Nuts and Bolts of Qualified Opportunity Zones

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Introduction

• Tax Cuts and Jobs Act of 2017
• IRC Sections 1400Z-1 and 1400Z-2
• October 2018 Proposed Regulations and Rev. Rul. 2018-29
• May 2019 Proposed Regulations
• December 2019 Final Regulations
  • Effective 60 days after Jan. 13, 2020 publication in Federal Register
• Form 8996
What are we investing in?

Geographically
• 2018 zone designations
• low income & low income adjacent areas
• 2010 census

Assets
• Real Estate
• Operating Business
What are we investing in?

• About 12% (8,800) of all (74,000) U.S. census tracts are qualified opportunity zones.

• Qualified census tracts are typically small, and located throughout the U.S., giving considerable flexibility in using the qualified opportunity zone program.
What are we investing in?

• For example, because many downtown locations have relatively low residential income, many downtown areas, which traditionally have attracted CPA firms, consulting firms, luxury hotels, and other firms targeting high end customers, qualify as opportunity zones.

• So tax advisers generally considering choice of entity should consider use of qualified opportunity funds for real estate and start-up service businesses.
What are we investing in?
What are we investing in?

• Example: Prospective new Detroit-area client is a new certified public accounting, actuarial and litigation support firm, catering to high income clientele. It plans to build up goodwill and sell out after 10 years.

• Consider suggesting that the new firm locate in one of the downtown Detroit opportunity zones. Not only are many potential business referral sources (e.g. large law firms and banks) located there, but also the 10 year opportunity zone capital gain benefit may be achievable.
Tax Benefits

• Deferral of Eligible Gain
  • 12/31/2026

• Gain Reduction (10-15%)
  • 5-year
  • 7-year

• Exclusion of New Gain
  • 10-year Holding Period
  • Sale of Interests
    • Sale of Assets (other than inventory in the ordinary course)
      • Deemed reinvestment if proceeds not distributed

• Gain on Partnership and Corporate Distributions

• But No Tax Reduction on Pre-Sale QOF Operating Income
How do we get these benefits?

• Per the Regulations, must have gain
  • Capital Gain (But Sec. 1400Z-2(a)(1) refers to the gain on “any” property.)
  • 1231 Gain
  • No netting required
  • NOT ordinary income (including recapture)
  • Taxable in US – Foreign investors’ non-effectively connected capital gain and charities’ non-UBTI capital gains ineligible
  • Not contribution of services
  • Not from a related party sale

• Reinvest gain within 180 days into QOF
  • 180 days from recognition of gain
    • Installment sales on receipt of payments or end of year
  • OR from pass-thru entity year-end
  • OR from pass-thru entity return due date
  • Receipt of capital gains dividend from RIC or REIT
  • OR shareholder’s year-end for capital gains dividend from RIC or REIT
Gain on Transfer to QOF

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

• Final regulations identify circular cash flow issues if contribution of cash to QOF is part of the plan.

• What if contribution is contemplated but not pre-ordained?

• Does it matter if A has a <20% interest in QOF?

• Does it matter if A has other gain?
What is a QOF?

- Partnership
- 2+ member LLC
- S Corporation
- C Corporation

- Not a trust
- Not a single member LLC
What is a QOF?

• A QOF cannot invest in another QOF.
• But many brokerage and investment advisory firms prefer to review management of QOFs, rather than the business plans of the businesses those QOFs invest in.
• This rule prohibiting tiered QOFs generally prevents use by a brokerage or investment advisory fund of a QOF partnership “Fund of Funds,” which would raise funds from its clients’ eligible gains, and then invest those gains in later selected QOFs whose management the “Fund of Funds” likes.
• Similarly, a non-QOF “Fund of Funds” partnership formed by a brokerage or investment advisory fund, which would raise funds from its clients but which “Fund of Funds” itself did not have any eligible gains, would generally not provide directly (through the non-QOF), or indirectly (through the “Fund of Fund” lacking eligible gains), QOF benefits to its clients.
QOF Purpose Requirement & 90% Asset Test

• Investment vehicle formed for the purpose of investing in QOZ property
  • Organizing document statement of purpose
• 90% of all (tangible and intangible) assets is QOZ Property, which means
  • QOZ stock
  • QOZ partnership interests
  • QOZ business property ("QOZBP")
• Cash is not QOZ Property, even if working capital
• Failure to satisfy -> penalties -> possible decertification (under study)
Disregard Recently Contributed Cash

• For purposes of 90% test, a QOF can exclude recently contributed cash from the numerator and the denominator.
• Must be kept in cash and cash equivalents.
• Where all assets are recently contributed cash:
  • 0/0 is mathematically undefined.
Penalty Calculation

• Final regs do not provide guidance on how to calculate the penalty
• If on first testing date, all assets contributed were cash received within 6 months, but on second testing date, QOF has not yet acquired good QOZP, how does penalty apply?
  • There is a six-month period for an entity in which a QOF has invested to cure a defect that caused the entity to fail to qualify as a QOZB. This cure period can be used only once and is in addition to any “reasonable cause” penalty exceptions that would apply to a QOF.
Typical Structure
How to deal with cash limitations of asset test:

90-100% of QOF assets = QOZ stock or QOZ partnership interest
QOZ Stock/QOZ Partnership Interest

• Acquired at original issuance solely for cash after 12/31/17
• Is a QOZ Business ("QOZB")
• During substantially all (90%) of the time the QOF owns the QOZ stock or QOZ partnership interest, the entity qualifies as a QOZB
What is a QOZB?

- Subsidiary (other than wholly owned LLC) of QOF
- Meets certain tests...
QOZB – No Partially Owned Subsidiaries

- QOZBs cannot own more than 5% of their assets in “nonqualified financial property,” which includes partnership interests and corporate stock.

- Final regulations declined to allow an exception from “nonqualified financial property,” majority owned or minority owned partnership interests and corporate stock, even if those companies were themselves QOZBs. As a result, using QOZBs for large operating businesses, which often have joint ventures with unrelated companies, may be impractical.

- QOZBs can own 100% of a disregarded entity (e.g. single member LLC or QSSS).
What is a QOZB?

• Substantially all (70%) of its tangible property (owned or leased) qualifies as QOZBP
• 50% of total gross income from active trade or business
• Substantial portion (40%) of intangible property used in active business
• Maximum 5% nonqualified financial property
  • Exception for reasonable working capital
• No “sin businesses”
What is QOZBP?

- **Acquired** by QOF or QOZB **by purchase** after 12/31/17
  - From an unrelated party using a reduced relationship threshold of 20%
- **Original use** in the QOZ commences with the QOF or QOZB *or* QOF or QOZB **substantially improves** the property
- During **substantially all** (90%) of the QOF or QOZB’s **holding period** for such property, **substantially all** (70%) of the **use** of the property was in the QOZ
QOZBP-Inventory

• Inventory is treated, for purposes of determining qualification under the 90% QOF test or 70% QOZBP test, at the election of the QOF or QOZBP, as either includable in the numerator or denominator, or excludable from the numerator and denominator.

• Inventory need not be substantially improved.

• Inventory in transit, even if briefly warehoused off-site, can qualify.
QOZBP-Mobile Property Safe Harbors

• Up to 20% of the delivery vehicles or other tangible property of a QOZB can be treated as satisfying the 70% tangible property standard if (i) the QOZB has an office in a QOZ, (ii) the property is regularly operated by QOZB employees managed from the QOZ office and (iii) the property is not operated exclusively outside of QOZs for a period longer than 14 consecutive days.

• Short-term leases of rental cars or other tangible property by a business located within the QOZ to a lessee that utilizes the property outside of a QOZ, if (i) the tangible property is parked or otherwise stored at a location within a QOZ when the tangible property is not subject to a lease, and (ii) the lease duration (including any extensions) does not exceed 30 consecutive days.
QOZBP - Original Use

• First Placed in Service
  • Prior use
  • Prior non-business use?

• Vacant Property
  • 3-years
  • 1-year if vacant at time of designation
Prior Non-Business Use?

The following suggests that a house converted into a professional office, restaurant, or store, must meet the substantial rehabilitation requirement:

- **Preamble**: “The final regulations set forth an aggregation approach for determining whether a non-original use asset (such as a preexisting building) has been substantially improved.”
- **Preamble**: “A rule treating historically used property in a QOZ as ‘original use property’ because such property’s use was nonbusiness in nature would fail to sufficiently encourage the introduction of new capital investments in QOZs.”
- **Reg. 1400Z-2(d)(3)(i)(C)**: “If the tangible property had been . . . placed in service in the qualified opportunity zone before it is acquired by purchase, it must be substantially improved.”
- **Rev. Rul. 84-23, 1984-1 C.B. 38** held that a building purchased and used as an owner-occupied house, and then converted to depreciable rental use four years later, was placed in service when first used as an owner-occupied house four years earlier.
Prior Non-Business Use?

But the following suggests that a house converted into a professional office, restaurant, or store, need not meet the substantial rehabilitation requirement:

• **Preamble**: “The final regulations retain the rules set forth in the proposed regulations that a property’s ‘original use’ commences on the date on which the property is first (i) placed in service in the QOZ and is depreciated or amortized, or (ii) used in a manner that would allow depreciation or amortization.”

• **Reg. 1400Z-2(d)(3)(i)(A)**: “the original use of tangible property commences on the date any person first places the property in service in the QOZ for purposes of depreciation or amortization.”
QOZBP - Substantial Improvement

- More than double the basis of tangible property
- 31-month period
- Exclude land
  - Except if plan is to improve by no more than an insubstantial amount
QOZBP - Work in Process

• Property being substantially improved treated as QOZBP during period of improvement

• Reasonable expectation that will be substantially improved within 30 month period
QOZBP - Aggregation

• Final regs allow aggregation of assets for substantial improvement requirement if:
  • Used in same trade or business in the same QOZ or a contiguous QOZ; AND
  • Improve functionality of the non-original use assets in same/contiguous QOZ

• 2+ buildings on single parcel can be grouped
QOZBP - Brownfields

- Treat as original use
- QOF/QOZB must remediate
- Remediation will count as more than minimal improvement
Reasonable Working Capital

• Excluded from limit to 5% nonqualified financial property
• Kept in cash & cash equivalents
• Regulatory Safe Harbors
  • 31 months
    • Acquisition of property
    • Improvement of property
  • 62 month startup
    • Requires cash infusions that are part of integral plan
    • Adds 31 months for new cash up to 62 months max
• Working Capital for Operations
Active Trade or Business

- 50% of gross income from active trade or business
- Active trade or business includes rental real estate
- Excludes triple net leases
  - Property taxes
  - Insurance
  - Maintenance
  - An example concludes that where 2 of the 3 floors are not triple net leased, and the lessor actively manages those 2 floors, the entire 3 floor building is an active trade business.
Intangibles

• A substantial (40%) portion used in trade or business
  • Normal, usual or customary use in the conduct of the trade or business; and
  • Contributes to the generation of gross income for the trade or business

• No IP holding companies

• Intangibles do not factor into the 70% asset test and need not be acquired by purchase
Relocation of Business

- **Investor**
- **Founder**
- **QOF**
- **QOZB**
  - New lease in QOZB
  - Maybe some new furniture & computers

- **Original Business**

  IP does not need to be acquired by purchase from an unrelated person
Sin Business Prohibition

*Exception for *de minimis* leases to sin businesses
Sin Business Prohibition

• The Sin Business prohibition does not apply to businesses operated directly by a QOF. The final regulations illustrate this by approving, in an example, a golf course operated directly by a QOF.

• Whether a marijuana business is a “sin business” is not mentioned in the final regulations.
Valuation

• Applicable Financial Statements
• Alternate Valuation Method
  • Cost Basis
    • QOF with AFS may elect to use AVM instead
    • Assets not purchased or constructed valued at FMV
Leasing

• Present value of all lease payments
• Allowed between related parties
  • Unless option to purchase property other than at FMV at time of purchase
  • No discussion of Sec. 7701(o) lack of pretax economic substance of self-charged rent if lessor and lessee are closely related.

• Market-rate requirement
  • Between unrelated parties presumed to be market
  • With state, local, Indian tribal governments exempt from requirement

• Short-term leases of personal property outside don’t prevent property from being QOZBP
Step Up in Basis

• Step up after 5 years and after 7 years
• Basis for all purposes, including depreciation, suspended losses, etc.
Inclusion Events

• Dispositions of Interest
  • Sales, gifts, transfers between spouses and former spouses. (Consider leaving QOFs with original investor in pre-nuptial and divorce agreements).
  • 731 distributions of interests
  • 331 liquidations (but not 332 liquidations)
  • Not tax-free corporate transactions
  • Not 721 contributions
  • Not partnership mergers, but partnership divisions seem to be inclusion events
  • Death not a disposition, but no 1014 step-up on a decedent’s qualifying interest.

• Distributions in Excess of Basis

• Reinvestment after Inclusion Events
  • Reinvestments allowed after inclusion or partial inclusion event
Tax Benefits after 10 Years

• Dispositions of QOF interests
  • Distributions that would be treated as triggering gain

• Dispositions of QOZB interests or QOZB’s assets
  • No recapture
  • If no distribution of proceeds, deemed recontribution
    • Creates mixed fund
    • Subsequent sale of asset ends up partly taxable?
  • No inventory sales in ordinary course of business
Carried Interest

• Suppose the QOF’s management company contributes 5% of the eligible gain to a QOF, and a passive investor contributes 95% of the eligible gain to the QOF. Cumulative profits are allocated to the passive investor to the extent of a 10% preferred return, and then divided 25% to the management company and 75% to the passive investor.

• The Final Regulations, generally rejecting complaints from management companies, confirm that the management company’s share of its allocated QOF gain that qualifies for the 10 year exclusion is 5%/25% = 20%. This is true even though, because of the passive investor’s 10% preferred return, the management company receives as cumulative profits much less than 25% of the QOF’s total gain.
New Illustrations of Anti-Abuse Rule

1. and 2. Contribution of appreciated (apparently non-US real property holding corporation) stock by non-resident aliens to a partnership to create eligible partnership gain for the partnership to invest in a (presumably real estate) QOF, and thereby achieve a tax exemption after 10 years in the QOF, does not create a qualifying investment.

3. Sale of capital gain property to QOZB, and investment of that gain in a related party equity position in the QOZBs’ QOF parent, creates a related party sale and ineligible gain for the seller, and not a “purchase” by the buyer QOZBs.
New Illustrations of Anti-Abuse

4. Purchase of a parking lot with a small cabin and gate, for land speculation, without more, not a QOZB.

5. By contrast, no abuse where a farm is purchased, and significantly improved for use in raising different types of animals for 10 years, even though tax-free Sec. 1400Z-2(c) land appreciation was apparently the goal of the investment.

6. Pure speculation in unimproved land does not qualify an entity as a QOF, even if the annual penalty is paid.

7. A relatively inactive gold bar speculation operation by itself may not be a QOZB.
Consolidated Groups

• A parent of a consolidated group can be a QOF.

• In some cases, an investment by one member of the consolidated group in a QOF can be made based upon the eligible gain of another consolidated group member.

• A consolidated subsidiary may be a QOF.
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