INSIGHT: General Explanation and Technical Corrections Draft Show QOF Rules Still Uncertain

BY ALAN S. LEDERMAN

The Staff of the Joint Committee on Taxation’s “General Explanation of Public Law 115-97,” (12/20/18) (the “General Explanation”), and the “Tax Technical and Clerical Corrections Act Discussion Draft” (1/2/19) (Technical Corrections Draft), released by Chairman Kevin Brady of the House Ways & Means Committee, show that uncertainties still exist surrounding key issues pending in the Qualified Opportunity Fund (QOF) program. Technical corrections legislation amending the QOF provisions is likely to be taken up, if at all, later in this Congressional session.

Ineligibility of Ordinary Gains

Perhaps the most controversial issue in the QOF program is whether gains that produce ordinary income can be the source of an eligible investment in a QOF. Section 1400Z-2(a)(1) allows gain on sale of “any property” to an unrelated buyer to qualify. 2018 Proposed Treasury Regulation Section 1.1400Z-2(a)-1(b)(2)(i)(A) followed the 2017 Conference Report and the caption of Section 1400Z-2, rather than the plain text of Section 1400Z-2(a)(1), by stating that the source of tax-benefit-eligible QOF investments must be capital gain. However, the General Explanation conceded that “a technical correction may be needed to reflect this intent” that only capital gains are covered by Section 1400Z-2(a)(1).

The Technical Corrections Draft would, following the General Explanation’s suggestion, retroactively amend Section 1400Z-2(a)(1) to exclude from coverage by Section 1400Z-2(a)(1) gains that “are treated under this chapter as ordinary income.” No definition is given of “ordinary income,” through presumably such items as inventory sales minus cost of goods sold is intended to be encompassed.

If gain on sale of “any property,” such as the selling price of inventory minus cost of goods sold, is covered by Section 1400Z-2(a)(1) in the current absence of technical corrections legislation, the potential utilization of the QOF deferral and exclusion provisions would be dramatically expanded. For example, the Internal Revenue Service 2018 Statistics of Income shows that, for 2013—the most recent year of Forms 1120 covered—corporations in the fields of manufacturing, wholesaling, and retailing, with net income, reported gross business receipts of about $11 trillion, cost of goods sold of about $8 trillion, corresponding to gains on inventory sales of perhaps about $3 trillion, and net taxable income of $0.7 trillion. While this data would have to be updated and refined to determine its current implications, it suggests that, for profitable U.S. manufacturers, wholesalers, and retailers, use of Section 1400Z-2 for gain on sale of inventory property (sales minus cost of sales) could often, if they chose, completely or substantially defer, and partially eliminate, their pre-2026 taxable income as well as provide post-2028 gain exclusion benefits.

Some sellers of inventory may view the General Explanation’s concession of the possible necessity of an amendment to Section 1400Z-2, in order for the IRS to exclude ordinary gains as a source for eligible investment, as encouragement to challenge that IRS position in the current absence of such legislation. The U.S. Supreme Court’s holding in U.S. v. Woods suggests that General Explanations are to be given weight for substantive law and penalty protection purposes only to the extent that their rationale is viewed as persuasive. The existence of the Technical Corrections Draft, with its
retroactive effective date, will likewise dissuade some potential investors of ordinary gains in QOFs.

**QOF Certification**

Curiously, the General Explanation restates the 2017 Conference Report conclusion that Section 1400Z-2(e)(4)(A), which allows for the Treasury to promulgate rules for certification of QOFs, is intended to be carried out in a manner similar to the process for allocating the new markets tax credit. The Section 45D(f)(2) new markets tax credit allocation process involves an annual national competition, among entities which are certified as having some low-income community input, for a finite amount of tax-benefit-eligible equity interest issuances.

By contrast, even before the issuance of the General Explanation, the IRS proposed a simple system of QOF self-certification through filing a Form 8996. Social critics have observed that the effect of the QOF legislation, at least in the real estate area, is to provide a tax advantage in acquiring real estate in low-income areas. Such acquisitions, in terms of the tax rate benefits of the deferral-to-2026 and 15 percent gain exclusion, are most advantageous to traders having short-term capital gain, then to sellers of art and gold and other collectibles, then to stock market investors and others with long-term capital gains. These tax advantages, and the third tax advantage of the Section 1400Z-2(c) gain exclusion after 10 years, are unavailable to those taxpayers, including low-income residents of those same areas, who lack capital gains. Therefore it is not surprising that Treasury has decided not to enter into a political morass of certifying QOFs based on non-tax-related, perceived social benefit-related, criteria. The QOF certification process is not addressed in the Technical Corrections Draft.

**Used Property**

The General Explanation stated that technical corrections may be necessary to reflect Congress’s intent that “only new or substantially improved property qualifies as opportunity zone business property.” Now, Section 1400Z-2(d)(2)(D)(i)(D) only requires that the original use of such property in the qualified opportunity zone commences with the QOF or the QOF substantially improves the property. Section 4(dd)(2) of the Technical Corrections Draft would strike “in the qualified opportunity zone.”

The General Explanation and Technical Corrections Draft may be seeking to prevent post-2018 purchases of used, non-substantially-improved, equipment from unrelated sellers from qualifying as qualified opportunity zone business property, where the unrelated seller used the equipment outside the qualified opportunity zone. Perhaps the General Explanation and Technical Corrections Draft may also be seeking to block a QOF from arguing that an insubstantially renovated building that was bought by a QOF in early 2018 from an unrelated seller, before the 2018 Treasury Department’s designation of the census tract where such building is located, as a qualified opportunity zone, is qualified opportunity zone business property.

**Pass-through Entities**

The General Explanation sought to clarify to some extent the interaction of subchapter K and the QOF provisions by providing that investors in a pass-through QOF recognize their share of the pass-through’s income and increase their basis in the QOF for their share of the pass-through’s income. However, to illustrate the application of the Section 1400Z-2(c) step-up, the General Explanation noticeably limited itself to an example of apparently C corporate QOF stock with no pre-sale adjustments to stock basis. The General Explanation thereby avoided questions as to whether gains attributable to accumulated claimed pass-through losses of an S corporate QOF or partnership QOF, and whether gains attributable to relief of liabilities of a partnership QOF described in Treasury Regulation 1.1001-2(c) Example (3), are excused by reason of Section 1400Z-2(c). These issues are not covered in the Technical Corrections Draft.

**Conclusion**

To bolster its criticized position in the 2018 Proposed Regulations that limits gains described in Section 1400Z-2(a)(1) to capital gains, Treasury would likely support Congressional legislation, consistent with the goals of the Technical Corrections Draft, codifying that result. Treasury may also support other technical changes contained in the Technical Corrections Draft.

However, it will be up to Treasury to address most outstanding key issues. For example, Treasury will wish to clarify the scope of Section 1400Z-2(c) with respect to accumulated losses of a pass-through QOF, and the absence of gain due to QOF partnership liabilities. In addition, Treasury will have to deal with a plethora of comments submitted on how QOFs can comply with the more technical requirements of Section 1400Z-2.