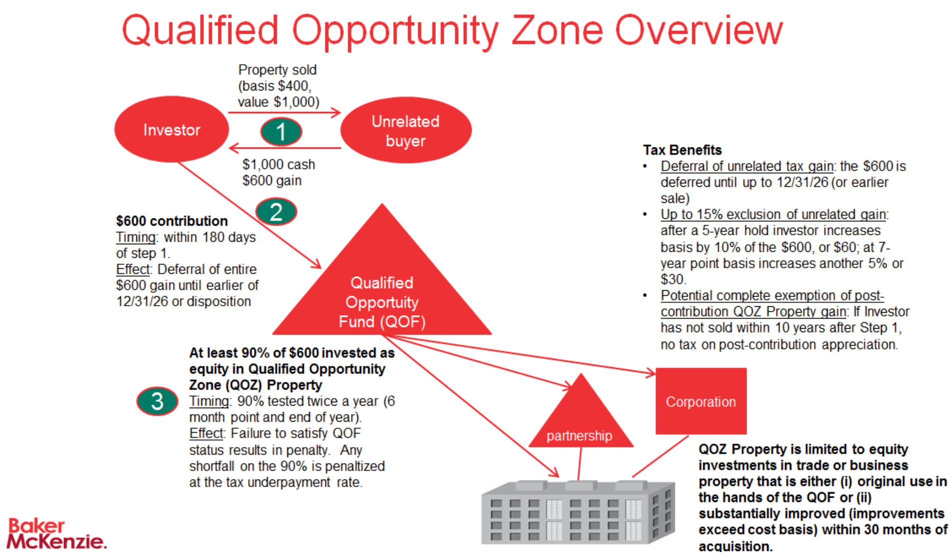
Client Alert
October 30, 2018

New IRS Guidance Opens Door to Use of Qualified Opportunity Zones

Tax reform introduced significant tax incentives for investments in a Qualified Opportunity Zone ("QOZ"), but until now taxpayers were waiting on the sidelines because of open questions on how the law works. With the IRS and Treasury release of proposed regulations, Revenue Ruling 2018-29, and new Frequently Asked Questions, (collectively, the "QOZ Guidance"), investors and new Qualified Opportunity Funds ("QOFs") are actively moving forward with structuring QOZ investments. Although many open issues remain, the IRS promised future guidance in short order to resolve many of the remaining gating questions. This client alert provides an overview of QOZs as compared to traditional tax incentives, outlines questions answered by the QOZ Guidance, and finally discusses questions that remain. Baker & McKenzie encourages your input so that we can assist in making QOZs work for investors, Qualified Opportunity Zone Funds ("QOFs"), persons selling to a QOF, and interested operators of businesses looking to locate within a QOZ.

QOZ districts, in general, consist of census bureau tracts that have high levels of unemployment, low-incomes, and which the government has designated as areas in need of development, hence the significant tax benefits to spur investment. The list of QOZ districts in each state is expansive; investors, real estate developers, and business owners alike are finding the significant tax incentives are a game changer in their decision to invest. The QOZ guidance clarifies that all types of taxpayers are eligible to invest in a QOF within 180 days of recognizing a short or long-term capital gain and make a QOZ election to receive a trio of tax benefits: (i) deferral of the otherwise taxable capital gain on the relinquished property until the earlier of disposition of the QOF investment or December 31, 2026; (ii) a permanent elimination of 10 or 15 percent of that deferred capital gain if the taxpayer holds the QOF investment for 5 or 7 years, respectively; and (iii) a complete elimination of federal income tax on gains from appreciation in the QOF investment itself (through 2047) if the taxpayer holds the QOF investment for at least 10 years. A taxpayer is only eligible for QOZ benefits for cash investments in a QOF after December 31, 2017. A key to qualification of the QOF is that the business investment must be either (i) an "original use" in the QOZ in the hands of the QOF, or (ii) the QOF, within 30 months of purchase, spends at least as much in improving the property as it did to buy the property – which the new QOZ Guidance clarifies is computed without regard to the cost of land. Further, the QOF must maintain 90% of its assets in qualifying QOZ businesses, which the QOZ Guidance helpfully loosened by (i) treating an investment in a lower-tier QOF partnership or corporation to qualify towards this 90% test even though the lower-tier partnership or corporation only has 70% of its assets as qualifying QOZ property and (ii) by providing for a "working capital safe harbor" for certain capital reserves held by a lower-tier QOF partnership or corporation -- thereby allowing QOFs to hold cash as QOZ property for purposes of the 90% test as long as such funds are designated in writing for an identified project.



QOZs In Comparison to Other Tax Incentives

The following is a high-level comparison of QOZ investments to more traditional tax incentives such as the Section 1031 Like-Kind Exchange ("Like-Kind Exchange"), the Section 45D New Market Tax Credits ("NMTC"), and the Section 42 Low-Income Housing Credits ("LIHTC"):

Uncapped tax benefits: Unlike NMTC or LIHTC, the tax benefits from QOZs are uncapped. Thus, there is no specific federal allotment of tax benefits that cannot be exceeded by taxpayers. If a QOF investment has a 10 fold return, the entire gain is exempted if held for the requisite 10 years.

Cash invested need not be traced to specific proceeds from capital gain: In contrast to a Like-Kind Exchange, which requires a qualified intermediary to hold the cash proceeds of sale until reinvestment, a taxpayer need only invest cash equal to the gain within 180 days of the gain recognition and there is no tracing requirement for this cash to be associated with the actual proceeds from the relinquished property.

Taxpayers only need to reinvest the gain, not the full proceeds from sale. Unlike a Like-Kind Exchange, which requires a rollover of 100% of the proceeds of the original investment for full tax benefits, a taxpayer in a QOF need only invest cash equal to the specific amount of gain it wishes to defer.

No complex tax credits to monetize. Unlike the NMTC or LIHTC, there is no need for complex structures to monetize credits.

Not only gain deferral, but potential gain elimination. Unlike a Like-Kind Exchange that only defers gain, a QOF investment can also eliminate tax on up to 15% of the invested gain dollars and can eliminate all future gain from the QOF investment itself.

QOZ deferred gain is recognized by December 31, 2026 as phantom income. One of the main logistical issues with the QOF investment is that taxpayers automatically recognize the deferred gain on December 31, 2026 and thus the investment creates taxpayer liquidity issues not present in a Like-Kind Exchange.

Not limited to real estate. Unlike a Like Kind Exchange which, post tax reform, is now limited to real property, QOZ incentives apply to QOZ businesses, and thus apply to investments in *operating businesses* located in a QOZ in addition to real estate development in a QOZ.

Questions Answered by New QOZ Guidance

The following Questions and Answers highlight many of the gating issues addressed by the QOZ Guidance.

Q. In light of the 90% Test, how long may a QOF hold on to cash raised in connection with a development or substantial rehabilitation project?

A. The QOZ Guidance makes it clear that there is a 30-month "*working capital safe harbor*" for lower-tier QOF partnerships and corporations to hold cash without creating an issue with the 90% test provided there is a *written* plan in place to invest the cash during the applicable 31-month period.

- The written plan must meet the following attributes:
  - Designated in writing. The cash amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a qualified opportunity zone;
  - Reasonable written schedule. There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets. Under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets; and
  - Property consumption consistent. The working capital assets are actually used in a manner that is substantially consistent with the written plan and schedule.

Q**.** What types of gain can be deferred into a QOF investment?

A**.** The QOZ Guidance clarified that only items taxed as capital gains can be deferred into a QOF investment, and thus ordinary gains (such as from depreciation recapture or sales of inventory) are not eligible. This should include capital gains and Section 1231 gains taxed as capital gains, although there is no guidance on how Section 1231 recapture rules operate in this context (particularly Section 1231 gains recognized by a partnership if the partnership itself elects to make the QOF investment). The QOF Guidance also clarifies that if the original capital gain is short-term, collectibles, or real estate gains taxed at the 25% rate under Section 1(h)(6), the original character of such deferred gain is retained when the deferral period ends in 2026 (or earlier if the there is an earlier sale).

Q**.** What taxpayers are eligible to elect to rollover over gain into a QOF?

A. Any taxpayer with US taxable capital gain can elect to invest an amount equal to such gain (or a lesser amount) into a QOF. Thus, corporations (including REITs and RICs), partnerships, and individuals can all defer gain with a QOF investment.

Q. How is the 180-day period to make a QOF investment measured?

A. The QOF investment must be made within 180 days from the date when a taxpayer would have otherwise recognized the gain absent the QOZ election. The QOZ Guidance clarifies that this is the trade date for a regular-way stock trade, the day on which the dividend is paid for a capital gain dividend from a RIC or REIT, and is the last day of the RIC or REIT's taxable year for deemed dividends from undistributed RIC or REIT capital gains.

Q. How does a QOF investment work for taxpayers who are pass-through entities, such as a partnership?

A. The QOZ Guidance clarifies that if a partnership has a capital gain the partnership can make a QOF investment and to the extent the partnership does not make a QOF investment, a partner can make a QOF investment for its allocable share of capital gain. The partnership must make the election within 180 days of its underlying otherwise-taxable sale and the partners can elect to make their QOF investment in the same time frame or otherwise have 180 days from the end of the partnership tax year to make a QOF investment.

Q. Can a taxpayer elect to rollover a single capital gain into multiple QOFs?

A. Yes, within the 180-day election window a taxpayer can elect to defer a single gain into one or more QOFs.

Q. What are the mechanics for measuring whether a real estate investment has been substantially improved so as to satisfy the substantial improvement requirement for a QOZ benefit?

A. The QOZ Guidance provides that investments can be made in either "original use" property or in substantially improved property. With respect to the acquisition of existing properties, as a favorable measurement tool for taxpayers, land value is excluded when determining whether substantial improvements have been made to Qualified Opportunity Zone Business Property ("QOZBP"), and instead taxpayers are required to invest in capitalized improvements in existing projects an amount equal to the value of the non-land portion of the QOZBP. Raw land acquisitions, although not directly addressed in QOZ Guidance, would similarly be able to independently meet the substantial improvement test if capitalized improvements in the land more than exceed the cost basis of the land.

Q. Does a QOF structured as a partnership cause an investor to have an additional "deemed" contribution from the investor's share of partnership-level debt?

A. No, partnership-level debt does not cause an additional deemed investment and therefore does not affect the QOF election or QOF benefits.

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Q. A QOZ business must have substantially all of its tangible property owned or leased by the taxpayer to be a qualified opportunity zone business property. For this purposes how is "substantially all" defined?

A. The QOZ Guidance clarifies that if at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property, then the trade or business is treated as satisfying the substantially all requirement for defining a QOZ business.

Q. What restrictions apply to the QOF investment structure itself in terms of equity features?

A. The QOZ guidance clarified that the investor only receives tax benefits for equity investments in the QOF (no loans), but qualifying equity can include preferred stock or a partnership interest with special allocations.

Open Questions

Although the QOZ guidance is extremely helpful, many gating questions remain. The QOZ Guidance acknowledged many of these questions and promises additional guidance in the "near future". These remaining questions include:

Q. What future events by a QOF investor or by the QOF itself will be considered a disposition that accelerates the original deferred gain and/or prevents a QOF investor from satisfying the 5, 7, or 10 year QOF holding periods?

A. The QOZ Guidance promised that these gain inclusion transactions will be addressed in the near future. We look forward to guidance to hopefully address typical tax-deferred transfers (such as partnership contributions or Like-Kind Exchanges) and financing transactions such as debt-financed distributions by a QOF to allow investors to pay their taxes when the deferred gain is recognized in 2026.

Q. If a partnership makes a QOF investment, what happens if one or more partners transfers their interest in the partnership with the QOF investment?

A. Although not specifically acknowledged by the QOZ Guidance, presumably this will be addressed as part of the promised guidance on transactions that will accelerate gain deferred by QOF investors. QOF investments made by a partnership are sure to create complication in tracking future gain to the partners when intervening events happen such as changes in partner composition.

Q. The QOZ statute in many places applies a "substantially all" test which is undefined.

A. The QOZ Guidance promised guidance on this question in the near future. In the meantime the only guidance is a 70% test for substantially all provided in the current proposed guidance, but the regulations are clear that this 70% standard is specific to the question addressed.

Q. How long does a QOF have to invest assets in qualifying property?

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A. The QOZ Guidance promised guidance on the "reasonable period" for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty under the general requirement that 90% of the QOF assets be invested in QOZ business property for each 180-day testing period. However, with respect to the original receipt of cash from QOF investors, there remains logistical issues on how to satisfy this 90% test if the cash is held at the QOF level itself. However, as noted above, the QOZ Guidance allow a lower-tier QOZ partnership or QOZ corporation to hold cash for 31 months provided it implements specific written plans to deploy that cash in QOZ property.

Q. Are there any special requirements that apply to the fund sponsor's compensation in a QOF?

A. The QOZ Guidance does not provide any specific answers on whether or how a fund sponsor's compensation can be structured, such as a carried interest or fees, or any combination thereof. There does not appear to be any restrictions, however, in the QOZ Guidance.

Conclusion

The QOZ Guidance provides answers to many gating issues on which taxpayers may currently rely for structuring their QOZ investments if consistently applied. While there continue to be additional ambiguities, in particular with respect to partnerships, the current guidance is robust, and Treasury has suggested it is diligently working on additional guidance. Public comments are certain to be plentiful and will assist Treasury in crafting workable solutions and helpful guidance.

Correction: Please note that the original Client Alert, distributed on October 30, was updated as of November 1, 2018 to reflect the addition of "working capital safe harbor" and to clarify the mechanics of the "substantial improvement" safe harbor in Q&A and in chart.

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