Opportunity Zone Benefits; Nuts and Bolts; and Loose or Missing Screws

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J. Leigh Griffith and Shane P. Morris examine the incentive available to taxpayers who invest in a Qualified Opportunity Fund (QOF) as well as the detailed requirements found in the first set of Proposed Regulations to be a QOF.

I. Introduction

The Tax Cuts and Jobs Act of 2017 (the “TCJA”) created a new tax incentive designed to encourage long-term investment in low income communities, as defined in Code Sec. 45D(e),¹ which are specifically designated as “qualified opportunity zones” (“QOZs”) in accordance with procedures set forth in Code Sec. 1400Z-1.²

Generally, the qualified opportunity zone legislation is designed to encourage investment in QOZs by providing taxpayers who invest in specially defined investment vehicles called “qualified opportunity funds” (“QOFs”) with (i) deferral of certain gains recognized by the taxpayer between January 1, 2018, and December 31, 2026, that are invested in QOFs within 180 days of the realization of such gains, (ii) the permanent exemption of up to 15% of those gains if the investment in the QOF is held for certain prescribed time periods, and (iii) the potential permanent exemption of all appreciation in the investment of those gains in the QOF if the investment is held for at least 10 years.

The QOZ statute left many unanswered questions that need to be answered before sponsors could realistically start forming QOFs. On October 29, 2018, the U.S. Department of the Treasury and Internal Revenue Service published proposed regulations under Code Sec. 1400Z-2³ (the “Proposed Regulations”) addressing many of these questions, but others still remain unanswered. The IRS initially announced that another round of proposed regulations is expected to be published before the end of 2018. However, at the time of the writing of this article, the second set of proposed regulations had not been published, and the authors would not be surprised if they are not released until the middle of the first quarter of 2019. This article will discuss the incentive available to taxpayers...
who invest in a QOF as well as the detailed requirements found in the Proposed Regulations to be a QOF.

II. What Is a Qualified Opportunity Zone?

Under Code Sec. 1400Z-1(b), the chief executive of each State, the District of Columbia and each U.S. territory could nominate the greater of up to 25% of the low-income communities as defined in Code Sec. 45D(e) of a State, District of Columbia or Territory (except all low-income communities in Puerto Rico were automatically designated4) or if the number of low-income communities in the State is less than 100, up to 25 could be designated as QOZs. A limited number of census tracks that were not low-income communities but were adjacent to low-income communities could also be nominated for such designation.5 The Secretary of the Treasury was to review the nominations and certify such tracts as QOZs. Over 8700 zones were nominated and certified.6 A complete list of all certified opportunity zones can be found in Notice 2018-48.7 QOZs have been designated in all 50 states, Puerto Rico, Guam, the Commonwealth of Northern Mariana Islands, American Samoa, and the U.S. Virgin Islands. The designation is final and began on the date of designation and ends at the close of the 10th calendar year beginning on or after such date of designation (i.e., December 31, 2028).8 After such time, new investments in the QOF will not qualify for the tax benefits of the QOZ, but existing investments in the QOF can continue to be held and qualify for the 100% basis step-up on a sale on or before January 1, 2048.9 A useful map of the QOZs can be found on the Treasury Department’s Community Development Financial Institutions Fund website.10

III. The Incentive

A. Gains Eligible for Election

1. Only Gain Is Eligible for Incentives

It is important to note that only gain from the sale of property is eligible for the incentives under Code Sec. 1400Z-2. This is distinguishable from the commonly used deferral provision in Code Sec. 1031 that requires all of the amount realized from the disposition of property be “exchanged” for like-kind property to obtain full deferral.

Example: Taxpayer A bought unimproved Whiteacre in 2000 for $10 million. On January 1, 2018, Taxpayer A sold Whiteacre for $20 million, recognizing $10 million of long-term capital gain. Taxpayer A can make an election with respect to the $10 million of long-term capital gain realized on the sale if Taxpayer A invests $10 million in a QOF within 180 days of January 1, 2018. The remaining $10 million of proceeds received by Taxpayer A in the sale of Whiteacre is not eligible for the tax incentives of Code Sec. 1400Z-2.

While the election under Code Sec. 1400Z-2 may only be made with respect to gain invested in a QOF, a taxpayer may invest other amounts in a QOF that do not constitute eligible gain. In such event, the investment is required to be bifurcated into two separate investments, one including only the amounts with respect to which the deferral election under Code Sec. 1400Z-2(a)(1) is made and the other investment consisting of the other amounts.11 Only the investment of the gain is eligible for the basis step-ups and gain exclusion incentives provided for in Code Secs. 1400Z-2(a), (b) and (c), which are discussed in detail below.12

Example: Same as example above, except Taxpayer A invests the entire $20 million of proceeds received from the sale of Whiteacre in a QOF before the expiration of the 180-day period and makes an election with respect to the $10 million of gain under Code Sec. 1400Z-2(a)(1). Taxpayer A is treated as making two investments in the QOF: one investment of $10 million of capital gain for which the election under Code Sec. 1400Z-2(a)(1) is made and that is eligible for the incentives in Code Sec. 1400Z-2(b) and (c), and another investment of $10 million that is treated like any other investment with no incentives.

2. Gain Must Not Be from Sale to a Related Person

Code Sec. 1400Z-2(a)(1) provides for an elective exclusion by a taxpayer of “gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer.”13 A taxpayer is treated as “related” for purposes of Code Sec. 1400Z-2 as persons related to each other under Code Sec. 267(b) or 707(b)(1), substituting 20% for 50% each place it appears in such Sections.

3. Gain Must Be Capital Gain for Federal Income Tax Purposes

The statutory language provides no limitation on the character of the gain that may qualify for deferral upon
involving a QOF, requiring only that it be gain from the sale of “any property.” However, the title of the section in the TCJA reads “Special rules for capital gains invested in opportunity zones,” and the Conference Report provides that the gain that is eligible for deferral is capital gain. The Proposed Regulations limit the gain eligible for deferral under Code Sec. 1400Z-2 to gain that is treated as capital gain for federal income tax purposes. Thus, gain from the sale of assets that are not capital assets or Code Sec. 1231 property does not qualify for deferral under Code Sec. 1400Z-2(a)(1) under the Proposed Regulations, nor does Code Sec. 1245 recapture gain or Code Sec. 1250 recapture gain. But “unrecaptured Section 1250 gain,” though taxable at a 25% rate, is considered capital gain under Code Sec. 1(h) and thus should qualify as eligible gain under the Proposed Regulations. Short-term as well as long-term capital gains are eligible for deferral.

4. Gain Cannot Already Be Subject to an Election

Code Sec. 1400Z-2(a)(2) provides that no election can be made with respect to a sale or exchange if an election previously made with respect to such sale or exchange is in effect. The Proposed Regulations clarify that in the case of capital gain with respect to which a taxpayer has made an election for a portion, but not all, of the capital gain from a transaction, the remaining portion for which an election has not been made remains “eligible gain.” Furthermore, the Proposed Regulations provide that if a taxpayer is required to include previously deferred gain upon the complete disposition of its QOF interest, the taxpayer may make an election with respect to that sale or exchange by making a qualified new investment of the gain in a QOF, on the theory that the election is with respect to a new sale or exchange and not a second election with respect to the same sale or exchange. The preamble to the Proposed Regulations states the following: “The complete disposition is necessary because section 1400Z-2(a)(2)(A) expressly prohibits the making of a deferral election under section 1400Z-2(a)(1) with respect to a sale or exchange if an election previously made with respect to the same sale or exchange remains in effect.” Presumably, if a taxpayer disposes of its entire interest in a QOF and timely makes another gain deferral election in a QOF, new holding periods will start with respect to the new QOF investment. Such a reinvestment could eliminate the availability of the 10% or 5% basis step up on the deferred capital gain depending on the date of the reinvestment.

5. Special Rules for Code Sec. 1256 Contracts

The Proposed Regulations provide that only net capital gain from the sale of Code Sec. 1256 contracts in a taxable year is eligible for the election under Code Sec. 1400Z-2(a)(1). Net capital gain, if any, from Code Sec. 1256 contracts is determined by taking all gains and losses for the entire taxable year from Code Sec. 1256 contracts and netting them.

6. Limitations on Gains Part of Offsetting-Positions Transactions

The Proposed Regulations provide that capital gain from a position that is or has been part of an “offsetting-positions transaction” is not eligible for an election under Code Sec. 1400Z-2(a)(1). An “offsetting-positions transaction” is defined to include a “straddle” as defined in Code Sec. 1092 as well as transactions that would be straddles if the straddle definition did not contain the active trading requirement.

B. Taxpayers Eligible to Defer Gain

The Proposed Regulations clarify that a “taxpayer” for purposes of the election under Code Sec. 1400Z-2(a)(1) is any person that may recognize gain for purposes of federal income tax accounting, including individuals, C corporations, regulated investment companies, real estate investment trusts, partnerships, S corporations, trusts and estates. Because both passthrough entities (e.g., partnerships, S corporations, trusts and estates) and the owners of passthrough entities who report the federal income tax on their tax returns are both defined as taxpayers under the Proposed Regulations, the Proposed Regulations provide special rules for gains recognized by passthrough entities. First, a passthrough entity may make an election under Code Sec. 1400Z-2(a)(2), and if the passthrough entity makes the election, the deferred gain is not included in its owners’ share of the passthrough entity’s income. When the deferred gain is later required to be included in income under Code Sec. 1400Z-2(a)(1)(B), the gain is recognized by the electing passthrough entity at that time and will flow through and be included in the owners’ tax returns at that time. If the passthrough entity does not elect to defer some or all of its eligible gains for a tax year, then those gains pass through to its owners unaffected by Code Sec. 1400Z-2, but the owners will then be eligible to make an election to defer their share of the eligible gain for which the passthrough entity did not make an election, by investing in another QOF on or before December 31, 2026, unless the gain arose from a sale or exchange with a person that is related to the partner within the meaning of Code Sec. 1400Z-2(e)(2).
C. Investment in a QOF

1. 180-Day Period

Code Sec. 1400Z-2(a)(1)(A) requires that a taxpayer’s gain from a sale or exchange be invested in a QOF during the 180-day period beginning on the date of the sale or exchange. The Proposed Regulations clarify that this generally means that the 180-day period commences on the day on which the gain would be recognized for federal income tax purposes if no election were made under Code Sec. 1400Z-2(a)(1). Thus, a taxpayer’s 180-day period would generally begin (i) with respect to gain from the sale of property, on the day the property is sold, (ii) with respect to a capital gain dividend received by a REIT or RIC, on the day the dividend is received, or (iii) with respect to undistributed capital gains included in the income of the REIT’s or RIC’s shareholders, on the last day of the REIT’s or RIC’s tax year. An example in the Proposed Regulations provides that if previously deferred gain is recognized under Code Sec. 1400Z-2 because the taxpayer disposes of its interest in a QOF prior to December 31, 2026, the taxpayer may make an election with respect to that gain by making another investment in a QOF within the 180-day period commencing on the date the taxpayer disposed of the QOF investment. As noted above, this opportunity for additional deferral is only available if the taxpayer disposes of its entire interest in the QOF because the statute expressly prohibits making more than one election with respect to the same sale or exchange. The gain that is automatically recognized on December 31, 2026, if the QOF interest has not been disposed of by that date is not eligible for a gain deferral election by investing in a QOF.

The Proposed Regulations provide a special rule for calculating the 180-day period with respect to an owner of a passthrough entity when the passthrough entity does not make the election under Code Sec. 1400Z-2(a)(1). In such event, the 180-day period for such owner generally begins on the last day of the flow-through entity’s taxable year in which the owner’s share of the passthrough entity’s eligible gain is taken into account. However, the owner may elect to treat its 180-day period as beginning on the same day as the passthrough entity’s 180-day period.

Example: On January 1, 2019, Partnership realizes a capital gain, and the Partnership decides not to make an election under Code Sec. 1400Z-2(a)(1) to defer the gain. If any individual partner in the Partnership wants to make an investment in a QOF to defer her distributive share of the Partnership’s eligible gain, she can either make the investment within the 180-day period beginning on January 1, 2019, or within the 180-day period beginning on December 31, 2019.

2. Required Investment in QOF

Code Sec. 1400Z-2(a)(1)(A) requires that there be an amount of gain “invested” in a QOF within the 180-day period in order to qualify for the deferral election. The Proposed Regulations clarify that an investment in a QOF requires the receipt of an equity interest issued by the QOF. An equity interest includes preferred stock or a partnership interest with special allocations but excludes any debt instrument within the meaning of Code Sec. 1275(a)(1). The Proposed Regulations also clarify that as long as the taxpayer is the owner of the equity interest in the QOF for federal income tax purposes, the taxpayer may pledge its interest in the QOF as collateral for a loan without jeopardizing its status as a qualifying investment in a QOF.

D. The Incentive

1. Gain Deferral

A taxpayer who timely invests eligible gain into a QOF and makes an election under Code Sec. 1400Z-2(a)(1) does not recognize the gain in the tax year that it would have been recognized absent such election. However, upon the earlier of (i) the date the taxpayer’s investment in the QOF is sold or (ii) December 31, 2026, the taxpayer is required to recognize the lesser of (A) the amount of gain previously deferred in excess of the taxpayer’s basis in the investment or (B) the fair market value of the investment over the taxpayer’s basis in the investment. The taxpayer’s basis in the investment in the QOF starts at zero. If the investment in the QOF is held for five years, the basis in the investment is increased by an amount equal to 10% of the amount of gain deferred by the election under Code Sec. 1400Z-2(a)(1). If the investment in the QOF is held for seven years, the basis in the investment is increased by an additional 5% of the gain deferred by the election under Code Sec. 1400Z-2(a)(1) (for a total of 15%). It is significant to note that because the gain deferred by the election under Code Sec. 1400Z-2(a)(1) must be recognized (in accordance with the rules described above) no later than December 31, 2026, a taxpayer must make its investment in a QOF no later than December 31, 2019, in order to take advantage of the 15% permanent exclusion of deferred gain and no later than December 31, 2021, to take advantage of the 10% exclusion of the deferred gain. Additionally, the taxpayers’ basis in the QOF is increased by any of the
previously deferred gain being recognized under Code Sec. 1400Z-2(a)(1)(B).

The Proposed Regulations provide that when previously deferred gain is later included in the taxpayer’s income under Code Sec. 1400Z-2(b), the gain has the same attributes in the taxable year of inclusion as it would have had if the gain had not been deferred. Thus, for example, if the taxpayer makes an election under Code Sec. 1400Z-2(a)(1) to defer gain that would have been short-term capital gain, collectibles gain, or gain from Code Sec. 1256 contracts when it would have been recognized absent an election under Code Sec. 1400Z-2(a)(1) with respect to such gain, the gain subsequently includible in income by such taxpayer under Code Sec. 1400Z-2(b) will be treated as short-term capital gain, collectibles gain, or gain from Code Sec. 1256 contracts, respectively and will be taxed at the then applicable rates.

Example: Taxpayer disposes of Whiteacre on January 1, 2019, and recognizes $10 million of long-term capital gain. Taxpayer makes an equity investment in a QOF of $10 million and makes the election under Code Sec. 1400Z-2(a)(1) with respect to the $10 million of long-term capital gain. Taxpayer’s initial basis in the QOF is zero. On January 1, 2024, the Taxpayer’s tax basis in its investment in the QOF increases to $1 million, and on January 1, 2026, the Taxpayer’s tax basis in its investment increases to $1.5 million. On December 31, 2026, the Taxpayer still holds its investment in the QOF when its investment in the QOF is valued at $15 million. The Taxpayer recognizes $8.5 million of long-term capital gain on December 31, 2026. The Taxpayer’s tax basis in her investment in the QOF is increased by $8.5 million to $10 million.

2. Permanent Exclusion

If a taxpayer has held its investment in a QOF for at least 10 years, the taxpayer may make an election for the tax basis of its investment in the QOF to be adjusted to equal the fair market value of such investment on the date the investment is sold or exchanged. Because the designated QOZs will expire at the end of 2028, some commentators had questioned whether anyone could take advantage of this provision (someone investing in a QOF on January 1, 2018, the earliest possible date, would be one day shy of a 10-year hold period when the designated QOZs expire on December 31, 2028). The Proposed Regulations resolve this issue by providing that the election to adjust basis to fair market value under Code Sec. 1400Z-2(c) may be made by a taxpayer upon a sale of a QOF interest at any time on or before December 31, 2047, even if the designation of the QOZ has ceased to be in effect.

Example: The same as the immediately preceding example, except on December 31, 2047, the Taxpayer sells her interest in the QOF for $100 million and makes an election under Code Sec. 1400Z-2(c) to adjust the tax basis in her interest in the QOF to fair market value on the date of sale, or to $100 million. Taxpayer recognizes no gain on the sale.

3. Other Investments in Qualified Opportunity Funds

As briefly discussed in Section III.A.1 above, a taxpayer may make investments into a QOF that is not deferred capital gain eligible for the incentives of Code Sec. 1400Z-2. If a taxpayer makes such an investment, it is treated as a separate investment not eligible for the incentives. Under Code Sec. 752, a partner’s allocable share of partnership debt is treated as a capital contribution by the partner. This led many commentators to worry that if a QOF taxed as a partnership for federal tax purposes utilized leverage, the partners could be treated as making a separate non-qualifying investment in the QOF equal to its share of partnership debt that would be ineligible for the 1400Z-2 incentives. Fortunately, the Proposed Regulations resolved this issue in a taxpayer-favorable manner by providing that deemed contributions of money to a QOF under Code Sec. 1400Z-2(e)(1)(A)(ii) are not treated as creating or increasing an investment in the fund described in Code Sec. 1400Z-2(e).

Example: Taxpayer sold Whiteacre on January 1, 2018, for $20 million and realized $10 million of long-term capital gain. Taxpayer acquired a 50% capital interest in QOF Partnership on February 1, 2018, for $20 million, utilizing all of his proceeds from the sale of Whiteacre. Taxpayer made the election under Code Sec. 1400Z-2(a)(1) with respect to his $10 million of long-term capital gain. QOF Partnership borrowed $60 million and invested $100 million in qualified opportunity zone stock. Under Code Sec. 752(a) and the regulations thereunder, Taxpayer is allocated $30 million of QOF Partnership’s debt and treated as making a $30 million capital contribution to QOF Partnership for purposes of computing his tax basis in QOF Partnership. Under Code Sec. 1400Z-2(e), Taxpayer is treated as making two investments in QOF Partnership, 50% of which is an investment
4. First-In, First-Out to Identify Qualified Opportunity Fund Interests

The Proposed Regulations provide that if a taxpayer acquires interests in a QOF on different days and if those interests have identical rights (such that they are fungible), then if the taxpayer disposes of less than all of the interests in the QOF on a single day, the taxpayer must use the first-in, first-out method to identify which interest(s) were disposed of.\(^5\)\(^4\) The identification of interests is relevant (i) if the taxpayer has made an investment to which a gain deferral election applies and a separate investment to which a gain deferral election does not apply, to determine which of the two investments was disposed of and (ii) in the case of investments of gain for which a deferral election applies and a separate investment to determine the appropriate attributes of the gain recognized on the disposition.\(^5\)\(^5\) If after the application of the FIFO Method, the taxpayer is required to prorate the characteristics among the interests sold, they are fungible, then if the taxpayer disposes of less than all of the interests in the QOF that it acquired on a single day and if the difference in interests is relevant, then the taxpayer is required to prorate the characteristics among the interests sold.\(^5\)\(^6\)

E. Unresolved Partnership Tax Issues

The Proposed Regulations do not specifically address a number of partnership tax issues that exist if a QOF is taxed as a partnership. Other than providing that the initial tax basis in the investment in the QOF of deferred gain for which an election is made is zero, nothing in Code Sec. 1400Z-2 indicates that there is any modification to the general rules of Subchapter K to a QOF taxed as a partnership.

Code Sec. 1400Z-2(e)(4) directs the Secretary to prescribe regulations to ensure that a QOF has a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity partnership interests, and to reinvest proceeds received from the sale or disposition of qualified opportunity zone property. The preamble to the Proposed Regulations indicates that additional proposed regulations will address these issues. Commentary has been specifically requested regarding the federal income tax treatment of any gains that the QOF reinvests during the “reasonable period” and the scope of statutorily permissible policy alternatives. The authors hope that the next set of proposed regulations would provide that gains reinvested in qualified opportunity zone property during the “reasonable period” would be eligible for tax deferral.

Another significant issue that the authors hope is addressed in the next set of proposed regulations concerns the fact that the exclusion of gain (after the 10-year holding period) applies under the statute only to sales of interests in the QOF (as opposed to sales of qualified opportunity zone property by the QOF or its subsidiaries). As a commercial matter, many buyers prefer to buy business or real estate assets over equity interests, and if a buyer is willing to acquire the QOF interests, the buyer might only be willing to do so at a discount compared to what it would pay for the underlying assets. If the QOF (or its partnership subsidiary) sells all of its assets and distributes the proceeds to the QOF partners in complete liquidation of their QOF interests, any cash distributed in excess of basis would be treated as gain from the sale of the QOF partnership interest.\(^5\)\(^7\) Such a liquidating distribution should be treated as a sale of the investment of the QOF for which an election could be made under Code Sec. 1400Z-2(c) to adjust the tax basis in the QOF partnership interest to fair market value. However, under the regular rules of Subchapter K, adjusting the basis to fair market value would likely not result in the exclusion of the appreciation intended by the statute. Assuming that the QOF partnership must recognize gain on the sale of its assets, this gain would be allocated among the QOF’s partners and would increase the partners’ tax bases in the QOF to fair market value of the underlying assets of the QOF. There would be no adjustment under Code Sec. 1400Z-2(c) because the tax basis in the QOF interest would already be at fair market value as a result of the asset sale gain allocation.

Example: Taxpayer invests $100,000 of long-term capital gain in a QOF, classified as a partnership for federal income tax purposes, on June 30, 2018, in exchange for a 50% partnership interest in the QOF and makes an election under Code Sec. 1400Z-2(a)(2) with respect to the gain. The QOF uses the $100,000 equity investment along with $100,000 in equity investments received from the other partners of the QOF to buy qualified opportunity zone stock. After holding the qualified opportunity zone stock for more than 10 years, the QOF sells the qualified opportunity zone stock, its sole asset, for $1 million and liquidates, distributing all proceeds to its partners. At the time of the sale, Taxpayer’s tax basis in the QOF is $100,000, reflecting the recognition of the $100,000 of initially deferred long-term capital gain on December 31, 2026. The QOF recognizes $800,000 of long-term...
capital gain on the sale, 50% of which, or $400,000 of which, is allocated to Taxpayer, increasing Taxpayer’s tax basis in the QOF partnership interest by $400,000 to $500,000, which is equal to Taxpayer’s share of sale proceeds. Taxpayer makes an election under Code Sec. 1400Z-2(c) to adjust the tax basis in the QOF partnership interest to fair market value. However, because Taxpayer’s tax basis in the QOF partnership interest is already equal to fair market value as a result of the allocation of $400,000 of gain from the partnership sale of qualified opportunity zone stock, there is no adjustment and Taxpayer has long-term capital gain to report of $400,000, representing all of the appreciation in its investment.

In order for the full appreciation to be excluded from tax by the QOF partners in this situation, the tax basis in the QOF interest would need to be stepped up to equal the sum of the fair market value of the membership interest plus all previously allocated gain to the QOF partner that had not been previously distributed to the partner. Alternatively, the rules could provide for the step-up in basis to fair market value immediately prior to the sale. In either case, the Taxpayer’s tax basis would be $900,000 at the time of the liquidating distribution, with Taxpayer recognizing not only $400,000 of long-term capital gain on the flow-through income but also $400,000 of long-term capital loss on the liquidating distribution.

Similarly, the treatment of debt on the sale of a partnership interest under the general rules of Subchapter K is also problematic in accomplishing full gain exclusion on the sale of a QOF partnership interest after the 10-year holding period if the QOF or its partnership subsidiaries have leverage. Under Code Sec. 752, if a partner sells a partnership interest, the partner’s share of partnership liabilities is included in the amount realized on the sale.58 Code Sec. 1400Z-2(c) provides that the interest in the investment in the QOF interest is adjusted to its fair market value on the date of the sale. The fair market value of the investment would take into account any debt at the partnership level as a reduction in value compared to if there were no debt. However, the partnership’s debt is already included in the partners’ tax bases prior to such adjustment to fair market value and (as noted above) is added to the purchase price when there is a partnership interest sale. If the basis in the QOF investment is adjusted to equal the fair market value of the interest only and the partnership’s debt is still included in the selling partner’s amount realized on the sale, the partner would have gain equal to his share of the partnership debt on sale, which could eliminate the gain exclusion and even make a taxpayer worse off from making the election than if no fair market value election had been made.

Example: Taxpayer invests $100,000 of long-term capital gain in a QOF classified as a partnership for federal income tax purposes on June 30, 2018, in exchange for a 50% interest in the QOF and makes an election under Code Sec. 1400Z-1(a)(1) with respect to such gain. The QOF borrows $800,000, $400,000 of which is allocable to the taxpayer under Code Sec. 752, and acquires qualified opportunity zone stock. After holding the interest in the QOF for 10 years, at a time when the QOF still has $800,000 of debt (allocable 50% to the taxpayer), the taxpayer sells his QOF partnership interest for $200,000 and makes the election under Code Sec. 1400Z-2(c) to adjust his tax basis in the QOF partnership interest to fair market value. Prior to the election under Code Sec. 1400Z-2(c), the taxpayer’s tax basis in the QOF interest was $500,000 (consisting of $100,000 of the originally deferred gain recognized on December 31, 2026, plus the $400,000 QOF liabilities allocated to the taxpayer under Code Sec. 752). After the election under Code Sec. 1400Z-2(c), the tax basis in the QOF interest is $200,000. Under Code Sec. 752(d), the taxpayer’s amount realized for purposes of computing gain on the sale of the QOF partnership interest is $600,000. The taxpayer recognizes $400,000 of long-term capital gain as a result of the election. Without the election, the taxpayer would have recognized only $100,000 of gain (his actual economic appreciation in the QOF interest), while one would expect that under the intent of the statute, the taxpayer would have recognized no gain.

This issue would be resolved if the tax basis of the QOF partnership interest was adjusted to equal the fair market value of the interest plus the partner’s share of partnership debt.

Another partnership tax issue arises as a result of the taxpayer’s beginning tax basis in a deferred gain investment in a QOF taxed as a partnership for federal income tax purposes being zero, while presumably the inside basis of the partnership’s assets will still be equal to the actual cost of its assets, which will result in an inside/outside basis disparity not contemplated anywhere in Subchapter K. Code Sec. 704(c) does not appear to apply to this situation. How should depreciation deductions be allocated? Should the answer be different if the investments in the QOF have been bifurcated under Code Sec. 1400Z-2(e)?
F. Partnership Compared to REIT
Some of the problems associated with subchapter K under Code Sec. 1400Z-2 and the current Proposed Regulations could be avoided if the QOF were instead classified as a real estate investment trust, or REIT, provided that the QOF can meet the stringent requirements under the Code to qualify as a REIT. A REIT shareholder includes the REIT’s debt neither in its REIT stock basis nor in its amount realized on its REIT stock, eliminating the debt issue discussed above. Further, if a REIT sells all of its assets and liquidates, the distribution of the liquidation proceeds should generally eliminate any REIT taxable income under the dividends paid deduction, while the REIT shareholder would be treated as selling his REIT stock, which if an election were made under Code Sec. 1400Z-2(c) should result in a tax basis in the REIT stock equal to the liquidation proceeds distributed to the REIT shareholder. The authors have seen offerings for QOF’s electing to be classified as REITs, utilizing a structure that contemplates investing in qualified REIT assets in qualified opportunity zones through one or more partnerships (i.e., utilizing an up-REIT structure).

IV. The Qualified Opportunity Fund

A. Introduction
In order for investors to obtain the previously discussed tax benefits of the QOZ incentive, the entity taxable as a corporation or as a partnership for federal tax purposes into which the investor invests must meet certain requirements set forth in the Code and somewhat fleshed out in the first set of Proposed Regulations in order to be a QOF. Generally, the statute provides that a QOF is “an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90% of its assets in qualified opportunity zone property (“QOZP”), determined by the average of the percentage of QOZP held in the fund as measured (A) on the last day of the first 6-month period of the taxable year of the fund, and (B) on the last day of the taxable year of the fund.” Unfortunately, the nuances of qualification as a QOF with direct investments in a trade or business and some of the details of the assets and activities of subsidiary entities operating in one or more QOZs are not completely fleshed out. It is anticipated that the second set of Proposed Regulations expected shortly will further elaborate on and flesh out the requirements. Nevertheless, there is at least a path for QOFs to start forward, particularly with respect to the construction and operation of real estate in a QOZ, even if many questions remain. The Proposed Regulations permit a QOF to rely on the Proposed Regulations with respect to taxable years that begin before the date of the finalization of the Proposed Regulations but only if the investors and QOF apply the rules in their entirety and in a consistent manner.

B. Defined Terms
The Code and the Proposed Regulations create many new defined terms framing the requirements for a QOF. In order to understand the requirements a QOF must meet to enable the taxpayer to obtain the benefits of this tax incentive, these terms must be understood and carefully applied.

1. Qualified Opportunity Zone
As discussed in Part II above, the chief executive officer of each State or territory selected certain census tracts which were approved by the Secretary of Treasury in the Spring of 2018. These specific tracts are the QOZs and they will remain QOZs until December 31, 2028. New investments in the QOF of gains recognized after December 31, 2026, will not qualify for the tax benefits of the QOZ, but existing investments in the QOF can continue to be held and qualify for the 100% basis step up on a sale on or before January 1, 2048. The purpose was to spur long term economic development into those low-income communities.

2. Qualified Opportunity Fund
The QOF must be an entity organized under the laws of any State, the District of Columbia or U.S. possessions for the purpose of investing in QOZP (other than another QOF). The entity must be classified as either a corporation or a partnership for federal income tax purposes. If the QOF is established in a possession, however, it must be organized for the purpose of investing in QOZP that relates to a trade or business operated in the possession in which the entity is organized. A QOF must hold at least 90% of its assets in QOZP determined by the average of the percentage of QOZP held in the fund as measured on the last day of the first six-month period of the taxable year of the fund and on the last day of the taxable year of the fund. Per the instructions to Part I of draft form 8996, by the end of the first QOF tax year, the organizing documents are required to include (i) a statement that the purpose of the entity is to invest in QOZP and (ii) a description of the qualified opportunity zone business(es) (“QOZB”) in which the QOF intends to engage directly or indirectly through a first-tier operating
entity. The required specificity of the business description is currently unknown.

The Code delegated the authority to the Secretary of the Treasury to prescribe regulations for the certification of QOFs. The Proposed Regulations permit the corporation or partnership to self-certify as a QOF, provided it is statutorily eligible to do so. This self-certification is to be pursuant to rules prescribed by the Commissioner in forms, instructions or publications or guidance published in the Internal Revenue Bulletin. Accompanying the Proposed Regulation was a draft of Form 8996 and draft instructions for the self-certification. Form 8996 is to be filed with the timely filed (including extensions) annual tax return or information reporting form of the corporation or partnership. The corporation or partnership must identify the first taxable year in which the eligible entity desires to be a QOF and the first month in which the eligible entity desires to be a QOF. If no beginning month is specified, the election will be for the first month of such taxable year. This form will be filed for each subsequent year reporting compliance with the QOF's asset test.

The beginning month is important as any investments made prior to that date will not qualify as QOZP and will not be eligible for deferral or exclusion. In addition, the first measuring date to determine the qualification of the QOF is the earlier (i) the end of the first six month period in which the entity is a QOF or (ii) the end of the taxable year. The computation of any penalty under Code Sec. 1400Z-2(f)(1) does not take into account any months before the first month in which an eligible entity is a QOF.

3. Qualified Opportunity Zone Property
QOZP is (i) qualified opportunity zone stock (“QOZS”), (ii) qualified opportunity zone partnership interests (“QOZPI”), or (iii) qualified opportunity zone business property (“QOZBP”). This definition of QOZP applies to the QOF for its determination as to whether it has met the 90% of assets semi-annual test.

4. Qualified Opportunity Zone Stock
QOZS is defined as stock in a domestic corporation that meets the following requirements:
1. The stock is acquired by a QOF after December 31, 2017, at its original issue directly from the corporation (or through underwriters) solely for cash. A transfer for other property or services is not a qualified acquisition.
2. At the time of stock issuance, the corporation was a QOZB or was being organized for the purpose of being a QOZB.
3. During substantially all of the QOF’s holding period for such stock, such corporation qualified as a QOZB.
4. At no time during the four-year period beginning two years before the issuance of the stock did the issuer directly or indirectly acquire any of its stock from the QOF or a related person within the meaning of Code Sec. 267(b) or 707(b). This is the case even if the purchase occurs after the issuance. Stock is not treated as QOZS if at any time during the two-year period beginning on the date one year before the issuance of stock the corporation made one or more purchases of stock (i.e., redemptions) with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of its stock as of the beginning of the two-year period. The anti-redemption requirement is borrowed from Code Sec. 1202, and is intended to backstop the requirement that the stock acquired by the investor in the QOF corporation be issued directly from the corporation (Code Sec. 1202 has the same requirement) for cash after December 31, 2017. Without such a provision, a result that is economically equivalent to a purchase of stock from a shareholder (instead of directly from the corporation) could be achieved by having the corporation make a related redemption of an existing shareholder of the number of shares acquired by the new shareholder at the price paid by the new shareholder to the corporation. This also prevents a shareholder of an existing entity from being redeemed and subsequently reacquiring equity interests for cash after December 31, 2017. The QOF should consider obtaining comfort that disqualifying redemptions have not and will not take place.

5. Qualified Opportunity Zone Partnership Interest
QOZPI is defined as any capital or profits interest in an entity classified as a partnership for federal income tax purposes if the following requirements are met:
1. It is acquired by a QOF after December 31, 2017, from the partnership solely for cash.
2. At the time the partnership interest is acquired, the partnership was a QOZB or was being organized for the purpose of being a QOZB.
3. During substantially all of the QOF’s holding period for such partnership interest, such partnership qualified as a QOZB.

The statutory redemption provisions that apply to QOZS do not apply to QOZPI. However, under Code Sec. 707(a)(2)(B), “under regulations prescribed by the
Secretary,” a direct or indirect transfer of money by a partner to a partnership combined with a related direct or indirect transfer of property by the partnership to such partner or another partner may be recharacterized as a disguised sale or exchange. Regulations have been promulgated addressing disguised sales of property by a partner to a partnership under Code Sec. 707(a)(2)(B), but these Regulations do not address disguised sales of partnership interests between or among partners. IRS and Treasury previously issued proposed Regulations that did address disguised sales of partnership interests between or among partners that provided a presumption that if money or property was transferred by a partner to a partnership and money or property was transferred by the partnership to a selling partner within two years of the transfer of money or property to the partnership, that the contribution and distribution would be treated as a sale of the selling partner’s partnership interest to the contributing partner. These proposed Regulations were withdrawn on January 15, 2009, by Announcement 2009-4. In the announcement, the IRS stated that “until new guidance is issued, any determination of whether transfers between a partner or partners and a partnership is a transfer of a partnership interest will be based on the statutory language, guidance provided in legislative history, and case law.” Accordingly, a purchase of partnership interest from the QOF may or may not be respected as such if there is a related redemption from another partner! Similar to the purchase of QOZS, the QOF should consider obtaining a representation providing a degree of comfort that the disguised sale rules will not apply to the QOF’s acquisition of the partnership interest.

6. 70% Test for QOZS or QOZPI
In determining whether the stock or partnership interest owned by the QOF is QOZP, a trade or business of an entity (corporation or partnership) in which the self-certified QOF entity invests is treated as satisfying the substantially all test for a QOZ if at least 70% of the tangible property owned or leased by the trade or business operated by the corporation or partnership desiring to have its equity classified as QOZS or QOZPI is QOZBP. This requires valuing the tangible assets of the entity in which the QOF has invested. For purposes of satisfying the 70% test, if the entity has an applicable financial statement, the tangible assets are valued at the value reported on the applicable financial statement. If the entity does not have a financial statement the self-certified entity may determine the value of the entity’s tangible assets by using the same methodology it uses for determining its 90% asset requirement compliance (Compliance Methodology which is discussed below) provided that no other equity holder in the entity is a Five-Percent Zone Taxpayer. If there are two or more equity holders that have self-certified and one or more are Five-Percent Zone Taxpayers, then the value of the entity’s assets may be calculated using the Compliance Methodology that is used by any Five-Percent Zone Taxpayer that produces the highest percentage of QOZBP for the entity. It should be remembered that the Proposed Regulations provide that if such entity has a qualified financial statement, the entity’s assets are valued in accordance with the value reported on the entity’s applicable financial statement for the relevant reporting period regardless of the Compliance Methodology used by the QOF. It may be useful for the governing documents of an entity in which a QOF invests to require each Five-Percent Zone Taxpayer owner to provide the Compliance Methodology and results to the entity for sharing with all other self-certified entity owners any year the entity does not have a qualified financial statement.

7. Qualified Opportunity Zone Business Property
QOZBP is tangible property used in a trade or business of a QOF if the following requirements are met:
1. Such tangible property was acquired by the QOF by purchase after December 31, 2017, not from (i) a person whose relationship to the acquirer would result in the disallowance of losses under Code Sec. 267 or 707(b) except “family” in Code Sec. 267(c) shall be limited to spouse, ancestors, and lineal descendants or (ii) from another component member of the same controlled group.
2. The original use of the tangible property in the qualified opportunity zone (i) commences with the QOF or (ii) the QOF substantially improves (as defined below) the tangible property.
3. During substantially all of the QOF’s holding period of the tangible property, substantially all of the use of the tangible property was in a QOZ.

Tangible property is substantially improved only if during any 30-month period beginning after the date of acquisition of such property, additions to the basis of such property exceed an amount equal to the adjusted basis of such tangible property at the beginning of such 30-month period. If a building located on land wholly within the QOZ is purchased, the substantial improvement is only tested against the basis of the improvements and does not require the QOF to separately substantially improve the land. In such case, the authors recommend extensive documentation establishing the consideration for the land and the consideration for the improvements. A
qualified appraisal supporting the value for the land and the value of the improvements should be considered. This requirement is embedded in the definition of QOZBP of a QOF. It applies to both direct investments of the QOF and also to entities in which the QOF invests. While the authors are confident that substantial improvement of vacant land with a QOZ is intended to qualify as QOZBP, the Proposed Regulations do not address how to measure substantial improvement in such case.

Per Code Sec. 1400Z-2(d)(3)(B), once tangible property is QOZBP that status will continue for the lesser of five years after the property ceases to meet the requirements or such property is no longer held by the QOZB.

8. Qualified Opportunity Zone Business

A QOZ involves tangible property being used in a trade or business in the QOZ and new capital being deployed in the QOZ with other additional requirements. Over 50% of the total gross income of the trade or business must be derived from active trade or business but if the working capital safe harbor applicable to QOZS and QOZPI is met, the income from the working capital will count as trade or business income for this purpose. Generally, with the notable exception for “working capital” as described below, less than 5% of the aggregate unadjusted basis of the assets of the entity may be attributable to non-qualified financial property. The QOZB itself is (i) a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is QOZBP (discussed above in the context of a QOF) and (iii) a substantial portion of the intangibles is used in such trade or business.

In order to provide adequate time for a QOZB to substantially construct or rehabilitate tangible business property located in a QOZ, the Treasury Department and IRS borrowed the working capital concept of the Enterprise Zone and permitted the business entity to qualify as a QOZB and to hold cash, cash equivalents or debt instruments with a term of 18 months or less as working capital for a period of up to 31 months if three requirements are satisfied. In order to fit inside the safe-harbor, there must be (i) a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the QOZ, (ii) a written schedule consistent with the ordinary business operations that the financial property will be used within 31 months, and (iii) substantial compliance by the business with the schedule and the working capital assets must be actually used in a manner consistent with the written plan and schedule. This permits the corporation or partnership in which a QOF invests time to substantially improve the asset while deemed to meet the requirements of Code Sec. 1400Z-2(d)(2)(D) for QBZBP. The Treasury Department and the IRS have requested comments as to the appropriateness of any future expansion of the “working capital” concept beyond the acquisition, construction, or rehabilitation of tangible business property to the development of business operations in the QOZ.

The intangible financial assets comprising the working capital will also satisfy or assist in satisfying the requirement that a substantial portion of the intangible property of the entity is used in the active conduct of the trade or business. As noted earlier, the working capital safe harbor applies only to a QOZB and the acquisition or substantial improvement of tangible property. Because having a QOZB is only a requirement for QOZS and QOZPI (but not QOFs), future Proposed Regulations should expressly clarify whether or not the trade or business of a QOF itself can utilize the QOZB working capital safe harbor in the trades or businesses conducted directly by a QOF using QOZBP and meeting the requirements applicable to a partnership or corporation in which it invests. Future Regulations should also provide that reasonable working capital for a trade or business will be permitted and is not limited to 5% if being used to reasonably support the operations of the trade or business of the QOF in the QOZ (even if not involving the improvement of tangible business property). The lack of clear safe harbors for general working capital will be problematic for most QOZBs and for all QOFs. The 5% may not be adequate for many operating businesses. The authors hope the next set of proposed Regulations will provide some form of working capital safe-harbor for trades or businesses conducted by a QOF and any entity in which it invests for an operating business that does not include the acquisition of or substantial improvement of tangible property.

A QOZB cannot be engaged in a trade or business providing any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

If the QOZB is carried on by a corporation or partnership in which the self-certified entity invests, such entity must be a QOZB when acquired (or newly organized with the intent to be a QOZB) and continue to be a QOZB during substantially all of the QOF’s holding period for that interest.

If an entity in which the QOF invests qualifies as a QOZB, the value of a QOF’s entire interest in the entity (subsidiary) counts toward the QOF’s satisfaction of the

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The authors do not see a reason that if the requirements of QOZBP and the additional requirements of a QOZB are met, that a QOF could not be conducting a QOZB, but such QOF would still be required to meet the 90% test (discussed later) rather than just the 70% test (discussed earlier). This compliance may be difficult, but perhaps not impossible. From a policy standpoint, in attempting to satisfy the 90% test, the working capital safe harbor that is applicable for the 70% test should be available for the QOF if it is meeting all of the tests applicable to QOZS or QOZPI for the QOZB and the 90% test. At least one author in an excellent article does not appear to believe a QOF can operate a QOZB. It is certainly unclear if the Proposed Regulations presently permit a QOF to apply the working capital concept to QOF direct investments in QOZBP as the working capital is an exception to QOZB found under the provisions applicable to entities in which self-declared entities invest. The authors hope the future Regulations will clarify this situation. Although as discussed in Part III E above, the authors also hope that future Regulations will be able to achieve the stated purpose of excluding the gains on the investment in the QOZ in the context of a sale of the QOZPI or the assets of the QOZPI, at least if the QOZPI sells its QOZBP and if the QOF liquidate. If future Regulations do not address these situations, it will be hard for taxpayers to achieve the full economic benefits generally believed to have been anticipated by Code Sec. 1400Z.

If a QOF makes a direct investment in QOZBP such property is not required to be used in a QOZB. Investments in QOZBP by corporations and partnerships, however, must use the property in a QOZB. This is confusing and would seem to technically permit a QOF to directly invest in and operate a liquor store or a casino as the restrictions on the nature of the business activities only apply to QOZBs. It is doubtful that this was the intention of Congress but it may further reinforce the premise that Congress did not intend for the QOF to operate a substantial business unless, perhaps, also qualifying as a QOZB.

C. The 90% Test

As noted above, a QOF must hold at least 90% of its assets in QOZP determined by the average of the percentage of QOZP held in the fund as measured on the last day of the first six-month period of the taxable year of the fund and on the last day of the taxable year of the fund. If the first year of a QOF is a short year, the first measurement is the last day of the first six-month period starting with the effective date of the QOF election. If the short year is six months or less, the sole measuring period of that first year will be the last day of the tax year. On an ongoing basis, this is a semi-annual asset test. This means the QOF’s assets must continue to qualify as either QOZS, QOZPI, or QOZBP. If a QOZS or QOZPI in turn meets the 70% asset test, 100% of the value of the QOZS or QOZPI is considered QOZP. However, if a corporation or partnership in which the QOF invested fails its 70% test, none of the value of the stock or partnership interest will qualify as QOZP for the QOF.

To determine whether the 90% test of Code Sec. 1400Z-2(d)(1) is met, the Proposed Regulations provide the QOZP owned by the QOF is valued in the following manner: first, if the QOF has an applicable financial statement within the meaning of Reg. §1.475(a)-4(h), then the value of each asset is the value reported on the applicable financial statement for the relevant reporting period. If the self-certified entity does not have an applicable financial statement, the self-certified entity may use the cost of the asset. The Treasury Department and the IRS requested comments on the suitability of these valuation methods and whether another method such as tax adjusted basis would be better for purposes of assurance and administration.

D. QOF Direct Business vs. Indirect Through Subsidiaries

As discussed above, the QOF has the legal ability to directly invest in a trade or business through the purchase of QOZBP whether or not the trade or business qualifies as one that can be conducted by a QOZB. However, its practical ability to do so is limited.
As previously discussed, although a QOF can hold QOZBP directly, neither the statute nor the Proposed Regulations provide a mechanic for the use of the 70% test for the QOF directly conducting a trade or business in a QOZ even though it can own QOZBP. Indeed, the wording of the statute appears to preclude the application of the 70% test to a QOF. The prologue to the Proposed Regulations, when discussing the 70% and 90% tests, states the following: “However, the 70 percent requirement for a trade or business will give QOFs an incentive to invest in a qualified opportunity zone business (meaning stock or partnership interest of an entity rather than owning qualified opportunity fund property directly).” Whether intentional or not, the statute envisions the QOF owning entities engaged in the QOZB and does not appear to envision the QOF significantly directly engaging in a trade or business.

Also as discussed above, under the current Proposed Regulations it is less than clear that the working capital safe harbor applies to direct investments in QOZBP. This is yet another incentive to have subsidiaries as the operating trade or business. In the view of the authors, there is no logical reason that a working capital safe harbor cannot be developed and applied to an active trade or business engaged in by either a QOF or an entity in which the self-certified entity invests and should be appropriate for the IRS to permit such.

At least 90% of the initial funds invested in a QOF must be invested in QOZP within the earlier of the end of the first six month period of the QOF or the end of the tax year as that is the first testing date for determining if the QOF qualifies (at least without a substantial penalty). Subsequent funds invested in a QOF must in turn be invested in QOZP in a manner to meet the mid-year and end of year testing date calculation. It will be difficult if not impossible to construct or substantially improve something in an opportunity zone in that short period of time (even if the full six months is available) unless massive advance payments are made to someone. Hopefully, future Regulations will permit a working capital safe harbor for a QOF directly investing in acquiring or improving tangible property in a QOZ as well as for operating a non-real estate business.

E. Pre-Existing Entities

Although the use of a pre-existing entity as a QOF is complex and uncertain, neither the Code nor the Proposed Regulations prohibit the QOF from being a pre-existing entity. The Proposed Regulations state the following:

There is no legal barrier to a pre-existing eligible entity becoming a QOF, but the eligible entity must satisfy all of the requirements of section 1400Z-2, including the requirements regarding qualified opportunity zone property, as defined in section 1400Z-2(d)(2). In particular, that property must be acquired after December 31, 2017.

With respect to a pre-existing entity, clearly property in such an entity must have been acquired for cash after December 31, 2017, if such property is to count toward the good assets in the 90% test. If such property is acquired prior to the effective date of the QOF election, what impact does that have on the QOF? Is this property in the 10% bucket? More thought and guidance may be in order before using pre-existing entities with property for either a QOF or an entity into which a QOF invests. One of the pieces of guidance will be guidance concerning the “original use of tangible property” by a QOF.

The time clock is running and many promoters are still in the starting blocks awaiting more through guidance.

In recognition of the difficulty facing pre-existing entities, the Treasury Department and the IRS requested comments on whether there is a statutory basis for additional flexibilities that might facilitate qualification of a greater number of pre-existing entities across broad categories of industries.

At the current time, before “original use” is defined, it is generally difficult to be comfortable that a pre-existing entity that owns significant property in a QOZ is a viable target for a QOF investment even when the property will be substantially improved and even when the land is unimproved. However, under Rev. Rul. 99-5 a pre-2018 single member LLC interest should be able to be acquired or under the analysis of Rev. Rul. 99-6 all of the interests in a pre-2018 partnership should be able to be acquired in a single transaction or series of related transactions.

F. Open Questions

Although this first set of Proposed Regulations help chart the path, as noted above, significant questions remain concerning the qualification mechanics of a QOF. Table 1 sets forth some of the areas in which the existing Proposed Regulations reserved and the Treasury Department and the IRS have requested comments.
The uncertainty posed by the open questions above and other complexity for which additional guidance is needed has caused the offering statements of the QOFs that the authors have seen to prominently include a disclaimer or warning that there can be no assurance that the QOZ incentives will be realized.

G. Penalty

If at any time a QOF fails to meet the 90% requirement of Code Sec. 1400Z-2(f)(1), the QOF shall pay a penalty for each month it fails to meet such requirement in an amount equal to the product of the excess of the amount equal to 90% of its aggregate assets over the actual aggregate amount of QOZP held by the QOF multiplied by the underpayment rate of Code Sec. 6621(a)(2) for such month. The draft form 8996, Part III combines each semi-annual percentage and divides by 2 to obtain the testing percentage. The draft form 8996, Part IV provides the result of underpayment rate computation is divided by 12 and each month is computed separately. In calculating the penalty, Part IV also utilizes the total assets and the QOZP on the last day of each month. If the current federal rate for the applicable quarter is 5%, the penalty would be computed on each month's shortfall in that quarter multiplied by 5% divided by 12. In the case of a QOF that is taxable as a partnership, the penalty shall be taken into account proportionately as part of the distributive share of each partner of the partnership. Under the new partnership audit rules, if the shortfall is discovered upon audit, the default rule is that the partnership will be held liable for such penalty. In the event the partnership does not pay, the liability will shift down to the partners of the partnership in the year of the adjustment (not the reviewed year) unless the Partnership Representative timely elects to “push out” the adjustment to reviewed year partners under Code Sec. 6226.

From the literal statutory language, it would appear that the monthly penalty for December 2018 would be 5% of the shortfall, but as discussed above, the draft form 8996 utilizes the federal underpayment rate for the quarter and divides the result by 12. This test is at the QOF level. The testing dates are semi-annual. The computation of any
penalty does not take into account any months before the first month in which an eligible entity is a QOF. If a partnership or corporation in which the QOF invests fails the 70% test, it appears that none of such investment will qualify.

It should be noted that no penalty shall be imposed with respect to any failure if it is shown that such failure is due to reasonable cause. It should also be noted that during substantially all of the QOF’s holding period of the QOZS or QOZPI, the corporation or partnership, as applicable, must be qualified as a QOZB for the stock or partnership interest to qualify. At this time, the Proposed Regulations do not indicate what “substantially all” in this context means as the matter is reserved.

V. Conclusion

The QOZ incentives have stirred substantial investor excitement, and the lack of guidance before (and perhaps after) the issuance of the Proposed Regulations has frustrated the investment bankers and syndicators. The time clock is running and many promoters are still in the starting blocks awaiting more complete guidance and the time period for investors to invest capital gains is running (or in some cases has run). The requirement for a long-term commitment to investments in the designated low-income areas is a worthwhile social policy which will hopefully not result in simply displacing the low income residents of the QOZ but rather provide opportunities for these residents.

A working capital safe harbor for developing non-real estate businesses in the QOZ might help develop jobs for the current residents. The current Proposed Regulations leave many questions unanswered. The ability of a QOF to make and operate direct investments needs substantial clarification and working capital safe-harbors and even then the Code’s restrictions may make such investment difficult. While the Proposed Regulations’ working capital safe harbor for substantial improvement of tangible property is very helpful for improving real estate, both the QOF and the corporations and partnerships in which it invests need more guidance or clarification concerning working capital for other purposes. The ability of an investor to actually realize the stepped up basis in a manner to avoid the gain inherent in his or her investment in a QOF in the event of a sale of assets, even if only in the year the QOF liquidates, would be very helpful for the incentive. Presently many QOFs that the authors have seen are structured as REITs which will permit the realization of such a benefit for real estate investments but does nothing for non-real estate trades or businesses and means that buyers will not obtain a basis step-up in the underlying assets which in turn negatively impacts the potential gain. If future Regulations can provide a more effective exit strategy permitting the sale of assets, QOFs will be much more popular. At the present time, investors need to have confidence in the operators of the QOF and their advisors when they make investments. As discussed above, the penalties for mistakes can be meaningful, and all tax benefits can be lost.

ENDNOTES

8 Leigh Griffith and Shane Morris examine the opportunity zone incentive available to taxpayers who invest in a QOF as well as the detailed requirements found in the Proposed Regulations to be a QOF.
9 All section references herein are to the Internal Revenue Code of 1986, as amended, unless specifically indicated to the contrary.
10 Code Sec. 14002-1; Code Sec. 14002-2.
12 Code Sec. 14002-1(b)(1).
13 Code Sec. 14002-1(e).
16 Proposed Reg. §14002Z2(c)-1(b).
17 Code Sec. 14002-2(c)(1).
19 Code Sec. 14002-2(c)(x)(1).
20 See infra Section III.D.
21 Code Sec. 14002-2(c)(x)(1).
22 Id.
25 Code Sec. 14002-2(a)(x).
31 Id.
34 See supra Section III.A.2 for discussion of related persons.
37 Proposed Reg. §1400Z-2(a)-1(b)(2)(ii)(A) (Example 1).
41 Id. (permitting an investor to reinvest within the 180-day period gain from the sale of an interest in a QOF in the same or another QOF). The ability to reinvest in the same QOF appears
OPPORTUNITY ZONE BENEFITS; NUTS AND BOLTS; AND LOOSE OR MISSING SCREWS

Taxes The Tax Magazine® FEBRUARY 2019

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