

TREASURY COMMENT INTRODUCES APPROACH FOR PURCHASERS OF NON-QUALIFYING QOF INTERESTS TO HAVE QUALIFYING QOF INTERESTS

Can a Qualifying Opportunity Zone Fund (QOF) structure be established with non-capital gain dollars and then such nonqualifying interests be sold at any future point before 2027 by the original investors to persons who have capital gain dollars and become eligible qualifying interests? According to a recent statement by a Treasury attorney at a Federal Bar Association meeting, the answer would be yes. If accurate and confirmed by future clarifying guidance, this raises a series of questions and additional opportunities.

BASIS FOR TREASURY COMMENT:

The basis for the comment is that “eligible interest” is defined as any equity interest issued by a QOF, and is broad enough to cover all equity interests, regardless of whether the interest was issued in exchange for the contribution of capital gain or non-capital gain dollars. The second round guidance extends the point by stating that a purchaser of an outstanding “eligible interest” has a qualifying investment equal to the cash or property value paid for such eligible interest.

QUESTIONS AND OBSERVATIONS:

1. QOF Without Any Initial Qualifying Interests. Is it possible to qualify as a QOF if no eligible gains are invested initially? There seems to be no restriction on having all non-qualifying interests issued by a QOF. Until the Treasury comment, this structure was not considered. It would mean that an entity would be filing an IRS Form 8996 electing QOF status, even though no deferral elections will have been made with respect to any equity interests in the QOF.

2. Structuring to Delay Capital Gain Investment. If permitted, consideration could be given to structuring QOF and OpCo arrangements with traditional financing at the second-tier OpCo level and no or minimal capital gain initial investment in the QOF and sell the outstanding QOF interests (whether qualifying or non-qualifying) down the road (no later than 2026) to a purchaser, with the purchaser owning an eligible qualifying interest.

The cash purchase price can include an amount to allow the seller to contribute and pay down part of the OpCo debt and allow the purchaser to get the OZ benefits for the full cash amount paid. Consistent with the first round of regulations, the portion of the debt allocable to the purchaser (and deemed assumed by the purchaser pursuant to Section 752) would not be treated as a cash payment, but an additional cash payment that would be contributed and used to pay down a portion of the OpCo debt would seem eligible.

As acknowledged by the Treasury representative, the clarification of this rule allows for a more expansive application of the capital gain timing requirements. While the QOF and the OpCo still needs to meet their timing requirements, the timing of the capital gain investment can be delayed and be paid to the seller as a substitute for the prior infusion of non-capital gain dollars.

3. Transfer of Appreciated Property as Consideration by the Purchaser of an Outstanding Eligible Interest. Can the purchaser transfer appreciated property to the seller of the non-qualifying eligible interest and be considered to be paying an amount equal to the value of such property for the qualifying interest?

This question illustrates how far the Treasury comment can be taken. The second round of regulations states that the purchaser of an outstanding QOF eligible interest would be treated as making a qualifying investment equal to the value of the property transferred. A purchaser would seem to be able to transfer appreciated property to the seller, recognize gain, and allow such gain be eligible for the deferral. It would even seem that the qualifying interest purchased would be equal to the full value of the property transferred.

The result would allow a result indirectly that could not be done directly. A qualifying interest would be available if the transfer of appreciated property were made by an investor to the seller of a QOF interest; however, a qualifying interest would not be available (in whole or in part) if appreciated property is transferred by the initial investor to the QOF.

4. Cash Paid by Purchaser in Excess of Cash Investment by Seller in QOF. Another illustration of the consequences that flow from taking into account the full amount of the cash paid for the outstanding QOF interest arises when the initial investor sells the QOF interest at a profit (even though not eligible for the OZ tax-free appreciation benefit) and the purchaser gets to benefit on the full amount paid, even though the profit element does not go to the distressed area. The justification is that the purchaser is not obtaining any tax basis for the additional cash paid and only the further appreciation is eligible for tax-free appreciation. However, a Section 754 election would be available to increase the cost basis at the OpCo level and the resulting losses can flow through without recapture on an eventual sale, along with the possible deferred gain and tax haircut for capital gain linked to the additional cash paid.

5. Sales of QOF Interests Between Related Parties. The Treasury representative also stated that there did not seem to be any prohibition against the purchaser and seller being related persons, which can also provide interesting structuring models.

6. Tax Basis to the Purchaser of a QOF Interest. The purchaser would have a zero tax basis for the capital gain dollars that are deemed used to purchase the outstanding QOF eligible interest with an increase for the allocable share of the OpCo debt pursuant to Section 752 principles.

7. Mechanics of Capital Gain Invested by Purchaser. Further clarity would be helpful to state that the purchaser of an outstanding interest can link capital gains to having a qualifying QOF interest.

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