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Opportunity Zone Talking Points for Fourth of July BBQs

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In December, we shared with you qualified opportunity zone (QOZ) talking points for your holiday get-togethers. In April, Treasury released a second set of proposed regulations concerning QOZs. Ahead of your Fourth of July BBQ, we offer you these small "bites," to nibble on with your hot dogs and potato salad.

Investment in QOZs, Generally

In order to make a qualifying investment in a QOZ, an investor generally must "reinvest" capital gain into a special investment vehicle (called a "qualified opportunity fund" or "QOF") within approximately six months of the sale of property that triggered that capital gain. An investor who makes a qualifying investment into a QOF receives up to four benefits: (1) deferral of paying tax on the reinvested gain until as late as 2026; (2) after five years, reduction of the deferred gain by 10 percent; (3) after seven years, reduction of the deferred gain by an additional 5 percent; and (4) after 10 years, permanent exclusion from tax of any additional gain on the sale of the investor's interest in the QOF.

Generally, a QOF is a business entity, organized for the purpose of investing in property located in a QOZ (generally, a designated low-income census tract), of which at least 90 percent of its assets are "QOZ business property" (certain tangible property, discussed below), or interests in special subsidiaries called "QOZ businesses."

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Carried Interests

Prior to the April regulations, it was thought that a when an investor reinvested gain into a QOF partnership in exchange for an interest in that partnership, that entire interest was a qualifying investment even if a portion of it was a carried interest.

Unfortunately, the April regulations bifurcate a QOF partnership investor's interest in a QOF partnership between (i) the portion received in exchange for an investment of capital with respect to capital gain, which is a qualifying investment, and (ii) the portion received (implicitly) for services (i.e., the promote), which is a non-qualifying investment (meaning that no QOZ tax benefits will attach to that portion of the interest).

Moreover, the April regulations are punitive: In the case of an investor in a QOF partnership who has both a qualifying capital interest and a non-qualifying carried interest, a disproportionate amount of the investor's overall interest is treated as non-qualifying for purposes of the exclusion from tax after 10 years (and certain other allocations).

Basis, Losses, Distributions, and Liabilities

Under the QOZ statute, generally, an investor's starting basis in a qualifying investment in a QOF is $0. Generally, under normal partnership tax principles, to the extent that a partner has basis in a partnership, that partner may deduct any losses that "flow up" from that partnership, or receive tax-free distributions of cash from that partnership. A partner in a partnership generally increases its basis in the partnership to the extent of that partner's share of the partnership's liabilities. However, under the QOZ statute and first set of proposed regulations, it was unclear whether an investor in a QOF partnership could increase its basis in its QOF interest by virtue of liabilities of the QOF.

The recent regulations clarify that an investor will increase its basis in a QOF partnership to the extent of the investor's share of the QOF partnership's liabilities. This means, generally, to the extent an investor in a QOF partnership has basis in that partnership due to liabilities with respect to its qualifying investment, that investor may take losses that flow up from the QOF partnership or receive tax-free distributions from the QOF partnership. Among other things, this makes possible a cash-out refinancing of a property owned by a QOF once the property has been stabilized. However, the distributions are subject to certain "disguised sale"-type limitations.

Leased Property and Affiliate Transactions

Among other requirements, in order for property to qualify as QOZ business property, the QOF (or QOZ business) must have acquired that property on or after Jan. 1, 2018, by purchase from an unrelated person, and either (i) that property must have its original use in a QOZ, or (ii) the QOF (or QOZ business) must "substantially improve" the property

(meaning, in general, to double its basis in 30 months).

For these purposes, entities with overlapping ownership greater than 20% (a rather low threshold) are considered to be related. This meant that real estate owners who had acquired property that happened to be in a QOZ prior to Jan. 1, 2018, were often not able to take advantage of the benefits of the QOZ program.

Prior to the April regulations, there was a concern that property leased from an affiliate would not constitute QOZ business property (as is the case with respect to property purchased from an affiliate). The recent regulations clarify that leased property, including property leased from an affiliate, may constitute QOZ business property. This clarification provides a mechanism for owners who acquired property in a QOZ prior to Jan. 1, 2018, to take advantage of the QOZ program by leasing the property to an affiliate QOF (or QOZ business). (Certain more sophisticated techniques may also work if there has been a meaningful amount of post–Dec. 31, 2017, investment in the subject property.)

Among other requirements, in order to qualify, the property must be leased on an arm's-length basis. Additionally, in the case of a lease to an affiliate, no rent payments for a term more than one year in advance may be made. (Certain other rules apply to affiliate leases of *personal* property, but not real property.) Interestingly, the affiliate lessee is not required to substantially improve the property.

Conclusion

In the months after the QOZ statute was enacted, there was much excitement about the program, but a lot of uncertainty on the part of investors as to many of the fundamental rules. With each set of regulations, Treasury has made great strides in clarifying the rules—in ways that have often been taxpayer favorable. However, even after the recent regulations, there remain areas of uncertainty. While this program provides tremendous "opportunities," and the path is clearer than ever, careful navigation is still required.