Some Open Issues in Qualified Opportunity Funds

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Moderator: Alan S. Lederman, Gunster, Fort Lauderdale
Private Sector Panelist: Matthew E. Rappaport, Falcon Rappaport & Berkman PLLC, New York City
QOFs: Investor Benefits

Investors receive the following principal benefits on investments in QOFs:

1. Step-up to fair market value in basis of QOF interests after 10 years.

2. Capital gains invested in QOFs deferred until 2026, and then up to 15% excluded upon their 2026 inclusion.
QOF-Effect of 10 Year Step-Up

Prop. Reg. §1.1400Z-2(c)-1 refers to the §1400Z-2(c) 10 year basis adjustment election but does not describe its effect.
QOFs-Effect of 10 Year Step-Up

“The bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years . . . the basis of such investment in the hands of the taxpayer shall be the fair market value of the investment at the date of such sale or exchange.” Conference Report 115-466. I.e., the Conference Report focuses on “post-acquisition capital appreciation” and a step-up of the QOF investment.
QOFs- Effect of 10 Year Step-Up

For a partnership or S corp. QOF, will the step-up apply even if there is no post-acquisition capital appreciation?

Assume Investor contributes $3 million to a QOF partnership for a 99.9% interest. QOF buys $3 million of depreciable property. Over 10 years, Investor claims $2 million of cumulative losses corresponding to $2 million depreciation. Investor’s basis in the partnership interest is then $1 million. There are no partnership liabilities.
QOFs- Effect of 10 Year Step-Up

After 10 years, Investor sells the QOF interest for $2.9 million, less than the $3 million that Investor paid. Investor recognizes a gain of $1.9 million, $2.9 million selling price minus $1 million basis in Investor’s QOF partnership interest. That is, there has been $0.1 million of post-acquisition capital depreciation in value, but the investor’s gain in effect reflects $2 million of depreciation recapture.
QOFs: Effect of 10 Year Step-Up

Is the QOF partnership interest stepped up to its $2.9 million fair market value, thereby eliminating all gain under §1400Z-2(c) even though there is no post-acquisition appreciation whatsoever, and indeed there has been $0.1 million capital depreciation in the QOF investment?
QOFs: Effect of 10 Year Step-Up

A second issue, unrelated to the post-acquisition appreciation issue, is:

For partnerships QOFs, is the benefit: (a) a step-up in basis to fair market value at the end of 10 years; or rather (b) no gain at the end of 10 years?
QOFs: Effect of 10 Year Step-Up

A potentially huge difference between elimination of gain and step up to value, where the QOF is a partnership and not a corporation, relates to a partner’s share of the QOF’s liabilities. If the basis of the partnership interest is stepped up only to its cash fair market value, net of the inside-the-QOF-liabilities, then the amount realized, which will equal the sum of the cash received plus the selling partner share of the QOF’s liabilities, will generate gain equal the share of partner liabilities. See Reg. §1.1001-2(c) Example (3).
QOFs-Effect of 10 Year Step-Up

E.g. Investor contributes $1 million cash for a 99.9% partnership interest in a QOF. The QOF borrows $2 million, and buys QOZBP for $3 million. Assume for simplicity the depreciation on the QOZBP is nominal.

Eleven years later, the QOZBP is worth $5 million, and the QOF interest is worth $3 million ($5 million QOZBP minus $2 million QOF loan). Investor’s basis in the QOF interest is $1 million cash plus $2 million share of liabilities, or $3 million.
QOF-Effect of 10 Year Step-Up

If Investor sells its QOF partnership interest for $3 million cash, $2 million more cash than Investor invested 10 years earlier, and makes no §1400Z-2(c) election, Investor’s amount realized is $5 million ($3 million cash plus $2 million relief of liabilities) and Investor, with a basis of $3 million ($1 million cash invested plus $2 million share of liabilities) recognizes a gain of $2 million.
QOF-Effect of 10 Year Step-Up

If Investor sells its QOF interest for $3 million, and the §1400Z-2(c) election steps up the basis of the interest sold to its fair market value of $3 million, its amount realized is $5 million and Investor recognizes a gain of $2 million.

If Investor sells its QOF interest for $3 million, and the §1400Z-2(c) election steps up the basis of the interest sold to its fair market value of $3 million plus the share of liabilities, Investor’s amount realized is $5 million and Investor recognizes no gain.
QOF- Effect of 10 Year Step-Up

Even if there is a step-up on sale of a QOF partnership interest, commentators have noted there may be ordinary income and an equal capital loss under Reg. 1.751-1(g) Example (1), in the typical case where the partnership has hot assets, such as §1245 recapture.
What is Eligible Gain?

Prop. Reg. §1.1400Z-2(a)-1(b)(2)(i)(A) excludes gain treated as ordinary income from being deferrable “eligible gain.”

This has the effect of excluding trillions of dollars of gross income annually earned by manufacturers, wholesalers, and retailers from being deferred under the QOF program, despite the fact that §1400Z-2(a)(1) allows deferral for the gain on “any property.” The IRS apparently relies on the legislative history and the caption of §1400Z-2, which refers to capital gains.
Amazon.com- Long Island City HQ

Amazon reportedly chose a QOF for its new Long Island City second headquarters facility. Can Amazon obtain tax benefits under §1400Z-2?

Much of the published skepticism focuses on the difficulty in meeting the QOZBP active business test.
Amazon.com- Long Island City HQ

However, the more fundamental problem seems an evident lack of eligible gain, absent a transaction generating such gain. Amazon’s 2017 Form 10-K: https://www.sec.gov/Archives/edgar/data/1018724/000101872418000005/amzn-20171231x10k.htm#s6054F0634AFB51E6A6B61B8B952F1620, at page 51 shows immaterial capital gains on marketable stocks and bonds. Almost all of Amazon’s income is commission income from third party sellers and gain on sale of its own merchandise inventory. The former is not “gain,” and thus not eligible gain under §1400Z-2(a),
Amazon.com- Long Island City HQ

and the latter is disqualified by Prop. Reg. §1.1400Z-2(a)-1(b)(2)(i)(A) (ordinary income). Further, even if there were some capital gains hypothetically available to Amazon, the 2017 Form 10-Q, at the bottom of page 66, shows large net operating loss, capital loss and tax credit carryforwards to 2018 to shelter many of those gains. Therefore, while it is possible that Amazon could generate future capital gains, and it is possible that such gains could benefit significantly from deferral under the qualified opportunity fund rules, this seems unlikely.
Amazon.com- Long Island City HQ

Although it seems doubtful that Amazon could itself generate eligible gains equal to the equity needed for a QOF to build Amazon’s new headquarters, Amazon could benefit significantly from §1400Z-2.
Amazon.com- Long Island City HQ

For example, Amazon could sign a lease for space for its second headquarters, located in the Long Island City QOZ, with a sufficiently active real estate rental business structured so that the renting entity or its parent could qualify as a QOF. That QOF could raise the construction and acquisition cost from investors unrelated to Amazon, having capital gains, and provide those investors with the deferral-to-2026, up to 15% 2026 gain reduction, and 10 year income tax exemption on sale of their fund interest. As a consequence, those investors could afford to offer Amazon’s Long Island City lessee relatively low cash rent.
Eligible Gain

Section 1231 gain treated as capital gain at the partner level apparently can be the source of eligible gain of the partner, because it is treated as long-term capital gain under §1231(a)(1).
Eligible Gain

But suppose a partnership sells §1231 property. Some indirect or direct partners may treat their distributive share as ordinary, e.g. because they have other current year §1231 losses, or prior 5 year §1231(c) losses.
Eligible Gain

Is the partnership’s §1231 gain entirely disqualified if any partner treats its distributive share as ordinary, or disqualified only to the extent a partner does in fact treat its share of the gain as ordinary, or, as some commentators have requested, not disqualified at all (on the theory that because the partnership has no way of knowing the partner’s overall situation, and even the partner may not know of its current year §1231 losses until it receives its K-1s from other partnerships, usually around September 15 of the next year, far more than 180 days from the end of the selling partnership’s year end.)
Eligible Gain

Prop. Reg. §1.1400Z-2(a)-1(b)(2)(ii) only requires that the gain be “recognized for federal income tax purposes.”

Commentators have requested that, for non-resident alien and foreign corporate investors, IRS allow non-effectively connected, and thus non-U.S.-taxable, recognized capital gains to be eligible gains.

Their idea is that such gains would not be included in 2026, under the preservation of attributes rule of Prop. Reg. §1.1400Z-2(a)-1(b)(5), but would permit the eventual gain on sale to avoid taxability.
Eligible Gain-Real Estate Aspects

The statutory text has some unfriendly aspects for using QOFs as to defer real estate gains:

◦ “Phantom income” event in 2026 hits illiquid portfolios harder
◦ Section 691, rather than full step-up at death, on QOF interest
Eligible Gain Real Estate Aspects

The Proposed Regulations add some other problem areas:

◦ Ordinary income recapture not eligible for deferral
◦ Uncertainty with cash-out refinance
◦ No “boot netting” rule similar to Section 1031; e.g. excess of liabilities over basis in the disposed real estate can’t be offset by the partner’s share of inside-the-QOF liabilities.
◦ Any IRS thoughts on liberalizing the Proposed Regulations in regard to making real estate-gains more friendly?
Eligible Gain: Real Estate Benefits

Nevertheless, §1400Z-2 has many benefits relative to §1031(a), e.g.

Can invest in a QOF partnership interest or QOF corporate stock.

10 year exemption from gain, without the need to pass away.

Each partner or S shareholder can decide whether to reinvest or not in a QOF upon the entity’s disposition of real estate.

Each partner or S shareholder can decide to sell its interest and reinvest separately in a QOF.

Replacement period of real estate can extend well beyond 180 days, e.g. QOZB can use 31 month safe harbor.
Eligible Interests

Will preferred QOF equity interests, e.g., those with mandatory put rights, be subject to an equity-debt analysis to determine if they are eligible equity interests?

Are there any limitations on special allocations of eligible gain, other than perhaps substantial economic effect? For example, if an eligible gain partner has a 1% interest in capital, plus a carried interest of 30% interest in excess of cumulative profits after the investors have received a 6% internal rate of return, is that carried eligible investor’s interest attributable to its entire gain entitled to the §1.1400Z-2(c) step-up?
Consolidated Corporate Groups

Can QOF reinvestments by any consolidated group member be made for purposes of excluding eligible gains of any other group member?
180 Days

Any exception to the 180 day rule?

Commentators have requested that IRS extend the date for investing gains until 180 days from the date the next set of proposed (or final) regulations are released. At that time, the consequences of investing in a QOF may be clearer, and more QOFs may be available for investment.
180 Days

Commentators have requested that foreign sellers of real estate who submit a reduced FIRPTA withholding certificate to IRS be given 180 days from the date the certificate is issued to invest in a QOF. A similar issue could arise under the §1446(f) foreign partnership interest withholding.

It would seem, however, atypical, that the §1445(a) 15% of selling price FIRPTA withholding, minus the actual tax, would exceed the eligible gain.
180 Days

More generally, under FIRPTA, will prospective investment in a U.S. real property holding company QOF, or even a non-real-estate-related QOF, itself be grounds for a reduced gain or non-recognition FIRPTA certificate, and will IRS insist on a security arrangement?

What if the QOF interest would not be taxable in 2026 (e.g. an interest in a QOF partnership owning only QOZB stock in non-U.S. real property holding corporations)? See Sec. 897(e) (FIRPTA gain must be rolled into FIRPTA gain to qualify for non-recognition.)
180 Days

How is the 180 days to be applied in an installment sale?

Suppose there is a installment sale in early 2020, with the first payment on the sale due in late 2021. Since no gain is recognized in 2020, and no cash to make an investment is available in 2020, a mid-2020 QOF investment by the taxpayer would typically not seem to be an attractive option.
180 Days

Does the 180-day period happily begin on the 2021 date the 2021 installment is collected, permitting a later 2021 QOF investment of the gain portion of the installment proceeds to reduce the 2021 gain? Section 453(a) states “… Income from an installment sale shall be taken into account for purposes of this title under the installment method,” and Prop. Reg. §1.1400Z-2(a)-1(b)(4) starts the 180 day period on the day on which the gain would be recognized for federal tax purposes absent the QOF deferral, suggesting that the 180 days does begin on the 2021 collection date.
180 Days

Prop. Reg. §1.1400Z-2(a)-1(c)(2) allows a member of a partnership, S corporation, trust or estate, which does not itself reinvest that gain at the pass-through level, to reinvest that gain at the member level.

In that case, the general rule is that the member’s reinvestment period is extended to 180 days from the end of the pass-through entity’s taxable year. However, unfortunately, under the general rule, the reinvestment period begins only on the date of the entity’s taxable year.
A special election was given by the Proposed Regulations to pass-through members who wish to make a QOF reinvestment of their distributive share of the entity’s gain before the entity’s year-end, but within 180 days of the (July to December date) of the pass-through’s recognition of eligible gain.

Can such an election be made for part, but not all, of the member’s share of the pass-through’s gain?
180 Days

If the QOF needs money before the taxpayer has eligible gain, can a taxpayer invest in or loan funds to the QOF not attributable to eligible gain, and then invest eligible gain funds in the QOF within 180 days of the eligible gain recognition event, and then take a loan repayment or distribution from the QOF later?
180 Days

REIT and RIC shareholders may not know the amount of their dividends which are capital gain dividends until after year end, e.g. in late January of the following calendar year. See §§857(b)(3)(B), 852(b)(2)(C). Therefore, some commentators have asked that the 180 days run from the next January, and not the date in Prop. Reg. §1.1400Z-2(a)-1 (b)(4)(ii) Example 2, which is the date of receipt of the dividend payment.
Investments Through Entities

Section 1400Z-2 seems to contemplate that the taxpayer with the eligible gain must invest directly in the QOF.

Some taxpayers have requested that they be treated as investing in a QOF to the extent of their share of the investment by a pass-through entity, e.g. feeder-fund or a family limited partnership.
Investments Through Entities

Can the GP or LPs of a fund “backdoor” into placing the QOF interest where they want? For instance, say an individual timely contributes cash in exchange for an eligible QOF interest. Can the individual then engage in a carry-over basis transaction with the QOF interest and preserve tax treatment? Examples: contribution to a family or other partnership, incorporation transaction, or a bona fide gift.
Reinvestment by QOF

Section 1400Z-2(e)(4)(B) provides for regulations authorizing rules allowing a QOF a reasonable amount of time to reinvest to reinvest the return of capital from investments in QOZB partnership interests and corporate stock, and to reinvest the proceeds from the sale or disposition of QOZBP.

Periods, crossing a measurement date, in which a QOF can hold cash for reinvestment without violating the 90% QOF test, have not been spelled out.
Reinvestment by QOF

Does IRS have authority to, and will IRS, permit QOFs and their pass-through members to avoid inclusion of QOF income, such as QOF income invested in QOZBP?
Non-recognition Transactions

In otherwise non-recognition subchapter C and subchapter K transactions, is it correct that the QOF investors nor the QOF itself recognizes gain? Does Treasury even have the power to change subchapter K and subchapter C rules for QOFs?
Non-Recognition Transactions

However, non-recognition transactions could cause QOF problems. For example, all the transferor QOF’s property acquired in a non-recognition transaction could cause the transferee to fail the QOZBP “purchase” requirement.

Guidance would be useful with respect to QOF or QOZB, partnership or corporate, merger or reorganization or roll-up or spinoff non-recognition transactions.
Taxability of Distributions

When will distributions from a QOF trigger gain?

Note that if the distribution was structured as retaining of eligible gain proceeds preceding the investment, i.e., the distribution and contribution steps were essentially reversed, the amount retained and not reinvested would be taxable.
Taxability of Distributions

Does the nature of the distributions make a difference? For instance, the distribution of recognized net operating income does not appear to be abusive. However, the distribution of proceeds of a cash-out refinance might be abusive, particularly to the extent of the initial investment of eligible gain.
Taxability of Distributions

Is timing relevant? Query the reconciliation between the 2026 recognition of deferred capital gain being a “phantom income event” and the potential abuse of a cash-out refinance. Might cash-out refinances only be allowed after December 31, 2026 to meet obligations on a taxpayer’s 2026 tax return? Would a moratorium last for one year? What about two or three years? Or would these refinances be OK immediately after closing on an acquisition?
QOFs vs. QOZBs

Some businesses can easily qualify as QOFs, but are prohibited from being owned by a subsidiary QOZB partnership or corporation. These include massage parlors and packaged liquor stores.

Will there be a doctrine of proprietorship anti-abuse regulations to avoid QOFs undertaking directly what they cannot undertake indirectly through QOZBs?
QOFs vs. QOZBs

The Form 8996 requires the QOF to describe the QOZBs the QOF expects to engage in directly or through a first-tier operating entity. Yet there is no requirement in the statute that a QOF must engage in a QOZB (e.g. a liquor store is prohibited from being a QOZB, but there is nothing prohibiting a QOF from operating a liquor store.)
QOFs vs. QOZBs

Conversely, many businesses can easily qualify as QOZBs, but not as QOFs. These include, for example, many businesses having between 70% and 90% of their assets as QOZBP, and businesses owning purchased intangible fast food and other franchises used in an active business. The QOF will often want control and 100% equity in the QOZB partnership or stock interests.
QOFs vs. QOZBs

Will the partnership anti-abuse rules of Reg. §1.701-2 preclude 100% ownership designed entirely or principally to take advantage of the more favorable than QOF QOZB partnership rules? Similarly, will QOZB corporate subsidiaries formed by a QOF to undertake operations that the QOF could not undertake directly be subject to attack under §269(a)(1)?
QOFs Investing in QOZBs

Will Treasury allow QOFs to rely on certificates of non-controlled QOZBs that the latter indeed qualify as QOZBs, in the absence of a reason to believe the certificates are incorrect? That would relieve QOFs of the burden of auditing every QOZB they buy a minority interest in.

Will Treasury allow QOZBs to look through lower-tier partnerships and corporations to determine their qualification as a QOZB?
Substantial Improvement of Property

Rev. Rul. 2018-29. QOF purchases land in a QOZ worth $480x, and a building on that land worth $320X. The QOF spends $400x over a 24 month period converting the building to residential rental property. Held, the building has been substantially improved, so the fact that it has been used before the QOF’s purchase does not disqualify it. The Ruling clarifies that land can never be originally used in a QOZ, but need not be substantially improved.
Substantial Improvement of Property

Prop. Reg. §1.1400Z-2(d)-1(d)(4)(ii) refers to the QOF’s “additions to the adjusted basis of the building.”

So, for purposes of the 90% and 70% tests, is land: (1) always QOZBP?; (2) never QOZBP (in which case the QOF in Rev. Rul. 2018-29, with substantially renovated building of $320X+$400X = $720X, and $480X land, fails the 90% test); or (3) ignored?
Substantial Improvement of Property

Suppose $100x$ of the amount spent by the QOF in Rev. Rul. 2018-29 was an separate but adjacent parking deck for the building and other parkers.

Would that not be a qualifying addition to basis with respect to the building?

Would it be a qualifying addition if the parking deck shared a wall with the building and was exclusively used by tenants?
Substantial Improvement of Property

What about a recreational center in a separate facility not sharing a wall?

What about a recreational center open to non-tenants that was required by the City as a condition of approving the project?

What if the City took title to the recreational center? Could that be, analogously to a permit fee, create a qualifying addition with respect to the building?
Substantial Improvement of Property

In close cases, where renovation costs may be slightly less than the basis of the building:

Perhaps purchase price allocation appraisals would be useful to justify a somewhat lower basis of the acquired building relative to the land.

In a role reversal, perhaps post-acquisition expenditure segregation studies could be used to justify allocating costs to the building rather than to separable personal property.

But developers have asked IRS that the proposed regs be amended to allow associated furniture and fixtures be counted as building improvements, perhaps even if immediate expensing is claimed.
Substantial Improvement of Property

What if the building in Rev. Rul. 2018-29 was worth $2X (an attendant’s booth on a parking lot or a newsstand or a shed on agricultural land), and $3X was spent to improve it? Would the $480X land price qualify?

Concerns have been expressed that residential rental property may be an ineligible business for a QOZB, as distinguished from a QOF. Is Rev. Rul. 2018-29, involving a QOF, meant to imply that residential rental property is either an eligible or rather ineligible business for a QOZB?
Substantial Improvement of Property

How will the Service treat related-party ground/master leases of property?

Example: Land Lessor purchased raw, undeveloped land in a QOZ before December 2017. In 2019, Land Lessor leases the land to the QOF. QOF then constructs a new building.

Suppose the QOF does not own the land for federal tax purposes.

Suppose the Land Lessor owns the QOF.

Is the building QOZBP of the QOF?
Substantial Improvement of Property

Questions:
◦ If the QOF has a GAAP applicable financial statement showing the land leased to the QOF as a QOF right-of-use asset, is that asset treated as owned by the QOF in the 90% QOF test?
◦ Is the building originally used by the QOF in the QOZ because the QOF constructed the building from scratch? Is the building treated as acquired from a related party because of the land lease?
Substantial Improvement of Property

◦ Does it make a difference whether the lease achieves a “land-building split,” i.e. the lessor truly owns only the land and the lessee truly owns only the improvements?
◦ Would the Service take different stances on this structure if the land were acquired after December 2017, as opposed to beforehand?
Substantial Improvement of Property

What if a building is nearly complete but has not yet received a certificate of occupancy or been placed in service. Does the buyer need to meet the double the basis rule applicable to previously-used property even though the building has never been used by occupants?
Substantial Improvement of Property

Does a QOZB short-term lessee have to substantially improve used leased equipment or used leased office space? This is often impractical. See Prop. Reg. §1.1400Z-2(d)-1(d).

What if agricultural land is bought, without a building. Under Prop. Reg. §1.1400Z-2(d)(4)(i), must the basis be doubled? If funds are expended for irrigation, drainage, environmental enhancement, etc., could this constitute substantial improvement?
“Substantially All”

“Substantially all” is not defined for 4 purposes, beyond the (70%) QOZB asset test. Namely, it used for 3 time periods: (1) during substantially all the QOF’s holding period of QOZB stock, the QOZB must qualify as a QOZB for the stock to qualify as QOZB stock; (2) during substantially all" the QOF’s holding period of QOZB partnership interest, the partnership must qualify as a QOZB for the partnership
“Substantially all”

interest to qualify as a QOZB partnership interest; (3) QOZBP must, during substantially all the QOF’s or QOZB’s holding period, be used (4) substantially all within a QOZ.

The IRS has not indicated whether it will use 70% or 90% or some other figure for these definitions, particularly compounded uses.
QOZB Active Business

Does IRS plan to issue more guidance on QOZB “active” businesses, especially for real estate rented out and maintained by independent contractors?
Pre-Existing Partnerships and Corporations

Pre-existing partnerships and corporations can become QOFs or QOZB partnerships or corporations. But since they typically will have mainly pre-2018 property, they are likely to be disqualified. Treasury asked about liberalizing the tests for pre-existing entities.
2047 Step-Up?

Whether a step-up in basis should be allowed on December 31, 2047 is left open in the Proposed Regulations.
Prop. Reg. §1.1400Z-2(d)-1(d)(5)(iv) provides a safe harbor for QOZBs to treat unexpended funds invested pursuant to a plan spanning 31 months to qualify in determining whether the QOF’s investment in the QOZB partnership interest. The preamble states that the expansion was meant to cover “situations where a QOF or operating subsidiary may need” time to expend its raised capital.

Does this 31 month-rule apply to QOFs? If not, will QOFs that invest directly have any grace period?
31 Month Rule

How specific must the plan be?
How close must the plan be followed?
Are there any unforeseen circumstances which could cause the period to be extended?
31 Month Rule

Will very large projects, or projects requiring a long regulatory approval process, be given more time? Is there any way an enormous fund deploying its capital over the course of several years could comply with this test? Suppose the Service is evaluating compliance for a $1 billion QOF. What does the QOF’s plan need to look like? Does it need to pinpoint specific investments ahead of time?
Operating Businesses

How will §1400Z-2 interact with the §1202(a)(4) exclusion? Can a C corporate QOF itself be a QSB for §1202 purposes? Can a C corporate QOZB be a QSB for §1202 purposes?

If both §1202 and §1400Z-2 can both apply to QOF stock in 2026, would the §1202 exclusion only apply to the 2026 gain that is not allocable to the original deferred capital gain? I.e., would only post-investment appreciation recognized before, as well as after, 10 years be excluded under §1202(a)(4)? Or would the 2026 deferred capital gain be excluded from income if §1202 applies?
Operating Businesses

The 31 month rule of QOZB’s protecting unexpended funds for acquisition, rehabilitation and construction of *tangible* property does not apply to funds for the creation of intangible property, such as brands, patents, trademarks, computer apps., etc.

Start-ups are seeking confirmation they can be treated as an active business if there is a reasonable expectation they will generate revenue within a specified period (3 years, under the new markets tax credit regulation).
Operating Businesses

Start-ups are also concerned that the GAAP value and tax basis of tangible property may be small, and will soon dissipate, creating problems with the 70% test if there are excess cash balances.

Start-ups question whether the valuation of leased office space under an operating lease is zero, if zero under GAAP and tax purposes, and so is ignored under the 70% test. That is, they request that qualification as a QOZB is independent of whether the leased office space is QOZB property (e.g. they can located their offices in a building located in a QOZ built by the landlord before 2017).
Operating Businesses

Start-ups want an expansive definition of reasonable amounts of working capital, e.g. 31 months of operations. Under §1400Z-2(d)(3)(A)(ii) and §1397C(b)(8),(e)(1), non-qualified financial property, which term favorably excludes reasonable amounts of working capital, cannot exceed 5% of the QOZB’s assets.
Operating Businesses

Section 1400Z-2(d)(2) requires that an existing QOZB meet the definition of a QOZB at the time the investment is made, whereas new QOZBs are given time (e.g. 31 months) to meet the QOZB tests.

QOF venture capital funds want the ability to invest in existing non-QOZBs that will shift the site of their operations and become QOZBs in a reasonable time (e.g. 31 months).
Operating Businesses

Operating businesses, such as software developer-licensors, mail order and internet sellers, and exporters, want confirmation that so long as their tangible assets and employees are based in QOZs, the fact that their customers are almost entirely outside QOZs will not cause disqualification from QOZB status under the 50% QOZ active business gross income test.
Tacked Holding Periods

If an individual QOF owner who bought her QOF interest before 2023 dies before 2027, do the estate and heirs receive a tacked holding period for purposes of the 5 year and 7 year basis step-ups? Section 1400Z-2(e)(3) suggests yes, but that the 2026 gain is §691 income in respect of a decedent.
Tacked Holding Periods

If the value of the QOF shares at the date of the decedent’s pre-2027 death exceeds the price paid by the decedent, i.e. the value of the QOF shares exceeds the decedent’s start-at-zero basis plus the deferred gain, is the excess eligible for a step-up under §1014(a)?
Tacked Holding Periods

Do the estate and heirs of a deceased QOF owner receive a tacked holding period for purposes of the 10 year gain exclusion?

If an individual QOF owner who bought her QOF interest before 2023 makes a gift of those QOF shares before 2027, does the donee receive a tacked holding period for purposes of the 5 year and 7 year basis step-ups?

Do the donees of QOF shares receive a tacked holding period for purposes of the 10 year gain exclusion?
Tacked Holding Periods

If a partnership that bought its QOF interest before 2023 liquidates, or makes a non-liquidating distribution, of QOF shares before 2027, do the distributee partners receive a tacked holding period for purposes of the 5 year and 7 year basis step-ups? Do the partners receiving a liquidating or non-liquidating distribution of QOF shares from a partnership QOF owner receive a tacked holding period for purposes of the 10 year gain exclusion?
Tacked Holding Periods

If an S corporation or C corporation that bought its QOF interest before 2023 liquidates, or makes a non-liquidating distribution, of QOF shares before 2027, do the distributee shareholders receive a tacked holding period for purposes of the 5 year and 7 year basis step-ups, even though their regular holding period begins again? Do the shareholders receiving a liquidating or non-liquidating distribution of QOF shares from a corporate QOF owner receive a tacked holding period for purposes of the 10 year gain exclusion, even though their regular holding period begins again?
Tacked Holding Periods

If a QOF interest is sold before 2027, and the capital gain recognized on sale is reinvested in another QOF before 2027, do the 5 year, 7 year, and 10 year holding periods of the new QOF begin at the date of the reinvestment, or do they relate back to the date of the purchase of the sold QOF?
Tacked Holding Periods

More generally, do the general 1223(2) substitute basis tacking rules apply for purposes of the 5-year, 7-year, and 10-year rules, or are other rules applicable?
Partnership Reinvestment and Dispositions

If a partnership reinvests eligible partnership gain in a QOF, and the partner disposes of her partnership interest before 2027, e.g. in a taxable sale or exchange or taxable redemption, does the partnership recognize the partner’s share of the deferred gain and specially allocate that gain to the partner?

Tier arrangements, and partial sales, make such accounting even more complex.
Partnership Reinvestment and Dispositions

In a publicly traded partnership, tracing and accounting for the buyer may be impossible.

Do pre-2027 §743(b) cross-sale or §734(b) redemption related basis adjustments reduce the partnership’s 2026 deferred gain?
Reasonable Cause

Section 1400Z-2(f) provides there is no penalty under that section for failing the 90/10 test if the QOF has reasonable cause. What could constitute “reasonable cause” for failing the 90/10 test? Will reliance on a written tax opinion rendered by a tax advisor constitute “reasonable cause,” by analogy to Reg. §1.856-7(c)(2)?
Reasonable Cause

How does this relate to the lack of a working capital safe harbor for QOFs owning QOZBP directly? For instance, if a QOF bought a building with the intent to substantially improve the building, does the QOF get penalized for having cash on hand to substantially improve the building when applying the 90/10 test?

What circumstances might cause the Service to decertify a QOF?
QOF and QOZB Joint Ventures

About 10% of the real estate in the U.S. is located in QOZs. Many existing QOZ real estate owners are interested in participating in renovation projects involving their own properties.

A contribution of land to a QOF or QOZB increases the equity, and therefore reduces the business risk of default on, a renovation loan.
QOF and QOZB Joint Ventures

Most QOZ real estate owners probably do not have enough stock market and other eligible gains equal to the value of their QOZ real estate, but some may have. Absent eligible gains, the QOF investments are not eligible for the 10 year step-up.
QOF and QOZB Joint Venture Issues

Suppose an existing property owner with eligible gain, e.g. stock market sales, contributes land and un-renovated building to a QOF, rather than cash.

Suppose an investor with eligible gains contributes cash for QOF shares funds, which, possibly together with a renovation loan, permits the QOF to substantially renovate the building.
QOF and QOZB Joint Venture Issues

Two major issues exist for property contributions, one for the contributor to a QOF, and one for the QOF or QOZB:

If the contributor has eligible gain and contributes property to a QOF (rather than to a QOZB), can the contributor’s QOF interest be eligible for the 10 year step-up?

If a QOF or to a QOZB receives a property contribution, can the renovated property qualify as QOZBP?
QOF Joint Venture Issues

Can a QOF accept property contributions at all?

- Section 1400Z-2(d) states that a contribution **by** a QOF to a QOZB partnership or corporation must be in cash in order for the partnership interest or stock to qualify in the numerator of the QOF’s 90% test, but says nothing about investments **in** a QOF.

- Prop. Reg. §1.1400Z-2(a)-1(b)(3)(i) allows purchase money subscription notes secured by an QOF interest to be the consideration for a QOF interest.
QOF Joint Venture Issues

Section 1400Z-2(a)(1)(B) defines the income exclusion by reference to the “aggregate amount invested” in a QOF. The phrase “aggregate amount invested” as used in former §6707 was construed by Treasury and IRS to mean the cash contributed, promissory notes contributed, plus the fair market value of property contributed.
QOF Joint Venture Interests

Suppose, however, the property owner has other gains (e.g. stocks), and contributes appreciated QOZ realty, otherwise tax-free under §721(a), to a partnership QOF, in an amount equal to such gains.

There is possible mischief, because in 2026, the QOF interest is stepped up, creating a forgiveness of two gains!
QOF Joint Venture Interests

E.g. Taxpayer has QOZ real estate bought with a basis of zero and a fair market value of $1 million. In anticipation of contributing the QOZ real estate to a QOF, taxpayer sells publicly traded stock for a gain of $1 million. Arguably, the taxpayer’s basis in the QOF partnership interest received for the contributed real estate is zero under the general §1400Z-2(b)(2)(B)(i) zero basis rule. In 2026, the basis of the QOF partnership interest is stepped up to $1 million to reflect the 2026 inclusion of the untaxed stock gain of $1 million under §1400Z-2(b)(2)(B)(ii). At that point, if the QOF
**QOF Joint Venture Interests**

interest is sold for $1 million, the taxpayer will have avoided tax on both the stock and the QOZ real estate.

Indeed, if the taxpayer had held the QOZ real estate for 10 years at the time of the contribution, it could arguably sell its QOF interest tax-free immediately after the contribution. That is because the 10 year holding period requirement of §1400Z-2(c) is arguably satisfied, because IRS has ruled that the basis of a partnership interest acquired with contributed real estate generally includes the tacked holding period of that contributed real estate.
QOF Joint Venture Interests

Idea:

Since an existing QOZ real estate (or business) owner could sell its business to a wholly unrelated third party and then invest the gain in another QOF, there seems to be no reason to deprive the owner of the opportunity to participate in the expansion of their own project or business. Perhaps there should be an election to treat a contribution, e.g. to a 20% or less owned QOF, as a taxable sale for fair market
QOF Joint Venture Interests

value rather than as a §721(a) contribution, and the QOF interest received for the gain portion as an eligible interest, permitting deferral to 2026 and 15% reduction of that gain, plus the 10 year step-up.

I.e., IRS might turn off “circular flow of funds” doctrine to allow a sale of QOZ real estate to a less than 20% owned QOF, coupled with a contribution of some or all of the selling price to that QOF, as an eligible-gain, purchase, transaction.
Is Contributed Property QOZBP?

Turning to the QOF or QOZBP receiving the contribution, under §1400Z-2(d)(2)(D)(i), property is not QOZBP unless it is purchased, within the meaning of §179(d)(2), which excludes partnership capital contributions. Therefore land and pre-renovated buildings are not QOZP for purposes of the numerator of either the QOF 90% test and QOZB 70% test.
Is Contributed Property QOZBP?

Query whether the renovation costs are QOZBP, or rather are they tainted as well, on the theory that the building is one indivisible item of property. See Reg. §1.263(a)-3(e)(2)(i) ("a building ...is a single unit of property); §42(e) (statutory election to treat renovation costs, of an otherwise disqualified non-purchased building contributed to a partnership, as a separate tax-credit eligible new building). There seems to be little policy reason to support tainting the renovation costs.
Is Contributed Property QOZBP?

Could substantial improvement under §1400Z-2(d)(2)(D)(i)(II) prospectively, or even retroactively, cure the “non-purchase” problem?

There are valuation issues on contributed property whose value exceeds its cost. Prop. Reg. §1.1400Z-2(d)-1(b) provides for either GAAP-based or “cost”-based valuations for purposes of the 90% QOF test or 70% QOZBP test,
Is Contributed Property QOZBP depending on the circumstances. GAAP sometimes provides a historical cost, and sometimes a fair market value valuation, for contributed property, depending on the circumstances. “Cost” is undefined—e.g. is it the contributor’s historical cost, or the partnership’s capital account credit given the contributor, typically the fair market value under the substantial economic effect safe harbor.
Tax Accounting Issues

In mixed fund investments, cumulative tax losses will have to be allocated among the eligible-gain and non-eligible-gain investments. Taxpayers will want to allocate as much cumulative loss as possible to the eligible-gain interests. This assumes that the §1400Z-2(c) step-up eliminates all gain, including gain attributable to recapture of accumulated losses.
Tax Accounting Issues

Is the initial basis of the QOF interest, for purposes of claiming pre-2027 losses, the subchapter K §722 cash contribution basis, or rather the §1400Z-2(b)(2)(B)(i) zero basis? If the latter, would it be possible, notwithstanding §704(d)(1), to use the anticipated pre-2027 5% and 10% step-ups as a basis for claiming pre-2026 losses?

Does undistributed QOF cumulative income create a mixed investment? This could be important under the FIFO or pro-rata rule if part of the QOF interest is sold.
Exit Strategies

Real estate buyers usually want to acquire title to the property, not QOF interests one tier, or two tiers (adding a QOZB partnership) above the title, with unwanted assets and undesired and unknown liabilities.
Exit Strategies

To permit an efficient sale of the property after 10 years by a QOF or QOZB partnership, would IRS consider allowing, with respect to partners making the §1400Z-2(c) election, their share of inside basis of QOF and QOZB property to be stepped up on a liquidating or non-liquidating sale, rather than insist all the partners sell their stepped-up interests?
Information Reporting

Information reporting beyond the compliance with the 90% test in draft Form 8996 is left open.
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