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Qualified Opportunity Zones and Select Partnership Issues

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The 2017 tax act (Pub. L. No. 115-97) created the new concept of qualified opportunity zones (QOZ), which are low-income census tracts in which certain investments are provided tax benefits. On October 19, 2018, the Treasury Department and the Internal Revenue Service released the initial proposed regulations, which address some QOZ issues but have created some new uncertainties, particularly in the partnership area.

INTRODUCTION

The QOZ provisions generally provide three tax benefits for a taxpayer who has capital gain from the sale or exchange of any property (with an unrelated person) in late 2017 through 2026. If the taxpayer invests an amount equal to its gain in a qualified opportunity fund (QO Fund) equity interest during the 180-day period beginning on the sale or exchange date, the taxpayer may benefit from:

- permanent exclusion of up to 15% of the gain;[1]
- recognition of the remaining 85% of the gain is deferred until December 31, 2026;[2] and
- permanent exclusion of gain from any post-investment appreciation in the QO Fund, if the QO Fund interest is held for 10 years or more.[3]

A QO Fund is any investment vehicle, organized as a corporation or partnership for the purpose of investing in three types of ''qualified opportunity zone property'' (QOZ property) in 2018 and later:[4]

- ''qualified opportunity zone stock'' (QOZ stock) in a lower-tier domestic corporation;
- ''qualified opportunity zone partnership interest'' (QOZ partnership interest) in a lower-tier domestic partnership; and
- ''qualified opportunity zone business property'' (QOZ business property).

The QO Fund must have at least 90% of its assets consist of the above three types of QOZ property.[5] QOZ business property is generally tangible property that the QO Fund purchased from an unrelated person in 2018 or later, is used in a trade or business in a QOZ, and is substantially improved by the QO Fund over a 30-month period (or its original use in the QOZ commences with the QO Fund).[6]

The lower-tier corporation or partnership must meet various requirements to be a QOZ business.[7] For ex-

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1 See §1400Z-2(b)(2)(B), which provides that 10% of the gain is excluded after the QO Fund interest is held for five years, and an additional 5% of the gain is excluded after seven years.

2 §1400Z-2(b)(1)(B).

3 §1400Z-2(c).

4 Prop. Reg. §1.1400Z-2(d)-1(c)(1). Prop. Reg. §1.1400Z-2(d)-1(a)(1) provides that a QO Fund may be an entity taxed as a corporation or a partnership, such as a limited liability company. Although §1400Z-2(d)(1) does not require the QO Fund to be a domestic entity, Prop. Reg. §1.1400Z-2(d)-1(e) requires the QO Fund to be organized in the 50 States or the District of Columbia (or in a U.S. possession in some cases).

5 §1400Z-2(d)(1). The 90% test is generally determined according to the QO Fund's applicable financial statement, or ''cost'' if there is no applicable financial statement, generally twice a year. Reg. §1.1400Z-2(d)-1(b)(1).

6 §1400Z-2(d)(2)(D); Prop. Reg. §1.1400Z-2(d)-1(d)(2).

7 §1400Z-2(d)(2)(B); §1400Z-2(d)(2)(C). For a more detailed discussion of the QOZ provisions, see Libin Zhang, Qualified Opportunity Zones: Hot Tubs and Other Hot Topics, 160 Tax Notes 769 (Aug. 6, 2018).

ample, substantially all (at least 70%)[8] of a QOZ business's owned or leased tangible property must consist of QOZ business property.[9] Furthermore, less than 5% of the QOZ business's tangible and intangible property (by unadjusted basis)[10] can be stocks, debt, partnership interests, and similar ''nonqualified financial property,''[11] but nonqualified financial property does not include cash and other working capital generally held for up to 31 months of acquisition, construction, and/or substantial improvement of QOZ business property.[12] A lower-tier corporation or partnership can therefore own any amount of such working capital, provided that the entity meets the 70% test for tangible property and the other QOZ business requirements.

> **Example:** A QO Fund contributes $700 of cash to a lower-tier partnership, which already owns $100 of contributed land. The lower-tier partnership plans to spend the $700 to construct a building on the land within a year, which permits the $700 cash to be held as working capital. The partnership's tangible property includes the land, which was not acquired by purchase and may cause the partnership to fail to be a QOZ business. Depending on the proper interpretation of the working capital safety harbor, the partnership may or may not have to spend at least $234 on construction in the QOZ quickly, in order to have at least 70% of its tangible property consist of QOZ business property, as periodically measured under the various methodologies in Prop. Reg. §1.1400Z-2(d)-1(d)(3).

If the lower-tier partnership is a new partnership, organized for purposes of being a QOZ business, the QO Fund may be able to own an interest in the lower-tier partnership as long as the partnership eventually becomes a QOZ business and remains so during ''substantially all'' of the QO Fund's holding period.[13]

There is no safe harbor for working capital owned directly by a QO Fund. In order to meet the 90% test, a QO Fund should apparently not directly own more than 10% cash, goodwill, or other intangible property, which may be an issue for certain businesses that can be owned directly by a QO Fund but are prohibited for a lower-tier corporation or partnership, such as a golf course, country club, massage parlor, hot tub facility, suntan facility, gambling facility, or liquor store.[14]

PARTNERSHIP-LEVEL GAIN

The proposed regulations provide that a partnership may defer its partnership-level gain with a QO Fund investment, within the 180-day reinvestment period beginning on the partnership's sale or exchange date.[15] This result conforms with the IRS's Draft Instructions to Form 1065 Schedule D, released on September 13, 2018.

The proposed regulations also provide that if the partnership does not defer the gain, the partnership gain is allocated to the partners, who may defer their allocated gain with a partner-level QO Fund investment.[16] The partner's 180-day reinvestment period begins on the last day of the partnership's taxable year, though a partner may elect to have the reinvestment period begin earlier on the partnership's date of gain recognition.[17]

The partnership-level QO Fund investment is allowed only if the partnership is not 20% related to the purchaser of the property.[18] The relationship requirement is stricter, however, if the partnership's gain is allocated to the partners, because a partner-level QO Fund investment is allowed only if both the partner and the partnership are not 20% related to the purchaser.[19]

Because a partnership allocates its gain on Schedule K-1s, which are normally due around 257 days (with extensions) after the end of the partnership's taxable year,[20] a partner may not have many days, or even any time period, between receiving information about partnership gain and the QO Fund investment deadline. Partners should encourage their partnership to provide more timely tax information, accurate to the nearest dollar if possible, because an investment of non-gain cash does not qualify for any QOZ tax benefits under the mixed investments bifurcation rule in §1400Z-2(e)(1).

The partner-level QO Fund investment effectively allows a partner to have a second shot at gain deferral, up to a year later.

> **Example:** A partnership sells land on January 1, 2019, for $1,000 of cash, all of which is transferred

[8] Prop. Reg. §1.1400Z-2(d)-1(d)(3).

[9] §1400Z-2(d)(3)(A)(i).

[10] For a discussion of unadjusted basis, see Prop. Reg. §1.199A-2(c).

[11] §1400Z-2(d)(3)(A)(ii); §1397C(b)(8); Prop. Reg. §1.1400Z-2(d)-1(d)(5)(iii).

[12] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(iv).

[13] See §1400Z-2(d)(2)(C)(ii), §1400Z-2(d)(2)(C)(iii).

[14] §1400Z-2(d)(3)(A)(iii); Prop. Reg. §1.1400Z-2(d)-1(d)(6).

[15] Prop. Reg. §1.1400Z-2(a)-1(b)(1). The same rules apply to S corporations, RICs, REITs, and (non-grantor) trusts and estates.

[16] Prop. Reg. §1.1400Z-2(a)-1(c)(2). The same rules apply to shareholders of an S corporation and the beneficiaries of a (non-grantor) trust or estate, under Prop. Reg. §1.1400Z-2(a)-1(c)(3).

[17] Prop. Reg. §1.1400Z-2(a)-1(c)(2)(iii)(B).

[18] Prop. Reg. §1.1400Z-2(a)-1(b)(2)(C).

[19] Prop. Reg. §1.1400Z-2(a)-1(c)(2)(iii)(C).

[20] §6072(b); Reg. §1.6081-2T(a)(1).

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to a qualified intermediary as part of a §1031 exchange. The partnership fails to acquire any replacement properties within 180 days (by June 30, 2019). The qualified intermediary returns the $1,000 to the partnership on June 30, which is too late for the partnership to have made its QO Fund investment within the 180-day reinvestment period that ended on June 29, 2019.[21] The partners, however, may make QO Fund investments by June 27, 2020, which is 179 days after December 31, 2019, and therefore within the partners' 180-day reinvestment period.

When a taxpayer receives a capital gain dividend from a RIC or a REIT, the proposed regulations provide that the capital gain may be deferred with a QO Fund investment,[22] apparently without regard to whether the shareholder is related to the purchaser of the RIC's or REIT's property. The shareholder's 180-day reinvestment period begins on the date that the dividend was received. However, the RIC or REIT does not have to designate its distributions as capital gain dividends until generally January of the next year,[23] which may be after the end of the shareholder's 180-day reinvestment period.

A taxpayer may be better off holding the RIC or REIT stock in a partnership, in order to use the 180-day reinvestment period for the partnership-allocated capital gain dividend that begins later.

Example: A calendar-year partnership owns REIT stock and receives a $600 REIT distribution on March 30, 2018. On January 30, 2019, the REIT issues a Form 1099 that designates the distribution as $200 ordinary dividend, $300 capital gain dividend, and $100 return of capital. It is too late for the partnership to make a $300 QO Fund investment, which was required by September 25, 2018. Instead, the partners may defer their partnership-allocated $300 capital gain dividend with a QO Fund investment by June 28, 2019.

SECTION 1231 GAIN

The proposed regulations provide that QOZ deferral is allowed only for an investor's gain that is "treated as capital gain for Federal income tax purposes."[24] The deferred gain can be the investor's gross amount of capital gain from a sale or exchange, without regard to the investor's capital losses.[25] No QOZ gain deferral is allowed for gain treated as ordinary income or dividend income, such as depreciation recapture, gain from the sale of inventory, §1248 deemed dividend from the sale of foreign stock, or ordinary income recapture under §467 from the disposition of certain leased property.

The proposed regulations do not address the treatment of §1231 gains and losses from the disposition of §1231 property, which generally includes real property and depreciable personal property used in a trade or business and held for more than one year. If such §1231 gains exceed §1231 losses for the year, the gains and losses are treated as capital gains and capital losses, respectively, which should allow the gross amount of the §1231 gains to be deferred with a QO Fund investment, while the §1231 losses are allowed as losses. However, if §1231 gains do not exceed §1231 losses, the gains and losses are treated as ordinary income and ordinary losses, respectively, and perhaps none of the §1231 gains may be deferred.

The resulting cliff effect is that a $1,001 §1231 gain and a $1,000 §1231 loss allows all $1,001 of gain to be excluded, whereas no deferral may be permitted for a taxpayer with $1,000 or less of §1231 gain and a $1,000 §1231 loss. The netting rule also has timing issues, as §1231 gain may be recognized early in the year, for which the 180-day reinvestment period may end before the taxpayer fully knows its offsetting §1231 losses for the year.

If the taxpayer does defer its $1,001 of §1231 gain with a QO Fund investment, its remaining $1,000 of net §1231 loss may be an ordinary loss. In determining whether §1231 gains exceed §1231 losses or not, §1231(a)(4)(A) somewhat circularly provides that gains and losses shall be included only if and to the extent taken into account in computing gross income.

When §1231 gain is recognized at the partnership level, the determination of the character of the gain is generally made at the partner level, after taking into account all of the partner's other §1231 gains and losses through the end of the partner's taxable year. A partnership may have difficulties in determining whether its partnership-level §1231 gain will eventually be treated as capital gain or as ordinary income at the partner level.

Example: A partnership has two equal partners, an individual and a domestic C corporation. The part-

[21] Section 1400Z-2(a)(1)(A) provides that the 180-day reinvestment period begins on the date of the sale or exchange. The sale or exchange date is therefore day 1 of the reinvestment period, and day 180 is exactly 179 days later.

[22] Prop. Reg. §1.1400Z-2(a)-1(b)(4)(ii) *Ex.* 2.

[23] §857(b)(3)(B); §852(b)(3)(C).

[24] Prop. Reg. §1.1400Z-2(a)-1(b)(2).

[25] Prop. Reg. §1.1400Z-2(a)-1(b)(2)(iii) provides that for taxpayers who have 60% long-term capital gain and 40% short-term capital gain from §1256 mark-to-market contracts, only the net amount of the gain at the end of the year may be deferred with a QO Fund investment.

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nership sells depreciable real property with §1231 gain. The individual's share of partnership-level §1231 gain is capital gain or ordinary income depending on individual's other §1231 gains or losses. For example, the individual may have recognized net §1231 losses from four years ago, which causes some §1231 gain to be recaptured as ordinary income under §1231(c).

The corporation is subject to §1231 as well. Furthermore, the corporation's share of unrecaptured §1250 gain may be subject to 20% recapture as ordinary income, which is not eligible for QOZ deferral.[26] It is possible that the final regulations will clarify that any partner-specific gain recharacterization does not apply at the partnership level, which would encourage partnership-level QO Fund investments.

If a taxpayer holds property for investment instead of using it in a trade or business, the property's disposition generally gives rise to capital gain that can be deferred with a QO Fund investment. Whether real estate is held in a rental trade or business is a complex issue that arises in many contexts, such as under the 20% §199A deduction for certain income from a pass-through trade or business. The distinction is particularly acute for property held for one year or less: if a taxpayer disposes of property used in a trade or business and held for one year or less, the resulting ordinary income cannot be deferred with the QOZ rules, whereas short-term capital gain from an investment property can be deferred.

SECTION 743(b) ADJUSTMENTS

A partner who purchases a partnership interest may have a §743(b) adjustment, generally equal to the difference between the partner's tax basis in its partnership interest and the partner's share of the partnership's tax basis in partnership assets.[27] A positive §743(b) adjustment can reduce the partner's allocable gain from the partnership's disposition of a partnership asset. Conversely, a negative §743(b) adjustment can increase the partner's allocable gain.

A partnership-level QO Fund investment apparently does not take into account any partner's §743(b) adjustment. The proposed regulations provide some optionality and allow the partner to use its (smaller) partner-level gain as the amount of its QO Fund investment instead. A partner with a negative §743(b) adjustment may be better off with a partnership-level QO Fund investment.

Example: A partner has a tax basis of $0 in its 50% interest in a partnership, which owns one property with $200 of tax basis. The partnership has a negative $100 §743(b) adjustment with respect to the partner. The partnership sells its property for $300 and recognizes $100 of partnership-level gain. The partner would normally be allocated $50 of the gain, which would increase to $150 with the §743(b) adjustment. If the partnership defers all $100 of partnership-level gain with a $100 QO Fund investment, the treatment of the negative $100 §743(b) adjustment is unclear. The adjustment may or may not be carried over into the QO Fund interest.

SECTION 752(a) AND QO FUND LIABILITIES

If a partnership borrows money, its partners normally increase their outside tax basis in their partnership interest under §752(a), as if the partners contributed money to the partnership. If a QO Fund partnership borrows money, the proposed regulations provide that the §752(a) tax basis increase is not a partner contribution of money that is subject to the mixed investment bifurcation rules for a non-gain QO Fund investment under §1400Z-2(e)(1).[28] As a result, all of the partners' gain from selling their interests in the leveraged QO Fund may be excluded after 10 years under §1400Z-2(c).[29]

Example: A taxpayer recognizes $100 of gain in 2018, which is invested in a QO Fund. The QO Fund borrows $400 and acquires $500 of land in an Orange County QO Zone, for use in its parking lot and apiary trades or businesses. The taxpayer recognizes $85 of gain in 2026. The taxpayer may sell its QO Fund interest after 10 years, through 2047,[30] with no taxable gain due to the basis step-up to fair market value under §1400Z-2(c). A QO Fund should substantially improve its purchased property that was previously used in the QO Zone, but the proposed regulations provide that land does not have to be substantially improved,[31] although the QO Fund may or may not be required to construct

[26] §291(a)(1).

[27] The §743(b) adjustment arises if the partnership has made a §754 election.

[28] Prop. Reg. §1.1400Z-2(e)-1(a)(2).

[29] See Prop. Reg. §1.1400Z-2(e)-1(a)(3).

[30] See Prop. Reg. §1.1400Z-2(c)-1(b).

[31] Prop. Reg. §1.1400Z-2(d)-1(c)(8); proposed regulations preamble (''an absence of a requirement to increase the basis of land itself would address many of the comments that taxpayers have made regarding the need to facilitate repurposing vacant or otherwise unutilized land.'') *See also* Rev. Rul. 2018-29 (a QO Fund acquires $480x of land and a $320x building, which is later substantially improved with $400x of additional improvements, so that the QO Fund owns $480x (40%) of land and $720x (60%) of

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a small building or other structure on the land within 30 months.

The proposed regulations suggest that the §752(a) tax basis increase is allowed for other tax purposes, which may allow a QO Fund partnership to allocate depreciation and other tax losses to its investors.

Example: A partnership QO Fund borrows $420 of cash to acquire a single-purpose agricultural or horticultural structure,[32] which was specifically designed, constructed, and used for the commercial production of plants in a Colorado QO Zone. Section 752(a) may increase the investors' tax basis in their QO Fund interests by $420, which allows the QO Fund to allocate up to $420 of depreciation deductions or other losses to the investors.[33] After 10 years, the investors may sell their QO Fund interests with a basis step-up to fair market value under §1400Z-2(c), without any taxable gain and apparently without any depreciation recapture.

A QO Fund must substantially improve its purchased property that was previously used in the QO Zone, generally by doubling the property's adjusted tax basis in the hands of the QO Fund over a 30-month period.[34] The single-purpose agricultural or horticultural structure's adjusted tax basis may be reduced by depreciation, in which case the substantial improvement can be done at less cost.

On the other hand, §1400Z-2(d)(2)(B) provides that the taxpayer's tax basis in its QO Fund investment shall be zero initially. It is unclear whether this zero tax basis rule applies only to the taxpayer's initial gain-related investment in the QO Fund, or whether it also requires a zero outside tax basis when the QO Fund partnership later has undistributed taxable income or incurs partnership-level liabilities as in the above example. A permanent tax basis of zero may have some collateral consequences under the partnership taxation rules. For instance, the investor may have gain under §752(b) when the QO Fund repays its loan. The investor may or may not also recognize too much taxable gain if it receives loan proceeds or other cash distributions, or if it sells its QO Fund interest and its amount realized includes the QO Fund's liabilities.

FUTURE GUIDANCE

The proposed regulations' preamble acknowledges that additional regulations are forthcoming, which may or may not cover the above issues and other widely debated partnership-related questions such as:

- When an investor reduces the tax basis of its QO Fund interest under §1400Z-2(b)(2)(B), whether the QO Fund also has to reduce the tax basis of its assets, including the QO Fund's interests in lower-tier corporations and lower-tier partnerships (which may have their own tax basis reductions).
- Whether an investor in a QO Fund partnership, S corporation, RIC, or REIT can avoid taxable gain if the QO Fund sells its assets after 10 years and allocates or distributes its gain.
- If a partner purchases an interest in a partnership that has previously made a QO Fund investment, whether the new partner may reduce its share of the partnership's gain recognized in 2026 with its positive §743(b) adjustment.
- Clarification of the interaction between the QOZ provisions and the centralized partnership audit rules in §6221 through §6241, as enacted by the Bipartisan Budget Act of 2015 (P.L. 114-74).
- For a foreign investor who defers its taxable gain with a QO Fund investment, whether the U.S. or foreign source of the initial gain carries over into the QO Fund investment, whether the gain recognized in 2026 is subject to U.S. withholding tax, and other international tax issues.
- For a foreign investor who sells a U.S. real property interest and acquires a QO Fund investment, whether §897(e) overrides the QOZ nonrecognition provisions, which may depend on the assets of the QO Fund.
- As the proposed regulations have expanded the QO Fund requirement of ''domestic'' entities to include Puerto Rican corporations and partnerships,[35] how the QOZ provisions intersect with the CFC rules for subpart F income and GILTI from lower-tier corporations that are Puerto Rican CFCs, federal partnership rules, and Puerto Rican tax law.

Likely less imminent are state-level rules that provide for conformity (or lack thereof) to the QOZ pro-

building).

[32] See §168(i)(13).

[33] The single-purpose agricultural or horticultural structure is depreciated over 10 years with the general depreciation system under §168(e)(3)(D)(i) or over 15 years with the alternative depreciation system (ADS) under §168(g)(3)(B). *See also* §168(k) (100% bonus depreciation for property with a recovery period of 20 years or less). For illustrative purposes, it is assumed none of the purchase price is allocated to land, and that §280E (expenditures in connection with schedule I and II controlled substances) does not apply.

[34] §1400Z-2(d)(2)(D)(ii); Reg. §1.1400Z-2(d)-1(c)(8).

[35] Prop. Reg. §1.1400Z-2(d)-1(e).

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visions. California, for example, has not yet conformed to most aspects of the 2017 tax act, and its treatment of §1202 qualified small business stock and other federal provisions suggests some reluctance to follow federal nonrecognition rules.[36]

Example: an investor recognizes $1,000 of gain in 2018, which is deferred for federal income tax purposes with a $1,000 QO Fund investment. The investor lives in state A, which does not conform to the QOZ provisions, and therefore has $1,000 of state A taxable income. The investor moves to state B before 2026, when the investor recognizes $850 of gain for federal income tax purposes. The investor may also have $850 of state B taxable income in 2026, even if state B would have also taxed the investor on the initial 2018 gain had he been living in state B at the time. State B may be reluctant to provide a credit for the taxpayer's state A income taxes paid in 2018, which may raise constitutional issues.

In conclusion, the proposed regulations have provided some helpful guidance for some QOZ topics, but additional guidance is necessary to address old and new uncertainties. Without clarity, taxpayers may find themselves in a difficult situation as they invest the wrong type of gain, miscalculate the timing of their investment, or otherwise find their QOZ tax benefits go up in smoke.

[36] See *Cutler v. Franchise Tax Board*, 208 Cal. App. 4th 1247 (2012); California Franchise Tax Board Notice 2012-03.

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