Qualified Opportunity Zones--Reboot

ABA Tax Section Meeting
New Orleans, Louisiana
Real Estate Committee
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Formation of a Qualified Opportunity Fund (QOF)

STEP 1: Capital Gain

STEP 2: Formation of Qualified Opportunity Fund

STEP 3: QOF acquires Qualified Opportunity Zone Property
QOF’s Direct or Indirect Ownership in OZ

QOF owns equity interest in Partnership or Corporation that Operates a Qualified Opportunity Zone Business

QOF directly owns QOZ Business Property

New QOZ Business
Expansion of existing business into QOZ
Improvement of existing business already located in QOZ

Construction of new asset
Substantial improvement of existing asset
Partial Forgiveness of Original Gain & Total Forgiveness on Additional Gains

- Original Gain Recognized
- Original Gain Invested
- Basis increased by 10% of deferred Original Gain (i.e. taxed on only 90%)
- Basis increased by another 5% of deferred Original Gain (i.e. taxed on only 85%)
- Basis Equals FMV
- Forgiveness of gains on appreciation above Original Gain investment

Held for 5 years
Held for 7 years
Held for 10 years

Gain Recognition
Original Gain Invested
180 Days
December 31, 2026

- Investment
- Held for 5 years
- Held for 7 years
- Held for 10 years

180 Days
Proposed Regulations

• Published in Federal Register, October 29, 2018
• Treasury and IRS solicited comments
• Real Estate Committee submitted Comments on January 10, 2019
  • Comments to be submitted in stages
  • Initial Comments attempted to be responsive to issues that Treasury and the IRS specifically requested comments in the preamble to the Proposed Regulations
Comments Regarding the 180-Day Election Period and Gain-Deferral Election with respect to a Partner’s Distributive Share of Gain from a Partnership

- Statute: Gain-deferral election applies to “gain”
- Proposed Regulation: Election applies to capital gain
- Issue: Application to section 1231 Gains
  - 180-day period may expire before taxpayer knows for certain whether 1231 gain, either from property owned directly by the taxpayer or by a pass-through entity in which the taxpayer owns an interest, will be taxed as capital gain
Comments Regarding the 180-Day Election Period and
Gain-Deferral Election with respect to a Partner’s
Distributive Share of Gain from a Partnership

• Recommendations:
  • Allow taxpayers to treat all section 1231 gain recognized
during the year as capital gain for purposes of section
  1400Z-2(a)
  • Allow partners of partnerships to disaggregate gains
recognized by a partnership and separately choose
between 180-day election period for each gain
Comment Regarding the End Date of the Step-Up Election

• Statute: Designation of all qualified opportunity zones designated in 2018 expires December 31, 2028
• Proposed Regulation: Propose a fixed end date of December 31, 2047 for the section 1400Z-2(c) step up election
  • 20 ½ years after the latest date in June, 2027 when a taxpayer may make an investment pursuant to a gain-deferral election under section 1400Z-2(a)
Comment Regarding the End Date of the Step-Up Election

• Issue: Whether to eliminate the fixed end date or provide alternatives to avoid forcing taxpayers to disinvest

• Recommendations:
  • Eliminate the fixed end date; or
  • If mandating a fixed end date, provide for a basis step-up election to fair market value without requiring disposition of the investment
    • Determine FMV in the same manner as for purposes of the gross asset test or by appraisal
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    • Determine FMV in the same manner as for purposes of the gross asset test or by appraisal
Comment Regarding the Determination of Asset Value for Purposes of the 90% Asset Test

- Statute: QOF must hold at least 90% of assets in QOZP measured on the last day of the first 6-month period of the taxable year and the last day of the taxable year.
- Proposed Regulation: Alternative methods of valuation
  - If the fund has applicable financial statement ("AFS"), then use the value on the AFS
  - If the fund does not have an AFS, then value equals "cost"
Comment Regarding the Determination of Asset Value for Purposes of the 90% Asset Test

• Recommendations:
  • Allow all funds to use the cost method
  • Avoids issues with GAAP accounting:
    • Possible that an asset may exist for GAAP and not for tax
    • Treatment of leases under recently updated accounting standards
    • GAAP may account for fluctuations in value
    • Funds would have to switch methods if no AFS initially and subsequently need one
Comment Regarding the Determination of Asset Value for Purposes of the 90% Asset Test

• Recommendations:
  • Define cost to mean unadjusted basis for tax purposes
    • Purchased asset remains on balance sheet for greater of asset’s recovery period or 10 years
    • For contributed property, cost is section 704(b) book value
    • For section 1031 replacement property, cost is unadjusted basis of the relinquished property
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

• Statute: QOZBs must satisfy paragraphs 2, 4, and 8 of Section 1397C(b):
  • (2) Gross income requirement: at least 50% of gross income of QOZB is derived from active conduct of a trade or business in the QOZ
  • (4) Substantial portion of intangible property of a QOZB is used in the active conduct of a trade or business in the QOZ
  • (8) Less than 5% of the average of the aggregate unadjusted bases of the QOZB’s property can be attributable to “nonqualified financial property”
    • NQFP excludes reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

• Proposed Regulation:
• (1) “Working Capital Safe Harbor”: working capital assets are treated as “reasonable in amount” if:
  • (i) the amounts are designated in writing for the acquisition, construction and/or substantial improvement of tangible property in a QOZ;
  • (ii) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets and, under the schedule, the working capital assets are required to be spent within 31 months of receipt by the business; and
  • (iii) the working capital assets are actually used in a manner that is substantially consistent with (i) and (ii)
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

• Proposed Regulation:
• (2) “QOZB Safe Harbor”:
  • (i) gross income derived from property treated as a reasonable amount of working capital is counted toward satisfaction of the 50% active income test;
  • (ii) the use test for intangible property will be deemed to be satisfied during any period the business is proceeding in a manner that is substantially consistent with the Working Capital Safe Harbor; and
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

• Proposed Regulation:
• (2) “QOZB Safe Harbor”:
  • (iii) if the Working Capital Safe Harbor treats some financial property as a reasonable amount of working capital, and if the tangible property with respect to which the working capital is expended is expected to meet the requirements of QOZBP, then that tangible property is not treated as failing those requirements solely because the scheduled consumption of the working capital is not complete
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

• Working Capital Safe Harbor--Issues:
  • QOZB in start-up mode may not be able to immediately identify property for substantial improvement within the QOZ
  • Common delays in the real estate development process, for example, delayed permits or variances, extensive municipal processes or approvals, construction delays, extreme weather events, embargoes on supplies, union disruptions, or possibly terrorist attacks
  • Staged cash contributions
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

• Working Capital Safe Harbor--Recommendations:
  • 31-month period commences when construction or reconstruction begins
  • Allow QOZB to hold cash up to 12 months after cash is received before construction commences, with additional 12 month extension if required under circumstances
    • QOZB required to demonstrate proper progress
  • Each contribution of cash from a QOF to a QOZB should have its own 31-month period, with QOZB using a FIFO method to identify which cash was spent by the QOZB
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

• QOZB Safe Harbor--Issues:
  • Cliff effect if trade or business is not operational by month 32, notwithstanding compliance with working capital safe harbor.
    • Many projects unlikely to be “shovel ready” immediately upon acquisition of the property
  • Forces development projects to use a tiered structure
  • Potential for unintentional and unavoidable delays in construction
  • Staged development project may require independent safe harbor periods.
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

- QOZB Safe Harbor--Recommendations:
  - Delink QOZB Safe Harbor from working capital safe harbor
    - 18-month predevelopment period
    - 36-month construction period (beginning upon end of predevelopment period)
    - 12-month reasonable cause extension of construction period (with one additional 12-month extension if required)
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

• QOZB Safe Harbor—Recommendations (con’t):
  • For staged development projects, provide for 24-month safe harbor for rural land would apply provided:
    • QOZB is actively developing property
    • Undeveloped land acquired at the same time as property being developed
    • Land is contiguous (directly or economically) with the property being developed.
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

• Issue: For direct investments by QOFs, no working capital safe harbor

• Recommendation: Extend working capital safe harbor to direct investments by QOFs
  • Deemed working capital to be QOZBP; or
  • Disregard working capital for 90% asset test; or
  • Reasonable cause exception under 90% asset test
Comments Regarding the Working Capital Safe Harbor and the Safe Harbor for Property on Which Working Capital is Expended

• Issue: Working Capital Safe Harbor limited to development of tangible property
• Recommendation: Expand working capital safe harbor for expenditures on operating costs of a QOZB within the QOZ for both start-up and business expansion
  • Examples of operating costs: Wages and salaries of employees working in QOZ, rent, maintenance and utility costs for facilities and equipment located in QOZ
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Statute: Upon investment of eligible gains in a QOF, the taxpayer’s basis in the eligible interest initially is $0 with partial step ups for recognition of deferred gain. Taxpayers basis in the investment initially shall be zero and thereafter increased by 10% of the deferred gain for investments held for five years, an additional 5% of the deferred gain for investments held for seven years, and deferred gain recognized in 2026.
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

- Proposed Regulations: For QOFs treated as a partnership for tax purposes, the deemed contribution of money described in section 752(a) does not create or increase a separate ineligible interest and any basis increase resulting from a deemed section 752(a) contribution is not taken into account in determining the portion of a partner’s investment subject to the gain-deferral election or alternatively, the portion not subject to the gain-deferral election.
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

- Issue: Whether taxpayer’s basis in an eligible interest in a QOF takes into account deemed cash contributions or distributions under section 752?

- Recommendations:
  - Clarify that partnership basis rules of section 705, including section 752, apply to an investment in a QOF treated as a partnership
  - Clarify that losses may be deducted to the extent of basis in partnership interest
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Issue: Whether a partner’s eligible interest, including debt allocated to that partner under section 752, is a single interest for purposes of applying subchapter K?

• Recommendations:
  • Clarify that a partner’s eligible interest includes debt allocated to that interest under section 752
  • Clarify that an eligible interest including debt allocated to that interest under section 752 is treated as a single interest for purposes of subchapter K
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Issue: Whether non-liquidating cash distributions by a QOF result in taxable gain under 731(a)?

• Recommendation: Clarify that distributions of money, other than in liquidation of a partner’s interest, do not result in sale or exchange treatment, except as otherwise provided under section 731(a)
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Issue: Treatment of non-liquidating distributions of property may create opportunity for indefinite deferral of eligible gains
  • Example: Partner invests eligible gain of $100 and prior to 2026 receives non-liquidating distribution of property having a value of $90. Remaining interest in QOF is reduced to $10.
• Recommendation: Amount includable in 2026 (or sooner upon disposition of an eligible interest in the QOF) includes the FMV at the date of distribution of prior non-liquidating distributions of property.
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Issue: Treatment of liquidating distributions of property may create opportunity for indefinite deferral of eligible gains
  • Example: Distribution of property in liquidation of partner’s interest in QOF may not result in gain under section 731(a) notwithstanding that partner no longer has a continuing in the QOF
• Recommendation: Clarify that deferred gain under section 1400Z-2 is recognized immediately prior to liquidating distribution by the QOF, regardless whether any gain or loss is recognized under section 731(a)
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Issue: Whether a special anti-abuse rule is needed to address debt-financed distributions by the QOF?
  • Example: QOF makes debt-financed non-liquidating cash distributions, reducing partner’s net equity investment to $0
    • If property has appreciated, distribution may be greater than equity investment
  • Recommendation: Special anti-abuse rule solely for this purpose is unnecessary
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Statute: Provides for investments held for at least 10 years with respect to which taxpayer makes an election under section 1400Z-2(c), “the basis of such property shall be equal to the fair market value of such investment on the date that the investment is sold or exchanged.”

• Issue: Whether the basis step up for investment held for at least 10 years includes basis attributable to partner’s allocable share of debt under section 752?
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Recommendation: Clarify that the step up for investments held for at least 10 years is calculated with reference to the gross FMV of the investment, except to the extent Treasury and the Service determine that Congress did not intend for the step up to eliminate recapture of the portion of losses exceeding the taxpayer’s net equity investment (the “GFMV Approach”)

• Treasury and the Service to determine if Congress intended for the GFMV approach to apply in circumstances where an investor in a QOF would recognize gain if a QOF asset were foreclosed upon immediately prior to sale of the interest.

• In all other cases, basis is stepped up to gross fair market value.
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Accordingly:
  • If QOF makes debt-financed distribution, debt does not reduce the value of the investment for purposes of computing the step up
  • To the extent that losses claimed by the taxpayer do not exceed the taxpayer’s net equity investment in the QOF, debt does not reduce the value of the investment for purposes of computing the step up
  • If the taxpayer would recognize gain if a QOF asset were foreclosed upon immediately prior to sale of the interest, Treasury and the Service need to decide whether to reduce the gross value of the interest by a portion of the debt equal to the taxpayer’s foreclosure gain
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Example (1): Partner A invests $100 of eligible gain in a QOF, QOF invests the eligible gains together with proceeds of new debt in a QOZB. A’s allocable share of partnership liabilities is $100. A claims total deduction of $50 during 10-year period prior to sale of its investment. At the time of sale, A’s share of the gross value of the QOF’s investment has doubled from $200 to $400.

• Under the GFMV Approach, A’s basis in its interest is stepped up to $400.
  • Contrast, under a net fair market value approach, A’s basis would only be stepped up to $300 and A would recognize $100 of gain on sale of the interest.
  • In this case losses of $50 claimed during the 10-year period do not exceed the partner’s net equity investment of $100
Comments Regarding Separate Investment Rule for Partners having Allocable Shares of a QOF’s Liabilities under Section 752

• Example (2): Partner A invests eligible gains of $100 in a QOF. After 10 years, the value of the QOF’s assets have doubled to $200, and the QOF makes a debt financed distribution of $100 to A. Later that year, A sells its interest for $100. Under the GFMV Approach, A’s basis in its interest at the time of sale is stepped up to $200.

• Contrast, under a net fair market value approach, A’s basis would only be stepped up to $100 and A would recognize $100 on sale of its interest.
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Statute: QOZBP includes tangible property used in a trade or business if:
  • (I) property was acquired by purchase after December 31, 2017;
  • (II) original use of property in QOZ commences with QOF or QOF substantially improves the property; and
  • (III) during substantially all of the QOF’s holding period for such property, substantially all the use is in QOZ
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Statute (con’t): Property shall be treated as substantially improved by QOF only if during any 30-month period beginning after date of acquisition of property, additions to basis with respect to property in hands of QOF exceed an amount equal to adjusted basis of such property at beginning of 30-month period in hands of the QOF
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Statute (con’t): QOZB includes a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is QOZBP
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

- Proposed Regulations for QOZBP:
  - Special rule for land and improvements on land: If a QOF purchases a building located on land situated within a QOZ, substantial improvement to the purchased tangible property is measured by the QOF’s additions to the adjusted basis in the building. QOF is not required to separately substantially improve the land on which the building is located.
  - Consistent with Revenue Ruling 2018-29 issued together with release of Proposed Regulations.
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Proposed Regulations for QOZBs: A trade or business treated as satisfying the substantially all requirement if at least 70% of the tangible property owned or leased by the trade or business is QOZBP.
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Issue: Whether leased property should be treated as acquired by purchase and what is the lease’s value for purposes of asset tests?

• Recommendations:
  • Clarify that property leased by a QOZB from an unrelated party may meet the acquisition by purchase requirement
  • Clarify that property leased from an unrelated party can be QOZBP when held directly by the QOF
  • Clarify that for purposes of the QOFs 90% test or the QOZB’s substantially all requirement, as applicable, the value of the lease is based on the value of the leasehold and not the value of the property under lease
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Issue: Whether the land held in connection with construction or substantial improvements to property is treated as a “good asset” for purposes of asset tests?

• Recommendations:
  • Clarify that if an improvement to land is treated as a “good asset”, the land on which it is placed is treated as a “good asset” even if the land cannot satisfy original use requirement and may not meet substantial improvement
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Recommendations (con’t):
  • Limit amount of land for this purpose to an amount reasonably consistent with facilitating an investment in the improved building
  • Extend the treatment of land accompanying an improvement to improvements other than building improvements (for example improvements to land such as environmental remediation costs)
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Recommendations (con’t):
  • Clarify that an improvement to land that at least doubles the basis of such land in the hands of the QOF is treated as meeting the substantial improvement test even if no structure on the land is improved
  • Clarify that self-constructed property that is constructed on land that was not acquired by purchase (for example, land contributed by a partner) is treated as satisfying the purchase and original use requirement
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Issue: Whether the basis of related assets may be aggregated for purposes of satisfying the substantial improvement requirement?

• Recommendation: Clarify that the substantial improvement requirement may be satisfied based on the aggregate basis of related assets
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

Recommendations (con’t):
Propose two safe harbors for aggregation of assets:
• Assets located or stored on a single tract of land or contiguous tract within a QOZ and which are purchased as part of the same investment decision are “related” for this purpose
• Adjacent buildings may be aggregated if operated as an integrated unit
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Example: QOF acquires parcel improved by office building and parking garage serving the office building for $150, allocating $50 to the land, $50 to the parking garage, and $50 to the office building. Office building needs renovation, and QOF invests $105 to improve the office building.

• If the office building and parking garage can be aggregated, both the office building and parking garage are treated as substantially improved and are therefore “good assets” for purposes of the asset tests. If separate assets, parking garage is not substantially improved and QOF will fail to satisfy the 90% asset test.
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Issue: Whether movable property (including abandoned and underused property) satisfies the original use requirement?
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Recommendation: Provide that movable property satisfies the original use requirement if during each year in the five-year period ending on the date of acquisition, such property was located primarily outside of any QOZ and that no more than 20% of its use was within a QOZ.

• For any groups of assets that are interchangeable, for example, a delivery fleet or a laptop computer pool made available to traveling employees, determination is made on an aggregate basis.
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Recommendations (con’t):
  • Movable property within a QOZ not actually used for any business purpose within a year is treated as not used during that year
  • Movable property used within a QOZ but for an amount of time or number of uses representing less than 20% of utilization capacity is treated as not use during that year
  • Purchaser of assets shall be entitled to rely on a certification from the seller that the purchased assets satisfy the foregoing requirements barring actual knowledge to the contrary
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

• Issue: Whether newly constructed improvements acquired by purchase (and not self-constructed) by a QOF or QOZB satisfy the original use requirement?
Comments for Forthcoming Guidance Regarding Acquisition by Purchase, Substantial Improvement, and Original Use Requirements for QOZBP

- Recommendations
  - Original use of newly constructed real estate begins at the first time that the improvement is occupied and used for the conduct of the activity for which it was intended by the owner or any tenant; or
  - Alternatively, original use of newly constructed real estate begins the first time that the owner occupies the real estate or the owner delivers possession of the leased real estate to a tenant.