

## IRS Guidance Addresses Opportunity Zones

October 21, 2018

On October 19, 2018, the IRS provided guidance with respect to Qualified Opportunity Zones (QOZs) through the issuance of 74 pages of proposed regulations, a revenue ruling addressing the qualifying use of funds towards substantial improvement of a building, and a draft form to certify the Qualified Opportunity Fund (QOF) annually, including the requirement that 90% of the QOZ assets are QOZ Property.

1. **Residential Rental Property Development.** The accompanying IRS Revenue Ruling would seem to confirm that the development of residential rental property is an eligible QOZ Business.

2. **Substantial Improvement Standard Is Based Only On Building Cost and Excludes Land Cost.** The general rule is that the purchase of land and building with “substantial improvement” to be made to the building can be eligible for QOF investments. The cost of the improvements paid by the QOF (or the partnership or corporation in which the QOF owns an interest) must equal/exceed the tax basis of the building to satisfy the substantial improvement requirement. QOF dollars can be used to purchase the land but a favorable rule is that only the cost of the building (and not the cost of the land) is taken into account to determine if the substantial improvement standard is met. This can be very important where land cost is high. The allocation of the purchase price between land and building will be important in determining whether the building is considered “substantially improved.”

The alternative to substantially improving tangible property is to have the original use of the acquired property in a QOZ. Future guidance will address whether the purchase and renovation of a building that has been vacant or underutilized qualifies for the “original use” standard, without the need for “substantial improvements” equal to the building cost.

These rules are part of the requirement that the investment be made in QOZ Business Property.

3. **QOFund Can Be an LLC Treated as a Partnership for Tax Purposes.** An entity organized as an LLC under state law that is treated as a partnership for federal income tax purposes (along with a partnership and corporation under state law) is eligible to be a QOF. The QOF can invest by having an equity interest in a separate LLC, partnership or corporation. Draft IRS Form 8996 is now available and would be filed with the QOF income tax return to self-certify and then annually to confirm that 90% test is met.

Pre-existing entities can qualify as a QOF but need to assure that all QOZ Business requirements are met. Absent additional guidance, this can be difficult when the pre-existing entity has existing operations that commenced prior to 2018.

Unlike NMTC favorable portion-of-business-rule that allows to using only a segregated portion of entire operations within an existing entity, there is no similar provisions that allows a portion of a pre-existing entity to be treated as a QOF. However, could segregate new QOZ Business from existing operations through a subsidiary entity.

4. **Timing of Investment in QOF.** Investments in a QOF are eligible for the tax benefits only if the QOF has certified through filing IRS Form 8996 that is effective at time that QOF investment is made. QOF can select month that self-certification is first effective. Selection of first QOF month starts commencement of six-month period to test if 90% test met. Investments need to be timed to make sure that the cash meets QOZ Property requirements by applicable dates. Investors make the first election to use the available tax benefits on a IRS Form 8949, reflecting the capital gain from the property sale.

Until future guidance, seems that if QOF self-certifies by using a month during second half of calendar year, then QOF needs to meet 90% test by December 31.

5. **Amount of Required QOZ Business Property.** The substantially all “QOZ Business Property” requirement for partnerships or corporations in which the QOF holds an interest must be met by 70% of all tangible property owned or leased by such entity. Describing all of the required details is beyond this summary.

The 90% test for the QOF and the 70% substantially all test for the partnership or corporation in which the QOF holds an interest are applied by measuring the assets as shown on the applicable financial statement used by such entity, with an alternative approach available if the entity does not have an applicable financial statement.

If an existing business has more than 30% of tangible assets that are either outside of QOZ or do not satisfy QOZ Business Property requirements, consideration could be given to having existing business form subsidiary for expansion and have QOF invest in the new subsidiary entity, provided it satisfies all requirements.

6. **Thirty-One Month Safe Harbor Available to Hold Cash for Substantial Tangible Property Improvements.** If cash is received by the QOF (or by the partnership or corporation in which the QOF owns an interest) to be used towards acquiring, constructing, and/or rehabilitating real or personal tangible business property, a 31-month working capital safe harbor is available if there is (1) a written plan that identifies the cash as held for property

development, (2) a written schedule consistent with ordinary business operations showing how the cash will be spent over the construction period (not to exceed 31 months) and (3) the business substantially complies with the schedule. This is a big positive point regarding allowing cash investments to be received through a QOF and held by the partnership or corporation that will use the funds for construction or property improvements. This safe harbor could limit the need to have the QOF stage the receipt of investments. The 31-month cash reserve safe harbor coincides with the permitted 30 month period available to substantially improve certain purchased tangible property.

Future guidance might expand the working capital safe harbor to also pick up the use of a cash reserve for the development of business operations, apart from the construction or property improvement safe harbor. This would be an important added feature but it would be available only if the tangible property meets the QOZ Business Property requirements.

A common expected structure will be for the QOF to hold equity interests in a partnership or corporation that complies with the 70% substantially all QOZ Business Property requirements. The QOF will satisfy the 90% test through its ownership of partnership or corporation equity interests. It would seem that the cash investments into the QOF would need to be transferred to the operating partnership or corporation in which the QOF holds an equity interest to be eligible for the 31-month working capital safe harbor if construction will occur at the lower tier operating entity. The 31-month safe harbor is better than the 12-month cash reserve safe harbor for real estate development in the NMTC context.

Apart from the cash reserve safe harbor available for property development, the cash held by the QOF and the partnership or corporation in which the QOF holds an equity interest needs to be less than 5% of the aggregate tax basis of the assets held by each such entities.

7. **Only Capital Gains Eligible for QOF Investments.** Only capital gains (long term and short term) can be invested in a QOF. Depreciation recapture amounts are ineligible. The eligibility of short term capital gain can be favorably used with respect to the gain from certain sales of LLC carried interests under tax reform. It seems that gains reported on an installment basis (meaning that payments are made post-closing, whether through escrow, earn-out, or simple installments) might either need to elect out of such reporting or have QOF investments made as cash is received.

The guidance seems to imply that capital gain from the sale of property within a QOZ is eligible. This contrasts with the Committee Reports and more should be forthcoming on this point.

Note that only the capital gain portion of property sale is eligible for QOF investment. If invest all of the sale proceeds into the QOF, less than all of the investment is eligible for the federal income tax benefits and dilutes some of the future tax benefit available.

8. **Only QOF Equity Investments.** Qualifying investments in the QOF must be equity, including preferred shares and LLC interests with special allocations. Guidance confirms that convertible debt is not an eligible investment in a QOF.

9. **Treatment of Borrowed Funds.** The guidance states that borrowings by QOF or lower-tier entity organized as an LLC is not a substitute investment for cash linked to capital gains. However, investor could borrow against QOF equity interest as collateral and use the borrowed funds as the QOF investment. Under proper circumstances, consideration might be given to monetization of the QOF equity interest (initially or later if appreciation is available) that would provide a further benefit with respect to tax deferral. Need to assure that investor remains treated as owner for tax purposes and the lender is not the deemed owner.

Would expect that QOF would not want Fund assets to be collateral for personal loans by investors.

There is a favorable flip side of excluding borrowings by QOF and lower-tier partnership/LLC entities as an QOF investment. The QOF borrowings does not create a level of LLC investment that would dilute investors future appreciation eligible for the 10-year tax-free benefit.

10. **Reinvestment of Future Sales of QOF Interests.** If taxpayer investor sells entire separate QOF investment, new 180-day period is available for reinvestment in another QOF. Identification rules are provided if taxpayer QOF investments are represented by one certificate for investments over a period of time and only portion of such certificate is sold.

11. **Investment of Capital Gains in Multiple QOFs.** Taxpayers can make investment into different QOFs regarding the total capital gain amount from a property sale, but can't make multiple investment for the same capital gain amount.

12. **Flexibility with Partnership/LLC Capital Gain Investments.** Investments in a QOF can be made by a partnership/LLC that has capital gain or, if the partnership/LLC does not make such investment, then the equity owners can take such action. If the partnership makes the QOF investment, the capital gain is excluded from the members K-1. If the partnership elects to use the QOF for only part of the gain from a property sale, each member can elect to make a QOF investment for the balance of the eligible gain. If the partnership decides not to make a QOF investment, the members 180-day period to invest begins on the last day of the

partnership tax year. There is a method to allow a member to make a QOF investment during the partnership tax year in which the capital gain is recognized, rather than waiting until after the end of the partnership tax year.

An important point not addressed are the tax consequences if partnership/LLC makes QOF investment and then member sells interest.

Another approach that was not expanded by the guidance is that if an individual has capital gain, such individual must make the QOF investment. The individual cannot make the QOF investment through a wholly owned operating corporation. This could have been useful in the context of expanding existing business property operated by the wholly owned corporation. Additional structuring would be needed.

13. **Capital Gain Exemption for Post-QOF Investment Appreciation.** The 100% capital gain exemption for investments in a QOF that are held for at least 10 years is available only if a deferral election is in effect for the QOF investment. Additional investments made into a QOFund for which a deferral election is not in effect is not eligible for the 100% capital gain exemption. Note that additional investments into a QOFund for which no election is in effect dilutes the 100% capital gain exemption available to those investors who made the deferral election.

In addition to the election made with respect to the initial QOF investment, a second election is required with respect to the 100% capital gain exemption for additional appreciation. This second tax benefit is available for all post-investment appreciation through December 31, 2047. This means that if is capital gain sale occurs at the end of 2026 (last day available) with 180-day period through June 2027 to make initial QOF investment, investor is given 20 years to hold such investment with appreciation following the investment date exempt from taxation.

As drafted, QOF investors need to sell their investment by the end of 2047 to be eligible for this second tax benefit. Consideration is being given to allowing a basis step-up with respect to the post-investment appreciation without the need for an actual sale of the QOF investment. Under this approach, the focus is how to properly value QOF investments as of the end of 2047.

As part of QOF formation, can require investors to provide signed form showing deferral election (on Form 8949) and broker 1099 and apply penalty if not provided.

14. **Effect of Sales by QOF or by LLC, Partnership, or Corporation in which QOF Holds an Investment.** Future guidance will address the timing for QOF and partnership or corporation in which the Fund has an interest to reinvest sale proceeds or reinvest return on capital and meet the 90% test for the QOFund and the substantially all (70%) tests for the partnership or corporation in which the QOF has an interest. Future guidance will also address whether sales by QOF or entity in which the QOF holds an interest will trigger the deferred gain at the investor level.

15. **Unaddressed Areas.**

- a. Government Oversight of Opportunity Zones Investments.
- b. Application of QOZ Business Property requirement where leased building space is used by start-up company. What amount, if any, should be given to the leased building space in determining whether the purchased tangible property meets the 70% test. This is particularly a point when business is already using leased building space or leases space from an existing largely occupied building.
- c. In certain situations, consideration needs to be given to whether the book value shown on the financial statement of the operating entity can cause the eligible property to dip below 70% in any year that the QOF has an ownership interest.
- d. If tangible property requirements met, can remaining investment go towards operational costs (e.g., compensation, licenses) even though such costs greatly exceed any tangible property costs.
- e. For QOF that will invest in partnerships and/or corporations or that do not yet have a business plan for property development, future guidance will hopefully address additional grace period beyond six months to invest cash. Looking for 12-18 month period to make investments.
- f. Definition of Active Conduct of a Business requirement by QOZ Business.
- g. Application of requirement that 50% of QOZ Business gross income must be derived from active conduct of a business to start-up companies, including software and biomedical companies.

h. Application of requirement that 50% of income of QOZ Business must be from active conduct of a business in QOZ and that substantial portion of QOZ Business intangible property is used in active business in QOZ in the context where revenue stems from sales or license income from use outside the QOZ.

i. Guidance does not allow making investment in a QOF (through intermediary) and using capital gain from sales within 180-days following such investment. This point surfaced where timing and lack of guidance and closing certain financing did not permit proper sequencing. It would have been be equivalent to a reverse like-kind exchange.

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