ALERT MEMORANDUM

Tax Incentives for Investments in Opportunity Zones: New Regulations Provide Clarity and More Questions

October 30, 2018

The 2017 Federal Tax Reform bill enacted a new set of tax incentives for investments in specially designated low-income communities (called "opportunity zones"). Because these tax breaks have the potential to be very valuable, there has been a lot of interest in how these rules work. While the statute sets out some very rigid requirements, many significant aspects of the new rules were left to be fleshed out or determined through the regulatory process. The statute also authorized the issuance of regulatory anti-abuse rules. The first set of proposed regulations were released on October 19, 2018 (the "Proposed Regulations"), together with an IRS Revenue Ruling. This is the first step in what is likely to be a long rule-making process. Many important issues were flagged to be addressed in a second set of proposed regulations, which are in the works, and comments were requested on many other issues.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

TAX

Jason Factor
1 212 225 2694
jfactor@cgsh.com

Diana Wollman
+1 212 225 2660
dwollman@cgsh.com

REAL ESTATE

Daniel Reynolds
+1 212 225 2426
dreynolds@cgsh.com

FUND FORMATION

Elizabeth Lenas
+1 212 225 2612
elenas@cgsh.com

One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

The Q&A below explains what we currently know and identifies some of the unknowns we anticipate will be addressed in the future.

By way of background, opportunity zones are specific geographic regions (census tracts) located throughout the United States and United States possessions; they were designated as such last year and these designations will last through 2026 (i.e., this is a limited-time program). The opportunity zone tax incentives are intended to encourage new investments in these opportunity zones. They do so by allowing a taxpayer who has recognized otherwise taxable gains to defer taxation of those gains by investing that same amount in a "qualified opportunity zone fund" ("QOF") within 180 days of recognizing the gain.

clearygottlieb.com

© Cleary Gottlieb Steen & Hamilton LLP, 2018. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

The gains that are so invested are rolled-over (i.e., not currently taxed) until December 31, 2026 (or if earlier the date the taxpayer disposes of the interest in the QOF); and as discussed below, up to 15% of the deferred gain may remain untaxed permanently. If the investment in the QOF is held for 10 years or more, taxation of any gain from that investment may also be avoided. QOFs are entities that must be invested 90% or more in "qualified opportunity zone property," which may be a direct investment in "qualifying opportunity zone business property" or may be an investment in a partnership or corporation that meets certain requirements to be treated as a "qualified opportunity zone business" (including that substantially all its tangible property must be in "qualifying opportunity zone business property").

The Four Tax Benefits Available Under the Opportunity Zone Rules

Q: What exactly are the tax benefits for investments in opportunity zones?

A: There are four separate potential tax benefits. In order to obtain any of these benefits, the investor must first have capital gain from the disposition of property and then must make an investment in a QOF within 180 days after the capital gain was recognized. The four potential tax benefits for such an investor are:

(1st) Taxation of the capital gain is deferred until the earlier of the disposition of the QOF interest and December 31, 2026.

(2nd) If the QOF interest is held for 5 years prior to that gain recognition date, there is a basis step up that is intended to result in 10% of the deferred gain never being taxed.

(3rd) If the QOF interest is held for 7 years prior to that gain recognition date, there is an additional basis step up that is intended to result in a total of 15% of the deferred gain never being taxed.

(4th) If the QOF interest is held for a full 10 years prior to the date it is disposed of, then all of the appreciation from the date of the initial investment in the QOF is intended to permanently escape federal taxation. To be clear, this fourth benefit applies only to the gain resulting from the QOF interest; the initially-deferred gain (or 90% or 85% of it) will always be subject to tax at some point. The Proposed Regulations would put an outside date on this by requiring that the disposition of the QOF interest take place no later than December 31, 2047. Comments were requested as to whether a later date should be used taking into account administrability concerns and the goals of the statute.

Timing

Q: Is there a window of time or cut-off date for making investments in a QOF?

A: Yes. These rules apply only to gains recognized by December 31, 2026, which means that the QOF investment can be made no later than 180 days after that.

Q: Are there more benefits the earlier the investments are made?

A: Yes. The deferral of gain lasts only until the end of 2026, and the 10% or 15% haircut on that deferred gain requires a holding period of 5 or 7 years. So, doing the math, maximum benefits (i.e., the full 15% haircut) require investment on or prior to December 31, 2019, and the 10% haircut is available for investments made on or prior to December 31, 2021. Also, the earlier the investment is made the longer the period of deferral prior to the end of 2026.

Q: What if I want to invest in a QOF first and then sell my other investment? Does that work if I do them both within a 180 day period?

A: No. You are required to recognize the gain first and then invest in the QOF.

Rolling Over Gain into an Opportunity Zone Investment

Q: If I am an individual holding an appreciated investment (e.g., stock), can I sell it and invest the proceeds directly in a property in a qualified opportunity zone?

A: No. In order to obtain the tax benefits, the investment needs to be made by acquiring an equity interest in a QOF. A QOF can be either a corporation or a partnership (including an LLC treated as a corporation or a partnership for U.S. tax purposes and also including an S corporation). You cannot hold the opportunity zone property directly (or through a single-member "disregarded entity" LLC). But the QOF does not need to be widely-held. A QOF could, for example, be a wholly-owned C corporation or S corporation, or a partnership with two partners (which might include a spouse or other family member, or a corporation wholly-owned by the other partner).

Q: Are there restrictions on the type of equity an investor can hold in a QOF?

A: No. In order to be a qualifying investment (i.e., with tax benefits) it must be an equity interest; it cannot be a debt instrument or any other type of interest (e.g., an option). But the equity can have a preference (e.g., it could be equity with a fixed coupon and liquidation preference), or can be a partnership interest with special allocations. It is also permissible for the equity to serve as collateral for a loan, so long as the investor is treated for tax purposes as the owner of the equity interest. It is possible that preferred equity investments in QOFs may serve as attractive collateral for borrowing, which would allow investors to derive some immediate liquidity while also deferring tax on their gains.

Q: Does the investment in the QOF need to be made through a cash contribution to the QOF?

A: It appears not. Neither the statute nor Proposed Regulations include such a requirement for the investment in the QOF. (This should be contrasted with the requirements for a QOF to invest in a subsidiary corporation or partnership, which must be in a primary issuance for cash.) It therefore appears that the investment might be in exchange for debt or other property, and it might be acquired from another holder in a secondary acquisition.[1]

Q: What if I own a partnership interest in a partnership that sells an appreciated asset and I want to roll over my allocated gain into a QOF investment?

A: The Proposed Regulations provide that if a partnership sells an asset either the partnership or you can make the election. Whichever makes the election has to make the investment in the QOF.

The 180 day rollover period starts for the partnership on the date it recognizes the gain. For the partner, the 180 day rollover period starts on the last day of the partnership's tax year, although the partner can elect to use the date when the partnership recognized the gain. This election would be most useful if the partner wants to make the QOF investment earlier than the last day of the tax year.[2] The partner need not receive a distribution of the sale proceeds from the capital gain transaction in order to make the rollover election. The Proposed Regulations provide that similar rules will apply to other pass-through entities (S corporations, trusts, REITs and RICs).

[1] The QOF could be a partnership and, presumably, could have a section 754 election in effect. The application of a section 754 election in this context (where the acquiror would take a basis of zero under the opportunity zone rules) will require additional guidance.

[2] Note that there could be some oddities related to timing as a result. For example, imagine a partnership that sells appreciated stock on February 1, 2019. A partner could elect to utilize the partnership's timing and make a QOF investment prior to July 30, 2019, or could make a QOF investment starting January 1, 2020, but the gain generally cannot be rolled over into a QOF during the interim period (in the absence of a partnership short year or a disposition of the partnership interest by the partner which causes an earlier allocation of gain).

Q: What sort of income or gain may be rolled over?

A: There was some uncertainty from the text of the statute as to whether the gain needed to be "capital gain". The Proposed Regulations provide that the rollover applies only to capital gains, and either short-term or long-term capital gain qualifies**.** Importantly, depreciation-recapture cannot be rolled over – meaning that if a capital asset is sold at a gain, only the portion of that gain that is characterized as capital gain (after applying the depreciation recapture rules) may be rolled over. Similarly, gain from the sale of inventory (which could include real estate properties held as inventory) gives rise to ordinary income that cannot be rolled over.

The gain may not be derived from a sale or exchange with a related party (determined using a 20% economic overlap test, and taking into account attribution rules). The Proposed Regulations also provide that the gain may not be derived from an asset that was hedged by any offsetting position, which may be an important point for investors trying to time their gain recognition to ensure that they reinvest in a QOF within the 180 day window. The Proposed Regulations also have special rules for net capital gain from section 1256 contracts.

Q: Do I need to invest the entire proceeds of a gain-recognition disposition?

A: No. You only need to invest an amount equal to the gain you want to roll over, and you do not need to roll over the entire gain. You can also divide the gain by rolling over different portions into different QOFs (provided that you meet the 180 day requirement for each QOF investment). The same gain cannot be subject to more than one rollover election.

Q: Do I have to dispose of an investment (i.e., have otherwise recognized gain) or can I just invest after-tax cash in a QOF and avoid gain on that investment if I hold it for more than 10 years?

A: You cannot just invest after-tax cash in a QOF and take advantage of the 10 year rule. This rule *only* applies to QOF investments that you identify as related to taxable gains recognized not more than 180 days before. Relatedly, the QOF investment amount is limited to gains and not all the proceeds from the sale of previously-held property. For example, if stock with a basis of 100 is sold for 120, only the 20 of gain can receive tax benefits from rolling into a QOF. An investment of the other 100 is *permissible* (it does not negatively affect the treatment of the QOF) but it is not eligible for tax benefits even if it is held for 10 years.

Q: Can I borrow to fund my investment in a QOF?

A: Yes. You can fund your investment with the proceeds of a borrowing. But only the amount of the investment that equals your rolled-over gain will be eligible for the tax benefits. So, for example, if you have recognized gain you want to roll over but do not have available cash to fund the investment, you can obtain the cash from any source – there is no tracing of funds requirement.

Q: When the rolled-over gain is eventually recognized (at the end of 2026 or upon an earlier disposition), how is it taxed?

A: The Proposed Regulations provide that deferred gain that is rolled over into a QOF retains its character such that when it is recognized (at the end of 2026 or upon an earlier disposition) it has the same character as it had when initially deferred. So, for example, if the deferred gains were from a section 1256 contract and thus were partially short-term capital gains and partially long-term capital gains, they would retain that character when recognized. It appears that this gain is then taxed under whatever rules and rates apply to you at that time. Any income or gain derived from the QOF itself would (unless permanently eliminated under the 10 year rule) be taxed under the normal rules.

Q: Can gain from a QOF investment be rolled over?

A: Yes. The Proposed Regulations clarify that if a taxpayer disposes of a QOF investment at a gain, capital gains recognized from that disposition may be invested in another QOF (assuming the sale occurs before 2027). The first QOF investment must,

however, be disposed of in its *entirety* before the gain can be rolled over (because the same gain cannot be the subject of multiple opportunity zone elections). The 10 year holding period for the new QOF investment would start on the date of that new investment.

Q: Suppose I have multiple interests in a single QOF, held for different periods of time or related to different deferred gains. If I want to dispose of a portion of those QOF interests can I select which QOF interest I want to sell?

A: The Proposed Regulations set out rules for this. If the interests are fungible (e.g., all common equity), then interests are treated as sold on a first-in-first-out basis, and if interests issued at the same time but related to different deferred gains are sold at the same time, the gains are treated as recognized pro rata. Presumably if interests are separately identifiable (e.g., different classes of equity) they can be sold separately.[3]

Q: How do the rules apply when the investment that is being sold at a gain is held in a tiered structure or the investor wants to hold the opportunity zone investment in a tiered structure?

A: An appreciated investment is eligible for the rollover essentially wherever it is being held in a tiered structure. But the entity that recognizes the gain and makes the rollover election must then acquire the QOF interest. As explained above, when it is a partnership that recognizes the gain, either the partnership *or* the partner who is allocated the gain can make the rollover election. If the partner makes the election, the partner must acquire the QOF interest. It is not addressed directly in the Proposed Regulations, but this rule would seem to permit the rollover election to be made by a partner that indirectly holds through tiers of multiple pass-through entities.

Q: So a partner in a partnership that was allocated gain can hold a QOF investment through that partnership (i.e., because the partnership made the rollover investment), or the partner can hold the QOF investment directly. Can the partner acquire a direct interest in a QOF and *then transfer it* to a partnership or corporation or trust under these rules?

A: The Proposed Regulations do not address the question of whether the QOF interest can be transferred in non-recognition transactions without triggering deferred gain or eliminating the other tax benefits provided. Conversely, they also do not address whether appreciated property could be transferred in non-recognition transactions prior to a disposition in order to cause the gain to be recognized by someone other than the historical holder (e.g., in order to facilitate ownership of the QOF by that transferee).

Q: In a tiered structure, if the entity that deferred the gain and holds the QOF interest is a lower-tier partnership, could an upper-tier partner transfer its interest "early" (i.e., before the 5 year, 7 year or 10 year holding period has run) without jeopardizing the realization of the tax benefits by the lower-tier partnership (which would then benefit its then-current partners)? Conversely, can the upper-tier partner benefit from these rules by selling its upper-tier partnership interest (after 5, 7 or 10 years of ownership) even if the lower-tier partnership continues to hold the QOF interest?

A: The statute and Proposed Regulations do not address these questions; it is hoped that future regulations will provide answers.

Q: How will the election to roll over gain into a QOF apply for state income tax purposes?

A: It will depend upon the state. Some states are already conforming to the federal law, others are doing so in a modified fashion and others have not yet spoken. It is also currently unclear how states will treat questions of nexus – e.g., if an initial gain that is

[3] Note, however, that a person is generally treated as holding only a single partnership interest (see Revenue Ruling 84-53), and so it is not entirely clear whether separate classes of partnership equity held by the same person could be identified and sold separately.

otherwise currently taxable in a state is invested in a QOF in another state, whether the first state will retain the right to tax the deferred gain when they are ultimately realized, and whether the second state may claim the right to tax the gain even though the initial character of the deferred gain (viewed broadly) is supposed to apply to the gain when ultimately recognized.

Structure of QOF

Q: May a pre-existing partnership or corporation qualify as a QOF?

A: Yes. The Proposed Regulations provide that a QOF can be a pre-existing entity, although it needs to qualify as a QOF for the entire period during which the roll-over investors hold their rolled-over interests.

Q: Does the QOF need to hold the opportunity zone business property directly?

A: No. The QOF has three options: (1) hold the property directly, (2) hold the property through a partnership (a "QOZB Partnership") or (3) hold the property through a corporation (a "QOZB Corporation"), or any combination of the three. If the QOF holds through a QOZB Partnership or a QOZB Corporation, the QOF must acquire its investment in that QOZB entity in exchange for a contribution of cash to the entity in exchange for a newly-issued interest. In other words, the QOF may not buy stock or a partnership interest from a prior owner,[4] or acquire an interest in exchange for property other than cash. There is, however, no requirement that the QOF hold any particular percentage interest in the QOZB Partnership or QOZB Corporation. Accordingly, a QOF could hold a small interest. We may see multiple different QOFs investing in the same QOZB Partnership or QOZB Corporation.

Q: There is a 90% asset test and a substantially all assets test, what are these?

A: As noted, a QOF can hold its qualified property in three different ways: (1) directly, (2) through a QOZB Corporation or (3) through a QOZB Partnership.

The 90% test applies at the QOF level: 90% of the QOF's assets must be invested in qualifying property (i.e., directly held opportunity zone business property or a directly held equity interest in a QOZB Corporation or a QOZB Partnership that directly holds the opportunity zone business property).

By contrast the "substantially all" test applies at the level of the QOZB entity: the equity interest in the QOZB Corporation or QOZB Partnership is a "good" investment for the QOF only if "substantially all" of the QOZB Corporation's or QOZB Partnership's assets are *directly* held opportunity zone business property. The Proposed Regulations provide that "substantially all" for this purpose means 70% of the *tangible* property owned by the QOZB Corporation or QOZB Partnership. Note that the 90% test that applies at the QOF level is measured by reference to *all* of the QOF's property (not just tangible property).

Q: There is a separate rule limiting the amount of the QOZB Partnership's or QOZB Corporation's assets that can be non-qualified "financial property," which includes cash. But in practice businesses need working capital. Is there an exception for working capital?

A: Yes. The rule provides that no more than 5% of the total assets of the QOZB Corporation or QOZB Partnership can be non-qualified financial property, and that working capital that meets certain requirements is not taken into account as "non-qualifying" for this purpose. These requirements relate to the entity having a written plan and schedule for deploying the working capital into the acquisition of qualifying assets within 31 months, and substantial compliance with the plan and schedule. The meaning of "substantial compliance" in this context is unclear. Note that this 5% limitation on financial assets does not apply at the QOF level, which means that the QOF

[4] There may at times be a question whether an investment into the QOZB Partnership or QOZB Corporation, followed by a distribution to another equity owner, is treated as a disguised sale/purchase from that other person.

could have up to 10% of its assets in financial property (i.e., it only needs to meet the 90% test).

Q: So what else is treated as a non-qualifying financial asset? Is this important?

A: Yes, it's important. There is a only a 5% cushion for these sorts of assets. Non-qualifying financial assets include any cash that doesn't fit within the working capital safe harbor, options, futures, forward contracts, warrants, notional principal contracts, debt instruments, annuities and similar sorts of assets. This could limit operational flexibility – for example, the ability to hedge floating interest rates with a swap, or the ability to enter into options to acquire property. It may be possible to hold these assets at the level of a QOF (with a 10% cushion) rather than at the level of the QOZB entity (which has only a 5% cushion).

Moreover, for this purpose non-qualifying financial assets includes any interest in a partnership or a corporation. As a result, structurally, although an investor can hold a QOF through one or more tiers of partnerships (if the partnership directly holding the QOF interest makes the rollover election), and a QOF can be a partnership or corporation, and a QOF can own interests in partnerships or corporations that qualify as QOZB entities, *those* QOZB entities generally cannot themselves have interests in subsidiary entities other than "disregarded entities" such as wholly-owned LLCs (unless the interests in regarded subsidiaries represents a very small percentage of the QOZB entity's assets). In other words, there can be only one tier of entities below the QOF itself. This could affect structural flexibility, including the ability to enter into joint ventures with other QOFs or local developer partners, or to compensate people with equity in projects, other than at the level of the QOF, QOZB Partnership or QOZB Corporation.

Q: How do we measure whether a QOF has met the 90% qualifying asset test if it has a short year?

A: The test is measured at the end of the first six months for which the entity is designated a QOF and at the end of the year. The average is determined by determining the ratio for each testing period and dividing by two; it is not a weighted average.

Q: Are the asset percentage tests based on fair market value, tax basis, cost or something else?

A: For purposes of the 90% test described above, a QOF that has audited GAAP financial statements must use the asset values reported on the financial statements. If the QOF does not have audited GAAP financial statements, then the QOF must use the cost basis of its assets.

Similarly, for purposes of valuing assets to determine whether a QOZB Corporation or QOZB Partnership meets the "substantially all" test, the QOZB entity must use the financial statement values if it has audited GAAP financial statements. If the QOZB entity does not have audited GAAP financial statements, the QOF equity investor in the entity may value the entity's assets using the same methodology that the QOF uses for the 90% test ("Compliance Methodology"). This rule is only applicable when there is no other equity holder in the QOZB entity that (i) has self-certified as a QOF and (ii) owns at least 5% in voting rights and value of the QOZB Corporation (or at least 5% in value of the profits and capital of the QOZB Partnership) ("Five-Percent Zone Taxpayer"). If the QOZB entity does not have audited GAAP financial statements and two or more taxpayers are QOF equity investors with at least one being a Five-Percent Zone Taxpayer, then the Compliance Methodology used by any QOF equity investor that is also a Five-Percent Zone Taxpayer and that produces the highest percentage of qualified opportunity zone business property can be used to value the QOZB entity's assets.

Q: Are there any other limitations on QOZB Partnerships or QOZB Corporations?

A: As noted above, the QOF must acquire its interests in these entities for cash, and directly from the entity (or for QOZB Corporations, from an underwriter) and the interests must be equity. As a result, this would exclude equity issued for services, or in exchange for property or interests in the form of debt.

A QOZB Corporation cannot redeem interests from the QOF or a related person (for the two years prior to the investment and the two years afterwards), and cannot engage in a redemption from any person, from a year before the investment to a year afterwards, in an amount equal to or greater than 5% of its equity value. The 5% is measured looking at the value of the QOZB Corporation stock at the beginning of this period (a year prior to the investment), so if the QOZB Corporation has appreciated in value this restriction might be violated through a redemption of less than 5% of its outstanding shares. If a QOZB Corporation is used, this limitation may limit flexibility to engage in joint ventures (if the joint venture partner can neither be bought out by a QOF or redeemed) or compensation (if employee stock cannot be repurchased, even after employees are terminated). There is no similar redemption limitation for QOZB Partnerships.

In addition, QOZB Partnerships and QOZB Corporations must have at least 50% of their gross income from the active conduct of a "trade or business" in a qualified opportunity zone (which may limit more passive activity, although returns from qualifying working capital are counted on the "good" side, and renting residential real property looks like it can qualify), and the trade or business cannot relate to certain types of "sun and sin" businesses (e.g., country clubs, golf courses, tanning salons, massage parlors, horse tracks and other gambling establishments, package stores). A substantial portion of the QOZB entity's intangible property must also be used in the active conduct of a trade or business; the Proposed Regulations provide a safe harbor that this will be met so long as the working capital safe harbor is met as well.

Q: In order to be good opportunity zone business property, the property has to have its original use in the QOF, and/or be substantially improved (a 100% increase in basis within 30 months). How does that work with real property?

A: Real property (land) inevitably will not have its original use in the QOF, and that is okay. The Revenue Ruling released with the Proposed Regulations (Rul. 2018-29) clarifies that for the "original use" test, land is not counted, and in determining whether that has been "substantial improvements" the purchase price for land and a building will be allocated between the two, and only the building needs to be substantially improved.

Q: Can a QOF borrow?

A: Generally, yes. A QOF must satisfy the 90% test and a QOZB Corporation or QOZB Partnership held by a QOF must satisfy the substantially-all test (taking into account borrowed cash as a gross asset), but there is no requirement that the QOF or its subsidiary QOZB Corporation or QOZB Partnership be funded only by rolled-over gains.

Mechanics of Benefit for QOF Investments Held for 5, 7 or 10 Years

Q: How do the rules work to avoid taxation of gain?

A: The rules work through adjustments to tax basis. When an investor rolls over gain by making an investment in a QOF, the investor has a basis in that investment of zero. (If the investor invests an additional amount in the QOF, that additional investment is not eligible for the tax benefits and has a basis computed under the normal tax rules.) The benefit available after a 5 year holding period is that basis is stepped up by 10% of the deferred gain amount; similarly, after a 7 year holding period, the basis is stepped up by an additional 5% of the deferred gain. At the end of 2026, the remainder of the deferred gain is recognized and taxed (although if the value of the investment at this time is less than the deferred gain amount, the amount that is recognized and taxed is the then-current value minus the then-current basis). After this gain recognition, the basis is increased by the amount of gain recognized. After the 10 year holding period is met, the taxpayer may, immediately prior to the disposition of the QOF investment, elect to

increase the tax basis to fair market value, thereby avoiding tax on appreciation in the QOF investment.[5]

Q: How does that basis adjustment offset income or gains derived by the underlying qualifying opportunity zone business?

A: It's complicated, but the answer is that, without regulatory clarifications, it may not work in all respects.

Even though the investor will have an initial basis in the QOF of zero (related to the investment of deferred capital gains), that does not mean that there is no tax benefit from basis related to the investment, or ability to receive cash without taxable income. The QOF will generally have a cost basis in assets that the QOF acquires with cash (this includes cash that the QOF received from investors who deferred tax on that cash). That basis may result in depreciation or amortization deductions and would be taken into account if the QOF were to sell any of its assets.

In addition, if a QOF is a partnership for tax purposes, it may be possible for the QOF to borrow and distribute cash to investors without them being taxed on the proceeds. Although the investor starts with a basis of zero in respect of its QOF investment, it would (presumably) have basis by reason of being allocated debt under section 752, and cash can be distributed in an amount up to the investor's outside basis in the QOF.

On the other side, even if there is a basis step up (in years 5, 7 or 10) that basis step up might not in practice work to prevent the recognition of taxable income or gain. First, income derived by the opportunity zone business (e.g., rental income) will generally be taxable to the QOF (if it is a corporation) or the investors (if they are allocated the income as partners). Second, if the QOF (or a partnership or corporation held by the QOF) sells an opportunity zone asset, that sale can give rise to gain which, similarly, would be taxable to the QOF as a corporation or to the investors as partners.[6] This aspect of the rules is unclear and potentially problematic and not addressed in this first set of Proposed Regulations. It is clear the tax basis step up is triggered and eliminates the taxable gain to the investor if the investor disposes of the interest in the QOF. But it is not clear whether the benefit applies if the QOF or a lower-tier entity sells a property. Take the following example: Investor rolls over $100 of gain by investing it in a QOF; the QOF buys an opportunity zone asset for $100. Eleven years later, the QOF sells the asset for $500. Is there a $400 gain that is recognized and subject to tax (at the level of the QOF if it is a corporation or the QOZB Corporation, as relevant, or at the level of the partners if gain is allocated to them)? It is clear that if instead the investor sold the QOF interest for $500, there would be no tax on the $400, but should the rules require sales at that level? In some cases, this mismatch could be simply a timing issue because the investor would pay tax on $400 of gain and get an offsetting $400 capital loss later (although individual investors cannot carry back capital losses). In other cases, including for QOF Corporations, the taxation could be permanent. It is hoped that future rulemaking clarifies the rules in a way that does not require structuring dispositions in a way that is inefficient or problematic.[7]

[5] The investor would not make the election if the investment had gone down in value; instead the investor would want to recognize the loss.

[6] To the extent that the allocable gains are capital gains recognized prior to 2027, it may be possible for an investor in a QOF partnership to reinvest those gains in the QOF, or in a different QOF.

[7] In the context of a QOF that is a partnership, it is possible that a section 743 adjustment, or the equivalent, should be made available to "push down" the partner's basis step up to the basis in the QOF assets. This might, however, be complicated to administer.

Mistakes

Q: There are a lot of conditions on how the rollover works, and how a QOF can qualify for tax benefits. What happens if something goes wrong?

A: It depends on what the issue is.

If an investor has improperly elected to rollover gain in a QOF (e.g., the investment did not meet the 180 day rule, or the relevant income was not capital gains or the gains had been subject to an offsetting position), that investment will not be eligible for benefits under the opportunity zone rules. The relevant income or gains will not, therefore, be deferred or eligible for the basis step ups. That investment will not, however, *violate* the QOF rules and will not adversely affect the QOF itself.

If a QOF makes an investment in a QOZB Corporation or QOZB Partnership that is not solely for cash in a primary issuance, then that investment will never qualify as part of the 90% qualifying opportunity zone property test. Similarly, if a QOZB Corporation violates the redemption rule discussed above, it will be treated as if it had never been a qualifying asset (even if that treatment is retroactive).

If a QOZB Corporation or QOZB Partnership holds qualified opportunity zone business property (i.e., tangible property used in the qualified opportunity zone business as required by the 70% "substantially all" rule) that ceases to be qualified, the statute provides that the property will continue to be treated as qualifying property for up to five years.[8] Presumably this rule will be of the most use for tangible property that is used outside the opportunity zone, or that ceases to be used in the business.

If the problem is that the QOF itself does not meet the 90% qualifying asset test, it is not clear what rules will apply. It is possible that it might cause the QOF to lose its status. But it is also possible that it will simply give rise to a penalty. The statute provides that if a QOF fails to meet the 90% asset test, it will owe a penalty for each month that it fails to meet the requirement,[9] measured at the underpayment rate under section 6621(a)(2) multiplied by the amount that it was under the 90% threshold (i.e., 90% of its total assets less the value of qualified opportunity zone property).[10] That penalty amount will be payable by a QOF that is treated as a corporation, or will be part of the distributive share of each partner in a QOF that is treated as a partnership. If this distributive share provision is intended to mean that partners must make these payments directly, it will require specific reporting from the QOF and it may cause certain partners (e.g., foreign or tax-exempt partners) that otherwise would not have a tax filing requirement to file tax returns and pay penalty amounts. It should be noted that this penalty looks to the assets of the QOF and could adversely affect investors without regard for what sort of tax benefits those investors expect to receive -- e.g., it might adversely affect partners that made non-qualifying investments in the QOF, and this penalty is based on a deficit measured in relation to the *gross* assets of the QOF (so might be larger for a QOF that had borrowed money for additional investment).

It is also uncertain how this penalty regime would be implemented for purposes of state tax.

[8] It is not clear whether the property will need to qualify for any particular length of time to be eligible for this rule.

[9] It is not clear how the monthly deficit will be measured, since the percentage of qualified opportunity zone property is generally measured semi-annually.

[10] Conceptually this is like the interest charge for underpayment of tax equal to the deficit in qualifying assets.

General Take-Aways

Q: Now that the Proposed Regulations have been issued, are the rules sufficiently clear that a sponsor can organize a fund, or an investor can make a QOF investment?

A: In simple cases, perhaps. In many cases it will still be difficult. There are a large number of open issues, some of them openly acknowledged by the IRS and Treasury (e.g., how "original use" is to be determined, what "substantially all" means in the various places it is used in the statute, what transactions should trigger gains deferred under a qualified opportunity zone election, how proceeds from qualifying assets may be reinvested, the rules related to penalties for failure to maintain the 90% qualifying asset standard), some inherent in the statute (e.g., how the basis adjustments are supposed to work, how intangible assets are to be measured, what is an active business for this purpose) and some points that are clear as a matter of law but may be commercially impracticable (e.g., structural limitations on tiered structures, how carried interest might work, how the statute might be implemented for non-real estate businesses). We would be happy to discuss this.

…

CLEARY GOTTLIEB