held by the QOF or QOZB, and
     - during substantially all of the QOF’s or QOZB’s holding period for such property, substantially all of the use of such property was in a Qualified Opportunity Zone.
Qualified Opportunity Zone Business

• An entity is a Qualified Opportunity Zone Business if:
  – 70% of the tangible property owned or leased by such entity is QOZ Business Property (determined as if such owner were a QOF),
  – such entity does not operate, or lease land to, any 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,
  – at least 50 percent of the total gross income of such entity is derived from the active conduct of the trade or business,
  – a substantial portion of the intangible property of such entity is used in the active conduct of the trade or business, and
  – less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to “nonqualified financial property” (e.g., stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts and annuities).
Working Capital Safe Harbor

- The Regulations adopt a 31-month working capital safe harbor for QOF investments in QOZBs that acquire, construct, or rehabilitate tangible business property in a QOZ. The safe harbor treats a trade or business’s cash, cash equivalents, and debt instruments with a term of 18 months or less as working capital that does not constitute “nonqualified financial property” (and thus does not disqualify the trade or business from being a QOZ business) so long as:
  - there is a written plan that identifies the working capital as held for the acquisition, construction, or substantial improvement of tangible property in a QOZ,
  - there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets within 31 months of the receipt by the business of the assets, and
  - the business substantially complies with the schedule.
In connection with the 31-month working capital safe harbor, the Regulations provide an additional safe harbor for tangible property of a QOZB.

Specifically, tangible property is treated as QOZ Business Property for purposes of meeting the 70% test for QOZBs if:

- the business utilizes the working capital safe harbor described on the prior slide,
- the tangible property for which the working capital is dedicated is expected to satisfy the necessary requirements to be QOZ Business Property as a result of the planned expenditure of the working capital assets within the 31 months immediately after the working capital was acquired, and
- the working capital assets are actually used in a manner that is substantially consistent with the business’s 31-month schedule.
**Timeline**

- **Date on which gain is recognized by taxpayer**
  - (or, in the case of a partnership where a partner is making a gain deferral election, generally the last day of the partnership’s taxable year)

- **Date on which QOF invests in a QOZB**

- **Date on which investment into QOF is made**

- **Date by which QOZB deploys working capital in building or substantially improving property**
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<tr>
<th>Comparison</th>
<th>REITs</th>
<th>Partnerships</th>
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<tbody>
<tr>
<td>Ability to Use QOF Losses Against Non-QOF Income</td>
<td>No</td>
<td>Potentially</td>
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<td>Ability to Charge Different Management Fees</td>
<td>No</td>
<td>Yes</td>
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<td>Allows Potential Separate Sales of Multiple Properties</td>
<td>Yes</td>
<td>Generally no, unless side-by-side partnerships are used</td>
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<tr>
<td>Carry</td>
<td>Must be taken at lower tier level</td>
<td>Can be taken at QOF level – but complexity may result if side-by-side partnerships are used</td>
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<td>Ability to Make Tax-Free Leveraged Distributions</td>
<td>Generally no</td>
<td>Possibly yes – subject to further guidance</td>
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<td>State and Local Tax</td>
<td>May result in more favorable SALT treatment</td>
<td>Generally taxed on a pass-through basis</td>
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<td>QBI Eligibility</td>
<td>Yes for ordinary REIT dividends</td>
<td>Income may (but does not automatically) qualify</td>
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<td>Ability to conduct non-rental qualifying businesses</td>
<td>Limited by REIT rules</td>
<td>Generally not limited</td>
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Major Issues - Partnerships

• How is a partner’s basis in its QOF partnership interest initially determined and subsequently adjusted?
  – Does it take into account its share of liabilities under Section 752?
  – If so, may a partner deduct currently excess depreciation allocated with respect to a QOF partnership interest? And if that is the case, is there required recapture of any excess depreciation taken?

• When a partner sells its QOF partnership interest, does the FMV step up after year 10 also include its share of partnership liabilities, such that all gain will be eliminated?
Other Major Issues

• The OZ regime appears limited to 2-tier structures (QOZ owning QOZB), with no additional partnerships above or below the QOZ permitted. Was this intended?

• May a profits interest benefit from QOZ tax benefits if the service provider also contributes eligible gain in exchange for the interest?

• It appears that Section 1231 gains may be treated as eligible gain, but it is unclear how to make the determination of eligible gain treatment until the end of the taxpayer’s year.

• Logistics of establishing a QOF:
  – Ability to use traditional capital call provisions
  – Timing challenges
Selected Issue – Related Parties

1. Tangible property acquired from a related party is not acquired by “purchase” (as defined in Section 179(d)(2)) and therefore cannot be QOZ Business Property.

2. For this purpose, although not entirely clear, the seller is “related” to the QOF or QOZB if it actually or constructively owns more than 20% of the QOF or QOZB.

3. This rule can limit opportunities for investors which were “premature” QOZ investors and who purchased property (with the intention of developing it) in an area later designated as a QOZ.

4. Such investors may be left with the option of either (a) limiting their participation in the development to less than 20% or (b) selling the property to a QOF or QOZB and forgoing participation in the development.

Are there other approaches that could be considered?
Example:
X owns Blackacre, located in an Opportunity Zone, which has basis of $20X and a fair market value of $100X. Blackacre is unimproved, but once entitled and remediated it could support improvements such that the improved Blackacre would be worth an estimated $400X.

X could sell Blackacre to a QOZB sponsored by a friendly QOF and roll the $80 of gain into the QOF. So long as X’s interest (and those of persons related to X) is less than 20%, the QOZB has acquired the property by purchase.

X’s $80 of gain, however, may be more than 20% of the QOZB’s capital if (for example) 50% of the buildout is most efficiently financed by a construction loan. So X cannot roll all of its gain into the QOF without creating a related party issue.

Even if X reduces the amount of gain it rolls into the QOF, it may still trip the related party threshold if it receives a carry or promoted interest. Scaling back that promote may create an unanticipated change in the economics of the business deal.
X might consider ground leasing the property to the QOZB on arms-length terms. If treated as a separate piece of property, the QOZB’s interest in the lease should have a nominal value even if X is related.

• What if the rent contains a participation feature?
• What if X grants an option to purchase the fee to the QOZB?

X might contribute Blackacre to the QOZB. If the QOZB has applicable financial statements, would the QOZB’s cost of the land be equal to X’s cost ($20), the “book value” of Blackacre ($100), or some other number?

Assuming the “cost” is equal to book value, would the improvements to the contributed land be treated as a separate asset?

– Would this result in only 25% ($100/$400) of the QOZB’s assets being “bad”? If so, more than 70% of the QOZB’s assets could potentially be good QOZ Business Property.