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Tax Accounting Committee

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The Basics on OZs

The What, Who, Where, When, Why & How of the Opportunity Zone (“OZ”) Incentive

- **What** is the OZ incentive?
 - The OZ incentive was introduced as part of the Tax Cuts & Job Act of 2017 and offers significant tax benefits to businesses and investors by way of deferring, and potentially reducing, gains from sales or exchanges of property to unrelated parties. It requires a reinvestment of the gains (and only the gains) from a sale or exchange of certain assets in a Qualified Opportunity Fund (“QOF”).
 - The principal benefits of the incentive can include:
 - Recognition of the original gain can potentially be deferred until the end of 2026 (“**Deferred Gain**”);
 - Up to 15% of the Deferred Gain can be permanently excluded from gross income (“**Excluded Gain**”) if certain holding periods are met; and
 - A fair market value step up in basis in the interest in the QOF (“**QOF Gain**”) if such interest is held for at least 10 years.
- **Who** can use the OZ incentive?
 - Any taxpayer (foreign and U.S., corporate and non-corporate) with certain U.S. gains can benefit from the incentive.
- **Where** are OZs located?
 - OZs are located throughout the U.S., the District of Columbia, Puerto Rico, and U.S. territories and possessions.
 - An interactive map of all OZs can be through the Community Development Financial Institutions Fund’s website found at https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml

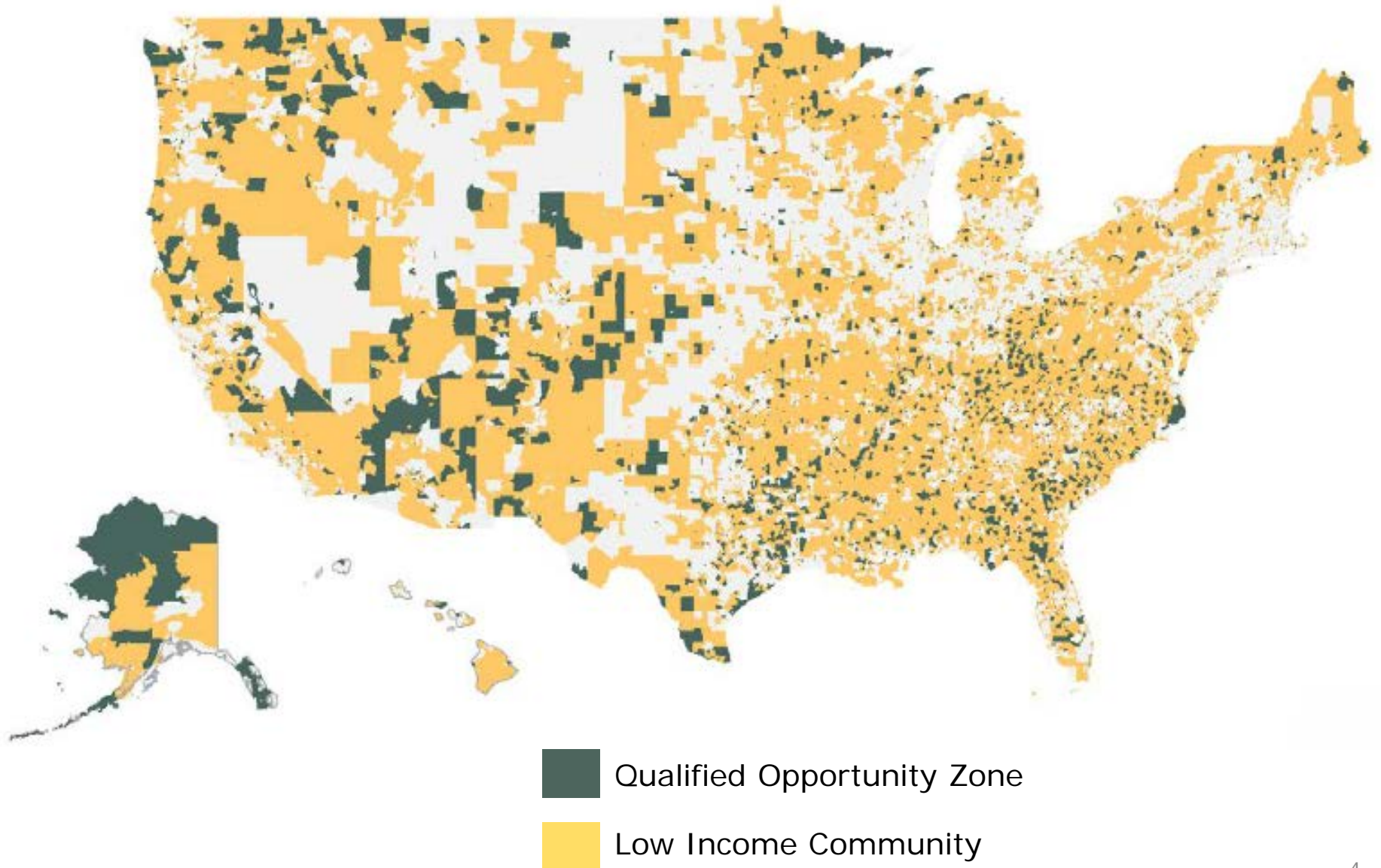
The Basics on OZs

The What, Who, Where, When, Why & How of OZs (*continued*)

- **When** can a taxpayer utilize the OZ incentive?
 - The OZ incentive is elective and can apply when the applicable taxpayer has certain U.S. gains from the sale or exchange of certain property and those gains are generally reinvested in a QOF within 180 days.
- **Why** was the OZ incentive enacted?
 - OZs are an economic development tool that were designed to spur economic development and job creation in distressed communities throughout the U.S. and its territories and possessions.
- **How** can a taxpayer make an investment?
 - Investments must be made through a QOF which is a U.S. corporation or partnership (and in certain cases an entity formed in a U.S. territory) formed for the purpose of investing in Qualified Opportunity Zone (“**QOZ**”) property.

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Map of Qualified Opportunity Zones in the 50 States



The Basics on OZs

Eligible Gains, Election & Reinvestment Period

- Proposed regulations indicate that only gains treated as capital gains can qualify as a Deferred Gain.
 - Eligible gains include:
 - Capital gains (both long term and short term)
 - Many dividend distributions taxed as capital gains (qualified dividend income)
 - Certain futures contracts (net Section 1256 contracts)
 - Collectible gains (gains from art, antiques, rugs, certain coins, stamps, wine, gems, etc.)
 - Potentially section 1231 gains (gains from sale or exchange of assets used in a trade or business)
- Deferred Gain is deferred until the earlier of (i) a disposition of all or a portion of the investment in the QOF or (ii) December 31, 2026.
 - A disposition of an entire interest in a QOF may also be a Deferred Gain.
- The taxpayer must affirmatively elect to be included in the OZ incentive. See Form 8949 to be filed with the federal income tax return for the tax year in which the gain would have been recognized if it had not been deferred.
- The Deferred Gain must generally be reinvested in a QOF within 180 days of the transaction generating the gain.
 - The OZ incentives only apply to the gain portion that is reinvested.
 - Special rules apply with respect to the reinvestment period for entities treated as partnerships and S corporations, and undistributed REIT or RIC capital gains dividends.

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Amount of Deferred Gain Recognized & OZ Basis Rules

- The amount of Deferred Gain recognized equals:
 - the lesser of
 - The Deferred Gain or
 - The fair market value of the investment in the QOF on the applicable date;
 - minus the “taxpayer’s basis in the investment” in the QOF.

- OZ Basis Rules:
 - Taxpayer’s starting basis in its investment in the QOF is \$0.
 - If the investment in the QOF is held for at least *5 years*, taxpayer’s basis in its investment in the QOF is increased to 10% of the Deferred Gain.
 - If the investment in the QOF is held for at least *7 years*, the taxpayer’s basis in its investment in the QOF is increased by another 5% of the Deferred Gain.
 - If the investment in the QOF is held for at least 10 years and taxpayer makes the Section 1400Z-2(c) election, the taxpayer’s basis in its investment in the QOF is adjusted to fair market value on a subsequent disposition of the QOF.

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Example of Tax Inclusion Amount

- For example:
 - Taxpayer sells capital gain assets with a tax basis of \$0 for \$100 million to an unrelated party and reinvests all \$100 million of the gain in a QOF which otherwise qualifies for the OZ incentive.
 - The taxpayer holds the interest in the QOF for seven years increasing its basis in the investment in the QOF from \$0 to \$15 million (\$10 million in Year 5 and \$5 million in Year 7).
 - **Alternative #1 (Increase in QOF Value)**
 - The QOF investment has increased in value from \$100 million to \$150 million and the taxpayer sells in Year 8.
 - The amount of the Deferred Gain recognized would be \$85 million (i.e., \$100 million minus \$15 million in basis in the investment in the QOF).
 - **Alternative #2 (Decrease in QOF Value)**
 - The QOF investment has decreased in value to \$90 million and the taxpayer also sells in Year 8.
 - The amount of the Deferred Gain recognized would be \$75 million (i.e., \$90 million fair market value of the QOF minus the \$15 million in basis in the investment in the QOF).

The Basics on OZs

Qualifying as a QOF

- A QOF is an investment vehicle organized as a U.S. corporation or partnership; in certain circumstances an entity formed in a U.S. possession can qualify.
- 90% of the QOF's assets must be qualified opportunity zone property ("**QOZ Property**") which cannot include an interest in another QOF.
 - 10% of the QOF's assets can be non-QOZ Property.
- The 90% threshold is tested by averaging percentages of QOZ Property (defined below) held by the QOF generally at six month intervals.
- The underlying business property must be acquired from an unrelated party, which is determined using a relatively low, greater than 20% threshold.
- A QOF self-certifies on IRS Form 8996 that is to be attached to its U.S. federal income tax return.
- QOZ Property is comprised of three items:
 - Qualified opportunity zone stock ("**QOZ Stock**");
 - Qualified opportunity zone partnership interest ("**QOZ Partnership Interest**"); or
 - Qualified zone business property ("**QOZ Business Property**").

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Qualifying as a QOF

- QOZ Stock is generally a U.S. corporation (or a possession corporation) that:
 - Has its stock acquired after 2017 for cash;
 - Was in a qualified opportunity zone business (“**QOZ Business**”) or formed for the purpose of investing in an QOZ Business; and
 - During substantially all of the QOF’s holding period, the corporation qualified as an QOZ Business.

- QOZ Partnership Interest is generally a U.S. partnership (or a possession partnership) that:
 - Has its interests acquired after 2017 for cash;
 - Was in an QOZ Business or formed for the purpose of investing in an QOZ Business; and
 - During substantially all of the QOF’s holding period, the partnership qualified as an QOZ Business.

- QOZ Business Property is tangible property used in a trade or business of the QOF if:
 - The property was acquired by purchase from an unrelated party after 2017;
 - The original use in an QOZ begins with the QOF or the QOF substantially improves the property; and
 - During substantially all of the QOF’s holding period, substantially all of the use of the QOZ Business Property was in an OZ.

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Qualifying as a QOF (*continued*)

- An QOZ Business is a trade or business in which:
 - Substantially all the tangible property owned or leased is QOZ Business Property;
 - At least 50% of the gross income is derived from the active conduct of such trade or business in the QOZ;
 - A substantial portion of the QOZ Business's intangible property is used in the active conduct of that trade or business;
 - Less than 5% of the QOZ Business Property is nonqualified financial property (e.g., stock, debt, and options), although reasonable working capital is allowed; and
 - Is not a specified "sin" business.
- There is a safe harbor with respect to reasonable working capital to the extent that three requirements are satisfied:
 - The amounts for the acquisition, construction and/or substantial improvement of tangible property in a QOZ are designated in writing;
 - The writing is consistent with the ordinary startup of a trade or business and the amounts are spent within 31 months; and
 - The working capital is used in a manner substantially consistent with the above.
- "Substantially all" is defined as 70% solely with respect to the QOZ Business's tangible property that must be QOZ Business Property.
 - Note: If a QOF invests directly in QOZ Business Property, its assets must meet the 90% threshold.

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Qualifying as a QOF (*continued*)

- The valuation of a QOF or of QOZ Business Property to meet the applicable 90% and 70% tests is determined under U.S. GAAP rules if they are required to be used or, alternatively, the applicable assets' "cost".
- "Substantial Improvement" is met if within 30 months "additions to basis with respect to the property" exceed the adjusted basis of the property at the beginning of the 30-month period.
 - The IRS has clarified in Rev. Rul. 2018-29 that where both land and a building are acquired, the substantial improvement to the building is measured by the QOF's additions to the adjusted basis of the building, and the land does not need to be separately improved.
 - At least on the facts of the ruling, there is no "original use" requirement applicable to the land.
 - Questions remain on vacant land with respect to the nature and type of improvements.

The Basics on OZs

Other Items of Note

- The calculation can result in at least 15% of the Excluded Gain being exempted from U.S. tax if the 7-year holding period is met, which requires investment by December 31, 2019.
- Recharacterized items like section 1245 recapture are not eligible gains under the proposed regulations.
- Income derived by or through a QOF is still subject to U.S. federal income tax but can be combined with tax credit or other incentive programs.
- QOF interests can be used as collateral for a loan without adversely impacting the beneficial tax benefits of the incentive.
- The working capital safe harbor allows for startup businesses to meet the gross income and intangible property prongs of the QOZ Business definition.
- Partnership interests that have special allocations of income are eligible for the incentives.
- The 10-year basis increase is elective, such that an investor who has a loss after the 10-year holding period may take the loss in the year of disposition.
- The 10-year basis increase election is effective until December 31, 2047.

The Basics on OZs

Some Material Questions Remain

- How is debt treated in a QOF that is a partnership for U.S. federal tax purposes?
 - Because of the way partnership debt rules work, a reduction in liabilities is treated as cash received, potentially creating gain on a disposition of a QOF treated as a partnership.
 - Could the step-up in basis to FMV possibly be to a gross value, eliminating this unintended outcome?
 - What distributions can be made by a QOF to its partners without triggering a disposition of the QOF interest.
 - Is a refinancing and debt-financed distribution a disposition of an interest in a QOF if it doesn't trigger gain under section 731(a)?

- The proposed regulations require that at least 50% of the gross income of a QOZB be from the active conduct of a trade or business in the qualified opportunity zone.
 - Some have suggested that this requirement imposed by the proposed regulations picks up more of section 1397C(b) than paragraph (2) literally provides; i.e., that the statute merely requires that at least 50% of the gross income of the entity be from the active conduct of a trade or business.
 - Any consideration of revising the approach here?
 - If the rule is retained, what's under consideration for determining whether gross income is derived in active conduct in the QOZ? Is use of tangible property in the QOZ sufficient? Must employees be located in the QOZ? Other?

The Basics on OZs

Some Material Questions Remain (*continued*)

- Is only a sale of the taxpayer's interest in a QOF eligible for the gain exclusion?
 - The language of the statute appears to reference only a sale or exchange of a taxpayer's interest in the QOF.
 - This restriction is problematic for a QOF that desires to invest in multiple QOZ Businesses.
 - Is there a way to extend the OZ tax benefits to a sale of underlying QOZ Businesses or QOZ Business Property?
- Are sales of a QOZ Business or QOZ Business Property taxable if replacement QOZ Business Property is acquired?
- How are construction costs treated if related parties are engaged (e.g., related general partner in a QOF provides construction services that are capitalized)?
 - It is common in the real estate fund space for related parties to generate arm's length fees and many in the industry have commented that such related party fees should not be disqualifying.
- Can carried or profits interests qualify for the basis step-up on disposition of an interest in a QOF treated as a partnership for U.S. federal income tax purposes? What if eligible gains are also contributed by the carry or profits interest partner?

The Basics on OZs

Some Material Questions Remain (*continued*)

— Land Issues

- Rev. Rul. 2018-29 – QOF buys land and factory building in OZ, with intent to convert the building to residential rental property. Basis is allocable 60% to land, 40% to building. Within 30 months, QOF invests more than the amount of the basis allocable to the building. The Rev. Rul. concludes that:
 - “Original use” of the building in the OZ is not satisfied, but the “original use” requirement does not apply to the land.
 - “Substantial improvement” of the building is measured by reference to the adjusted basis of the building only.
 - There is no further requirement of “substantial improvement” of the land.
- RR 2018-29 implicitly indicates that the land is qualified QOZ Business property. If so, how does this apply to a purchase by a QOF of vacant land? To a purchase by a QOZ Business of vacant land?
 - Example: QOF is formed with eligible gains of \$10mm and purchases vacant land in an QOZ for \$4mm, with an intent to spend \$5.5mm to construct a building and lease space to retail industry tenants and to use the remaining \$0.5mm for working capital.
 - Does this work if done directly by the QOF? Any difference if done in a QOZ Business? Will the working capital safe harbor in Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv) apply equally to both?
 - Could a QOZ Business use the reasonable cause exception to extend the 31-month safe harbor period?
 - Does the working capital safe harbor apply separately to additional capital infusions if pursuant to a written plan (e.g., construction in phases)?
 - Does the working capital safe harbor treat assets as qualifying QOZ business property throughout the safe harbor period (e.g., while it is construction work in process)?

The Basics on OZs

Some Material Questions Remain (*continued*)

- Other Original Use Issues
 - What constitutes original use of property for QOZ purposes (e.g., does the purchase of a newly constructed building that has not yet been placed in service qualify as the purchase of original use property?)
- Attributes of Deferred Gain
 - Prop. Reg. § 1.1400Z-2(a)-1(b)(5) provides that when a deferred gain is later included in income, such gain “has the same attributes” it would have had if the gain had not been deferred, including “those taken into account by sections 1(h), 1222, 1256, and any other applicable provisions of the Code.”
 - Is the rate of tax that would have applied under section 1(h) absent the deferral such an attribute? What is the scope of the reference to section 1(h)?
 - How do these rules apply to installment sale gain? Interaction with section 453A?
- Exit Issues
 - Any consideration of providing guidelines to accommodate asset dispositions by a multi-asset QOF after 10 years, rather than forcing a sale of the eligible interests in the QOF?
 - Divisions of partnerships? Other?
- Treatment of Land – Can land be contributed to a QOZ Business and improved (e.g., build a building on the land), and have the improvements be QOZ Business Property? What if the Land is leased instead of contributed?
- Leases of Other Property – How should a QOZ Business treat the lease of a building, or space in a building, in satisfying its asset tests for tangible and intangible property?

The Basics on OZs

Some Material Questions Remain (*continued*)

- Other “substantially all” issues
- “Reasonable period” for a QOF to reinvest asset sale proceeds without a penalty
- Penalties for failing the 90% test and the reasonable cause exception
- Information reporting requirements
 - Any consideration of gathering information not necessarily tied to statutory requirements (e.g., concerning employment or other economic impacts in QOZs)?
 - Other?

The Basics on OZs

State Tax Considerations of OZ Investments

Corporate Taxpayers (as of January 2019)	Non-Corporate Taxpayers (as of January 2019)
<ul style="list-style-type: none">• 38 likely conforming to the OZ Incentive (i.e., will automatically follow deferral and basis increases)	<ul style="list-style-type: none">• 35 likely conforming to the OZ Incentive (i.e., will automatically follow deferral and basis increases)
<ul style="list-style-type: none">• 6 nonconforming to the OZ Incentive (i.e., not automatically follow the OZ Incentive)• California & Minnesota are among the states not yet conformed to OZ Incentive<ul style="list-style-type: none">• California Gov. Gavin Newsom has included conformity in his proposed budget for 2019-2020• Iowa is set to conform, but only for tax years beginning on or after January 1, 2019• Hawaii and North Carolina have affirmatively decoupled	<ul style="list-style-type: none">• 6 nonconforming to the Opportunity Zone provisions of the IRC• California & Minnesota are among the states not yet conformed to OZ Incentive<ul style="list-style-type: none">• California Gov. Gavin Newsom has included conformity in his proposed budget for 2019-2020• Iowa is set to conform, but only for tax years beginning on or after January 1, 2019• Hawaii and North Carolina have affirmatively decoupled
<ul style="list-style-type: none">• 6 have no state corporate income tax	<ul style="list-style-type: none">• 9 do not impose income tax on capital gains

The Basics on OZs

Dates & Confusing OZ Terminology Cheat Sheet

- **Qualified Opportunity Zone Fund or “QOF”** – Generally a U.S. partnership or corporation formed to invest, directly or indirectly, in OZs. A taxpayer with gains *can only* participate in the OZ incentive through a QOF.
- **Qualified Opportunity Zone Property or “QOZ Property”** – What 90% of the QOF’s assets must contain. OZ Property can include (i) QOZ Stock; (ii) QOZ Partnership Interests; or (iii) QOZ Business Property.
- **Qualified Opportunity Zone Stock or “QOZ Stock”** – A U.S. corporation that generally (i) has its stock acquired for cash in 2018 or after, (ii) operates or plans to operate an QOZ Business; and (iii) throughout substantially all of the QOF’s holding period, the corporation qualified as an QOZ Business. **Qualified Opportunity Zone Partnership Interest or “QOZ Partnership Interest”** – A U.S. partnership that generally (i) has its interests acquired for cash in 2018 or after; (ii) operates or plans to operate an QOZ Business; and (iii) throughout substantially all of the QOF’s holding period, the partnership qualified as an QOZ Business.
- **Qualified Opportunity Zone Business Property or “QOZ Business Property”** – Is generally tangible business property used in a trade or business of the QOF if (i) the property was acquired from an unrelated party in 2018 or after; (ii) the original use begins with the QOF or the QOF substantially improves the property; and (iii) substantially all of the use of the QOZ Business Property was in an OZ.

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Dates & Confusing OZ Terminology Cheat Sheet

- **December 31, 2019** – The last possible date to invest in a QOF and receive the full 15% exemption from tax on the Deferred Gain.
- **December 31, 2026** – The last possible date that a taxpayer can defer capital gains under the OZ incentive.
- **December 31, 2047** - The last possible date that a taxpayer can elect the 10 year step up in basis.
- **Qualified Opportunity Zone Business or “QOZ Business”** – Is generally a trade or business where (i) substantially all the business’ tangible property owned or leased is QOZ Business Property; (ii) at least 50% of the income is from that active trade or business; (iii) a substantial portion of the business’ intangible property is used in that trade or business; (iv) less than 5% of the property is certain financial property; and (v) the business is not a “sin” business (e.g., golf club, country club, massage parlor, hot tub or suntan facility, racetrack or gambling facility, or business where sale of alcohol for consumption off premise). **Substantial Improvement** – Is additions over a 30-month period that equal or exceed the adjusted basis of property. Most likely relevant with respect to U.S. real estate investments under the OZ incentive.

