Opportunity Zones – A Few Open Issues

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What Taxpayer must do the investing, and when?

• Often partnership level gain

• Must investment be made by the partnership/LLC?

• Can investors with gains form a partnership and have it invest in a Opportunity Fund? (Note that O Funds cannot invest in other O Funds).

• How does a partner know that he has partnership-level gain? The K-1 will likely not come out till the following year.
What kind of entities can an Opportunity Fund Be?

• Section 1400Z-2(d) refers to “any investment vehicle organized as a corporation or partnership,”

• Many investors are worried that limited liability companies (whether having two or more members and taxed as partnerships, or electing to be taxed as corporations) are ineligible because they are not “organized” as corporations or partnerships.

• Of course, section 7701 regulations generally treat LLCs as partnerships. Should this rule apply?
What gains are eligible for Opportunity Fund tax deferral?

• The title of Section 1400Z-2 refers to “capital gains,” but the actual statute only refers to “gains.”

• Most sales of non-inventory or items held for sale yield capital gains, but what about:

  • 1231 gain,

  • depreciation recapture under Section 291, 1245 and 1250. Sections 1245 and 1250 include words to the effect of “such gain shall be recognized notwithstanding any other provision of this subtitle.” Section 291 refers to 20% of gain associated with previously taken depreciation, and it provides that that it “shall be treated as gain which is ordinary income under Section 1250 …”

• Section 582(c), which provides that sales or exchanges of bonds, debentures, notes or certificates or other evidences of indebtedness by certain financial institutions are not considered the sale or exchange of a capital asset.
More About Gains

• Section 1031 (like kind exchanges) has a *statutory exception* from the application of Sections 291, 1245 and 1250. Should a similar rule apply?

• Perhaps gains that are subject to depreciation recapture or ordinary income treatment should be eligible for nonrecognition treatment, but they will be treated as giving rise to ordinary income when the taxable event (or December 31, 2026) occurs.
Eligibility of property which is being newly constructed, rehabilitated or augmented.

• New construction or the rehabilitation of existing facilities can take significant time.

• Section 1400Z-2(d)(2)(D)(ii) considers property substantially improved only if during “any 30-month period beginning after the date of acquisition ... additions to basis with respect to such property in the hands of the qualified opportunity fund exceed an amount equal to the adjusted bases at the beginning of such 30-month period ...”

• So, Is property under construction or rehabilitation eligible or not? See next slide
Is there “tolling” while construction/rehab is going on?

• Section 1400Z-2(d)(2)(B)(iii) and (C)(iii) requires that “during substantially all of the qualified opportunity zone fund’s holding period for the such stock/interest, such corporation/partnership qualified as a qualified opportunity zone business.”

• So, if a corporation or partnership acquires property with a plan to undertake new construction or to make additions to basis over any 30-month period after acquisition, is the property a “qualified opportunity zone business” while it is awaiting construction or rehabilitation?

• Does the rehabilitation have to be “in place”, with actual tenants or use while the rehabilitation is going on?

• Should some kind of “plan” result in protection? (E.g., like the 60 month rule for historic rehabilitations). Architect’s plans? Merely a written summary?
Additions to Basis with Respect to Such Property.

• In the case of used property, the 30-month rule refers to “additions to basis with respect to such property,” indicating that the additional work need not be a rehabilitation.

• Is it sufficient if a Fund buys a housing development and also constructs an adjacent and appropriately sized community center or playground that passes the basis requirements? The second building or improvement would seem to be “with respect to” the first.

• Perhaps there should be a “substantially related and subordinate” rule, like the one that applies to tax-exempt bond transactions.
Reasonable Working Capital.

• Can money be held by the Fund pending its use on the project?

• While new construction, rehabilitation or “with respect to” construction is pending, are the funds which will pay for the “new construction/rehabilitation/construction with respect to” exempt from the “nonqualified financial property” (“NQFP”) rules of Section 1397C(b)(8)?

• The statutory rule is more than 5% NQFP. Thus, if more than a minimal amount of money is set aside, and the IRS doesn’t create a safe harbor, the entire investment would fail to be Qualified Opportunity Zone Property and cause a catastrophic failure of the 90% penalty test.
More on Cash Reserves for Construction, Etc.

• Perhaps cash to build the project should be treated as “working capital” (and therefore, not nonqualified financial property) if used to pay for the costs of a reasonable and diligently undertaken project, like the rule that applies to new markets tax credit transactions.

• Note that Section 1400Z-2(f)(3) provides that there will not be a penalty for failing to meet the 90% test where there is reasonable cause for such failure. Should having a plan for the money be sufficient to provide “reasonable cause”?
Pre-Investment Financing.

- Typically, taxpayers cannot easily dispose of assets (to generate gains) on the schedule associated with lengthy construction.

- In anticipation of this problem, developers might arrange financing in anticipation of these capital contributions, or the investor might loan amounts into the project entity, to be replaced by gain investments as the investor generates them, provided that the actual partnership or stock interest is acquired for cash, as required by the Code provision.

- Is this consistent with the requirements of Section 1400Z-2?
Grace Periods for Investing and the Measurement Dates.

• Section 1400Z-2(d)(1) requires that the QO Fund hold at least 90 percent of its assets in QOZ property, determined by the average of the percentage of qualified opportunity zone property 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.

• This raises several questions (next slide)
How does averaging work?

• Does the fund just determine its percentages on the two dates? Arguably, the 6-month reference applies only to the “first” such date in the life of the fund, although the Code does refer to “the taxable year”, not “the first taxable year”.

• What is being averaged? The fair market value of the assets? Their basis? Their original basis at the time of their acquisition by the fund? Perhaps computations should be made using “unadjusted basis” (recognizing that adjusted basis could yield nonsensical results on account of bonus depreciation), unless and until the taxpayer elects to obtain an appraisal and use that instead.
Illustrations of Averaging

- Should the first year computation start 6 months after formation, even if that runs into the next tax year?

- Example: Assume a calendar year fund formed on March 1, and it had 80 percent of its assets in QOZ property on September 1 (i.e., 6 months later), and 100 percent on December 31 (i.e., the end of the year). Then the average would be 90 percent, and the test would be passed.

- Example 2: Assume a calendar year fund formed on October 1, 2018. Should it measure compliance on April 1, 2019 and December 31, 2019? And then on June 30 and December 31 of each year thereafter?
Active Business

• Are we certain that leasing activities, particularly the leasing of residential real estate constitute a QOZ business?

• Section 1400Z-2 points to certain subsections of 1397C for additional definitions. While the pointers do not point to the subsections of Section 1397C that limit leasing (including residential and certain personal property leasing) activities, there is concern that the IRS might apply such rules. (Consider 267(b) and (c) example).
References to “Substantially all.”

- Section 1400Z-2 includes the phrase “substantially all” five times.
- Should this be 70%? 90%?
- Should it be a combination of a percentage, along with an initial phase-in and exceptions for reasonable cause?
Separate funds of non-gains money.

• It is possible to read 1400Z-2 to provide that *separate* funds that make use of only non-gains money can qualify for the benefits of the post-10-year basis step-up of subsection (c). Read by itself, subsection (c) simply states that the 10-year benefit is available without referring to the source of the investment.

• This seems inconsistent with the implication of subsection (e), but that subsection actually addresses *joint* funds of both gain and non-gain money, while subsection (c).

• What about Section 752(a)? It treats partnership level borrowing allocated to a partner as if the partner contributed money. Does the partner have to have a gain within 180 days of the borrowing or risk that this money will be subject to the separate funds rule?
Taxing the Operation and Distributions of the Opportunity Zone Business -- 1.

• When an Opportunity Fund owns a partnership interest or corporate stock or Opportunity Zone Business Property, presumably this investment will generally be taxed in the ordinary way.

• Example (1):

  • Opportunity Fund in a partnership: It will get a K-1, and report its share of the income; if such a partnership borrows money and makes a distribution to its partners, including the Opportunity Fund, this will be taxed under the rules that apply to distributions to partners (e.g., a distribution in excess of basis generally results in capital gain to the partner).

• [continued on next slide]
Taxing the Operation and Distributions of the Opportunity Zone Business -- 2.

• Example (2):
  
  • Opportunity Fund in a corporation: The corporation will be subject to the applicable tax rules for corporations; if it makes a distribution to its stockholders, including the Opportunity Fund, this will be subject to the normal tax rules that apply to distributions.

  • What about a sale of property owned by the fund (as opposed to selling an interest in the fund)?
Special Issues for Housing

• Related party Acquisitions – Section 42(d) applies a 50% test to determine if buyer and seller are related. Section 1400z-2(e)(2) applies a 20% test. Will this be a problem for resyndications?

• Rehabilitations – Section 42(e)(3) requires expenditures of 20% of original basis or $6K per unit (plus inflation) over 24 months. Section 1400Z-2 requires 100% of original basis over 30 months, a far larger expenditure.

• Zero basis in investment can require close scrutiny of ability to claim losses. (But it should be expected that basis and capital account issues will “work out”).

• How is Section 42(i)(7) ROFR price set? Can the parties take the position that the developer won’t owe tax when it leaves the investment because of the basis step-up rule of Section 1400Z-2(c)?