Qualified Opportunity Zones:
The Great Unknown

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INTRODUCTION

Qualified Opportunity Zones ("QOZs") were created as part of Tax Reform passed in December 2018. This is a brand new tax incentive with great potential. However, there are many unknowns that cause parties to hesitate before entering into transactions. Comment letters have been sent in and discussions have been are ongoing with Treasury and IRS personnel. Guidance is expected this year.

OPEN ISSUES

Below are some of the open issues for which guidance has been requested.

I. Bridge Financing – A QO Fund or a QOZB may need funds in advance of an taxpayer having taxable gains to invest. Can the QO Fund or the QOZB borrow funds and then when a taxpayer invests its gains use the funds to repay the debt?

A. Best Guess – Allowed

B. What if the Bridge Financing is from the party the eventually becomes the QO Fund Investor? Seems like it should be ok, but unclear if the IRS will frown on this.

II. Treatment of Debt – If a QO Fund is a partnership, how is debt at the QO Fund level or at the QOZB level treated?

A. General Partnership Treatment – debt of a Partnership is treated as if the Partners contributed funds to the Partnership. This gives the partners additional basis in the QO Fund which would allow them to use their share of tax losses. (Remember that the investors in the QO Fund have a zero basis in the fund initially and thus could not use losses without such debt.)

B. Is Debt Treated As Additional QO Fund Investment? Would the treatment of debt as an addition capital contribution mean that it would be treated under the mixed investment rules? Thus gain in 10 years would have to be allocated between qualifying QOZ investment and nonqualifying investment via the debt? This could be turned on its head and allow the investor to defer additional gain without having invested the funds.

1. Example – Taxpayer has $10,000,000 of gain, but invests $2,000,000 in a QO Fund. The QO Fund borrows $8,000,000 of nonrecourse financing and constructs a new building. If the $8,000,000 is treated as an additional investment by the Taxpayer, then it could defer tax on the entire $10,000,000 even though it only put $2,000,000 and was only at-risk on the $2,000,000.

2. Best Guess – there is a difference of opinion on this. My guess is that the loan would not be treated as an additional investment

III. Which Taxpayers Can Invest Gain?

A. Gain can be by individuals, but also by Partnerships. If a Partnership has gain, which party is the one that would make an investment in the QO Fund?

B. Partnerships – The Partnership incurred the gain and seemingly could directly invest in a QO Fund and receive the various QOZ tax benefits.

1. Partners – Gains are passed through to the Partners in the Partnership. Can the Partners invest the gain in a QO Fund?

a) Best Guess – Partners can invest Partnership gain

2. Timing Question – Partners generally have their gain at the end of the year. Is their window for investing gain 180 days from when the Partnership had the gain or 180 days when the Partner is allocated the gain?

a) Best Guess – Leaning toward 180 days from when Partnership incurred gain.

IV. Can Feeder Partnerships Be Used To Achieve Diversification

A. QO Funds cannot invest in QO Funds. A QO Fund can invest in multiple partnerships, but that is still limited diversification.

B. Feeder Partnerships – Could multiple taxpayers with gains invest in a partnership, a "Feeder Partnership", that then invests in QO Funds within 180 days of the date the taxpayers had their gain?

1. Example – Feeder Partnership says that if you have a gain in Q1 and invest with them by April 30, then they will get the funds invested by June 30 and thus meet the 180 period for any Q1 gains.

2. This is not explicitly allowed in the statute, but the IRS has been asked to issue guidance to allow this.

3. Best Guess – 50/50

V. <u>What Gains Are Eligible for QOZ Treatment?</u>

A. Other than a non-binding mention in the title of Section 1400z-2, the statute is silent as to the type of gains that qualify. What types of gains qualify?

1. Long-Term Capital Gains - Allowed
2. Short Term Capital Gains – Allowed
3. Gain from Sale of Inventory – Not Allowed
4. Depreciation Recapture – Unclear
5. Section 582(c) Gain - sales or exchanges of bonds, debentures, notes or certificates or other evidences of indebtedness by certain financial institutions are not considered the sale or exchange of a capital asset. Probably not allowed

VI. <u>Substantial Improvement Issues</u> – used property only qualifies as Qualified Opportunity Zone Business Property ("QOZBP") if within a 30-month period there are additions to basis to such property that exceed the basis of such property at the beginning of the 30-month period.

A. <u>Qualification of Property During Construction</u> - Does the property qualify as Qualified Opportunity Zone Business Property while it is in the process of being improved? Otherwise the property could cause the QO Fund to fail the 90% test during the improvement period.

1. <u>Best Guess</u> – some sort of exception will avoid for negative results during the improvement period.

B. <u>What About Cash Held for the Rehabilitation?</u>

1. <u>Example</u> – Taxpayer Invests $10,000,000 in QO Fund on January 1. QO Fund buys a building for $4,000,000 and plans on spending $6,000,000 to rehabilitate the building over the next 30 months. On June 30 $1,000,00 has been spent on the rehabilitation. On December 31, an additional $1,000,000 has been spent. The basis in tangible personal property in the QOZ on June 30 is $5,000,000 and on December 31 it is $6,000,000. The average over the year is 55%. This falls short of the 90% requirement and could incur a penalty.

a) Note that this theoretically could be handled by having the taxpayer invest its funds over 30 months. However, it can be very difficult for investors to predict that they will have the requisite gains within 180 days of when a capital contribution would be expected.

2. Reasonable Working Capital Exception – The IRS has been requested to allow a QO Fund cash which has been identified as necessary to complete the rehabilitation to have such funds be considered reasonable working capital and not count against the 90% test or the 5% Non-Qualified Financial Property standard for Qualified Opportunity Zone Businesses ("QOZB").

a) Best Guess – Some sort of exception will be allowed.

C. Raw Land – does the construction of a building on raw land constitute an addition to the basis of the land? Technically a building would be separate property from the land.

1. Possibilities

a) Buildings Considered an Improvement to Land?

b) Exception whereby land which has been vacant for a year would be considered new property. This has precedent in Empowerment Zones.

2. Best Guess – construction improvements on land will qualify.

D. Vacant Buildings Under Construction – 50% of revenue of ("QOZB") has to be from the active conduct of a trade or business. How will vacant buildings be treated during construction?

1. Best Guess – an exception will be provided while the building is undergoing its 30-month construction

E. Lease Property – the substantial improvement requirements apply to leased property. Does this apply to a business which rents office space? If it applies, how is the 30-month test measured, i.e. what is the basis target at the beginning of the 30-month period? Arguably if it is an operating lease, the taxpayer has not basis in the lease. But in other areas fair market value has been used. This would be a substantial impediment to businesses looking to move into the QOZ.

1. Best Guess – Some rule will be used to allow normal operating leases.

VII. Timing Problems for Investments – Grace Period? What if a QO Fund receives a substantial investment just prior to its 6-month or 12 month measuring date. It may not be possible to get the funds invested in time.

A. Grace Period – The IRS has been requested to give QO Funds a grace period to get funds invested.

B. Best Guess – unclear. Strong reasoning to allow for a grace period, but the IRS may feel restricted by the explicit words of the statute.

VIII. <u>Does Residential Rental Property Qualify?</u> Section 1400z-2 cross references certain portions of Section 1397C. One of the subsections of 1397C that is not cross-referenced says that residential rental property is not allowed. Will the IRS read these other sections in as limitations on 1400z?

A. <u>Best Guess</u> – Residential Rental Property will be allowed.