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New Qualified Opportunity Fund Guidance - Significant Forward Progress but Important Questions Remain Unanswered

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The Treasury Department and Internal Revenue Service recently issued proposed regulations (the **Proposed Regulations**) and Revenue Ruling 2018-29 (the **QOZ Revenue Ruling**), providing much anticipated guidance for Qualified Opportunity Fund (**QOF**) investors and sponsors. Although issued in proposed form, the Proposed Regulations may be relied on by taxpayers so long as taxpayers follow the relevant section of the Proposed Regulations in its entirety and in a consistent manner.

On balance, we believe the Proposed Regulations represent significant progress and clarify many ambiguities for QOFs. However, some critical questions have yet to be resolved. We identify below certain key takeaways from the guidance and important areas of remaining uncertainty. This discussion is not intended to be a comprehensive summary of the Proposed Regulations, but rather a brief synopsis of the items that, based on our early review, appear to be of significant potential interest to our clients and friends.^[1] We will continue to monitor developments in the QOF space and welcome your discussions and questions on the topic.

KEY TAKEAWAYS

Eligible Gains, Taxpayers & Investments in QOFs

Capital Gain Eligible for Deferral. The Proposed Regulations provide that long-term and short-term capital gains that otherwise would be recognized before January 1, 2027, generally will be eligible for deferral. Eligible gains are not limited solely to gains from sales of property, but may also include gains recognized from taxable exchanges or other transactions in which capital gain is recognized under federal income tax principles generally. However, gains taxed as ordinary income (presumably, including section 1245 depreciation recapture), gains from certain derivative contracts and gains from the sale of property to certain related parties may not be deferred under the qualified opportunity zone (**QOZ**) rules.

Who Can Elect. The Proposed Regulations clarify that a deferral election can be made by any taxpayer who otherwise would have recognized eligible capital gain. Accordingly, individuals, C corporations (including REITs and RICs), partnerships, trusts and other entities will be permitted to make deferral elections with respect to their eligible gains. Under the Proposed Regulations, if a partnership does not elect to defer all of the partnership's eligible gain, then the partners in the partnership may make separate deferral elections for their distributive shares of the eligible gain that is not covered by a partnership-level election. Analogous rules apply to other pass-through entities and investors therein, including S corporations, trusts and estates.

Permitted QOF Equity. QOF benefits are available only with respect to investments in equity interests of a QOF. The Proposed Regulations indicate that preferred stock and partnerships interests with special allocations are eligible for QOF benefits, allowing QOFs to issue equity interests with different economics to meet varying investor needs.

180-Day QOF Investment Period. Taxpayers must invest eligible gains in a QOF within 180 days to qualify for the deferral election. The 180-day period generally begins on the date of the sale or exchange giving rise to eligible gains, subject to certain notable exceptions. Under one such exception, a partner in a partnership that has not made a partnership-level deferral election with respect to eligible gain may reinvest its distributive share of such gain in a QOF using one of two alternative 180-day periods. The partner may elect to treat the 180-day period as beginning on the day that the partnership recognized the gain (*i.e.*, the standard starting date), or, if the partner does not so-elect, the 180-day period will begin on the last day of the partnership's taxable year in which the gain was recognized. This rule applies on a partner-by-partner basis and affords partners significant timing flexibility for investing their share of partnership eligible gains in a QOF. For example, if a calendar year partnership recognizes an eligible gain in January of any year and does not make a partnership-level deferral election for such gain, then the partners could have up to 18 months to reinvest, and make qualifying deferral elections for, their distributive shares of such gain.

Taxation of Deferred Gain. The tax attributes of deferred gain invested into a QOF carryover to the ultimate recognition of that gain. Thus, for example, an investor that makes a deferral election with respect to a short-term capital gain would recognize short-term capital gain under the QOF rules upon the earlier of December 31, 2026, or a sale or exchange of the investor's interest in the QOF, regardless of the investor's holding period in its investment in the QOF at that time.

Basis Step-up Horizon. Perhaps the most significant benefit of the QOF legislation is the rule that allows taxpayers that have held a QOF investment for at least 10 years to elect to avoid tax on appreciation in the QOF interest by treating the tax basis of the QOF interest upon sale as equal to its fair market value. The Proposed Regulations clarify that a taxpayer may make this basis step-up election after the existing QOZ designations expire at the end of 2028 and until December 31, 2047. This allows taxpayers that make an eligible QOF investment at the end of the QOZ designation period (*i.e.*, in 2028) to hold the QOF investment for an additional 20 years before being required to sell the investment and harvest the basis step-up tax benefit. The extended time horizon for making the basis step-up election grants taxpayers a long-term timeline to choose when to exit QOF investments without losing QOF benefits.

Reinvestment Elections. The Proposed Regulations allow a taxpayer that has completely disposed of a QOF investment before December 31, 2026, to reinvest the deferred gain in another QOF and make a new deferral election with respect to such gain. Therefore, taxpayers are not forced to continue holding their investment in the original QOF in which they made a gain deferral election, but may dispose of the investment (in its entirety) and continue to defer the gain by reinvesting in another QOF.

"Mixed Funds" Rule Not Applicable to Partnership Borrowings. It is possible for a taxpayer to invest in a QOF in part with gains for which a deferral election has been made and in part with other funds. This is called a "mixed funds" investment, and the portion of the investment made with other funds is treated as a separate investment that is not eligible for QOF benefits. Prior to the Proposed Regulations, practitioners were concerned that partnership borrowings might cause a partner's otherwise tax-deferred investment in a QOF partnership to be treated as a separate investment under the mixed funds rule, meaning the partner's share of the QOF's debt might cause a portion of the partner's interest in the QOF to be a non-qualifying QOF investment. The Proposed Regulations clarify that deemed contributions attributable to partnership borrowings do not cause a QOF investor to be deemed to have a separate mixed funds investment in a QOF partnership. Accordingly, liabilities incurred by a QOF partnership generally should not impede an investor's potential QOF benefits relating to an eligible investment.

QOF Qualification Requirements

Permissible QOF Entities. Under the Proposed Regulations, a QOF may be any entity classified as a corporation or a partnership for federal tax purposes. Therefore, it is now clear that limited liability companies (LLCs) and other entities that are not expressly identified in the QOF legislation may qualify as QOFs. Draft instructions released by the IRS to the form for electing QOF status confirm that REITs and S corporations also are eligible to be treated as QOFs.

QOZ Business Property. At least 90% of a QOF's assets must consist of qualified opportunity zone property (**QOZ property**), which includes QOZ stock, QOZ partnership interests and QOZ business property. In order to qualify as QOZ business property, the original use of the property must begin in the QOZ or the QOF must substantially improve the property.

- Original Use. If a QOF purchases an existing building located on land within a QOZ, the QOZ Revenue Ruling clarifies that original use of the building in the QOZ is not considered to have commenced with the QOF (regardless of whether the QOF intends to materially change the building's use). Accordingly, a QOF investing in real estate will either have to purchase land and undertake development itself or satisfy the substantial improvement requirement.
- Substantial Improvement. If a QOZ business property does not meet the original use test, then the QOF must substantially improve the QOZ business property by investing an amount equal to at least 100% of the cost basis of the property over a 30-month period. The Proposed Regulations and the QOZ Revenue Ruling clarify that the computation takes into account only cost basis attributable to the building(s) on the property and excludes the cost basis attributable to land. For example, if a QOF purchases a property for \$100, of which \$60 is apportioned to the land and \$40 is apportioned to the existing structures on the land, the QOF will be required to invest only an additional \$40 in improvements to satisfy the substantial improvement test.

QOZ Partnership Interests and QOZ Stock. As noted above, QOZ partnership interests and QOZ stock are treated as QOZ property for purposes of the 90% QOZ property requirement. In order for partnership interests or corporate stock to so qualify, the partnership or corporation must be engaged in a QOZ business for substantially all of the QOF's holding period in the partnership interest or stock. The Proposed Regulations provide the following clarifications with respect to qualifying as a QOZ business for this purpose.

- Working Capital Safe Harbor. The Proposed Regulations include a working capital safe harbor for QOZ businesses that hold cash, cash equivalents and certain short-term debt instruments for investment in QOZ business property for a period of 31 months, provided that certain requirements are satisfied relating to the plans for, and actual use of, such capital. As drafted, this favorable safe harbor appears only to apply to the extent that a QOF invests in a QOZ partnership or QOZ corporation that invests the working capital; the safe harbor does not appear to apply to working capital held directly by the QOF for investment in QOZ business property. Accordingly, cash and cash equivalents held directly by a QOF continues to be treated as a non-qualifying asset for purposes of the 90% QOZ property test. Unless further guidance is released on this topic, we expect many QOFs that expect to hold significant cash assets will need to adopt a two-tier structure, such that the QOF makes its investments through subsidiary entities that, in turn, will develop the QOZ business property. While adopting such a two-tier structure can increase a QOF's flexibility with respect to working capital and may have other tax advantages, it also has disadvantages that must be considered with the QOF's tax advisors.
- Tangible Property Test. For investments by a QOF in QOZ partnership interests or stock, the requirement that "substantially all" of the tangible property of the QOZ partnership or corporation consist of QOZ business property will be satisfied if at least 70% of the tangible property is QOZ business property. Assets are valued for purposes of this test based on the partnership's or corporation's applicable financial statements or, if none, cost basis. This rule provides considerable flexibility for businesses that may have material tangible assets located outside of a QOZ to qualify as a QOZ business, broadening potential investment opportunities for QOFs.

Valuation. The Proposed Regulations provide that the 90% QOZ property test is applied utilizing the values reflected in the QOF's applicable financial statements or, if the QOF does not have applicable financial statements, cost basis. Applicable financial statements include audited financial statements given to creditors for lending decisions or to investors for purposes of evaluating their investments.

QOF Start Date. A QOF may designate the first taxable year and month in which it will be treated as a QOF. This rule provides considerable flexibility for funds that, for various reasons, may need to be formed or begin operating before they satisfy the QOF asset test or that pre-date the QOF legislation. Investments made in a fund before it has designated its starting date for QOF qualification, however, cannot qualify for deferral elections.

Use of REITs as QOFs. As noted above, the IRS has confirmed that REITs are eligible to be treated as QOFs. Given the current parameters of the QOF legislation and the Proposed Regulations, we believe that using a REIT as the QOF in certain circumstances can provide significantly more flexibility than using a traditional partnership structure for investors and sponsors seeking to develop multi-asset or blind pool style real estate funds. Potential investors and fund sponsors should consult with their tax advisors as to the feasibility and desirability of using a REIT as the QOF.

IMPORTANT REMAINING AREAS OF UNCERTAINTY

Interim Gains on Property Dispositions. Under the QOF legislation, an investor must sell (or be treated as selling) its *interest* in the QOF (rather than the QOF disposing of the QOZ property directly) in order to avoid tax on QOF investments held for at least 10 years. Accordingly, interim gains recognized by a QOF with respect to sales and exchanges of underlying assets generally would trigger taxable gain to the QOF or its investors, absent any favorable guidance from Treasury. The Proposed Regulations do not provide any such guidance regarding the treatment of gains recognized by QOFs on interim sales of QOZ property. Practitioners had hoped that QOFs would have been permitted a reasonable period of time to reinvest interim sale proceeds in new QOZ property on a tax-deferred basis, or that rules would have been proposed allowing QOF investors to realize QOF benefits with respect to their share of interim sale gains by the QOF. The preamble to the Proposed Regulations suggests that Treasury is considering addressing interim gains in another round of guidance later this year, but such guidance may be limited due to concerns over the scope of Treasury's grant of regulatory authority.

Partnership Issues. Although the Proposed Regulations clearly contemplate that partnerships may make deferral elections, there is considerable uncertainty as to how the QOZ rules will apply to such partnerships and their partners. Questions include issues relating to changes in partners' interests in the partnership and allocations among the partners between the deferral date and the date the gain is recognized, the impact of QOF basis adjustments on partners' interests in the partnership, and the treatment of gains recognized with respect to previous tax-deferred contributions of property to the partnership. Partnerships and partners considering deferring capital gain under the QOZ rules should consult their tax advisors regarding the advantages and disadvantages of having the partnership, rather than the partners, make the election and QOZ investment.

As expected, except for the limited guidance provided with respect to mixed investments noted above, the Proposed Regulations do not deal with the interaction of QOF rules with existing tax partnership rules, particularly those relating to tax basis and partnership debt. Future guidance likely will address certain of these issues.

Multi-Tiered Entities. A QOF may own a QOZ partnership interest or QOZ stock, but there is considerable uncertainty as to whether the QOZ partnership or corporation can, in turn, hold interests in lower-tier

partnerships or corporations. If interests in lower-tier entities do not qualify, then QOFs may be significantly restricted in their ability to enter ordinary course joint ventures with developers and other investors. Practitioners had hoped that the Proposed Regulations would provide favorable guidance on this question, but consideration of the issue is notably absent from the Proposed Regulations.

Original Use for Personal Property. While the Proposed Regulations offer clarity with respect to the original use of real property, guidance is lacking regarding when personal property will be considered to have its original use in a QOZ. The IRS is apparently evaluating what metrics would be appropriate for determining whether tangible property has its original use in a QOZ. In the interim, a QOF making investments in property other than real estate continues to face uncertainty regarding the qualification of the QOF's investment as QOZ business property.

Despite the lack of guidance in certain important areas, the Proposed Regulations provide welcome clarifications on many topics that were significant worries for QOF investors and sponsors. With these Proposed Regulations in hand, we expect to see clients move more aggressively toward forming and investing QOFs and for investors to feel more confident about making investments in QOFs, and we look forward to helping them in those efforts.

^[1] For more general information regarding the qualified opportunity zone legislation, please refer to the IRS "Opportunity Zones Frequently Asked Questions." <https://www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions>.

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