



## THE QUALIFIED OPPORTUNITY ZONE TAX INCENTIVE

**WILLIAMS MULLEN**

# CURRENT & ANTICIPATED GUIDANCE



## > Statutory Guidance

- Enacted December 22, 2017

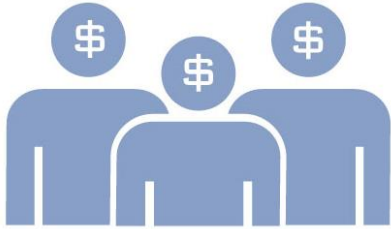
## > Proposed Regulations

- First tranche of proposed Regulations issued October 2018
  - Rev. Rul. 2018-29 issued simultaneously
- Second tranche of proposed Regulations issued April 17, 2019

## > Technical Corrections

- On January 2, 2019, the Joint Committee on Taxation issued a draft of its “Tax Technical and Clerical Corrections Act” that included changes to the OZ statute

# THE OZ INCENTIVES



Investors with eligible capital gains

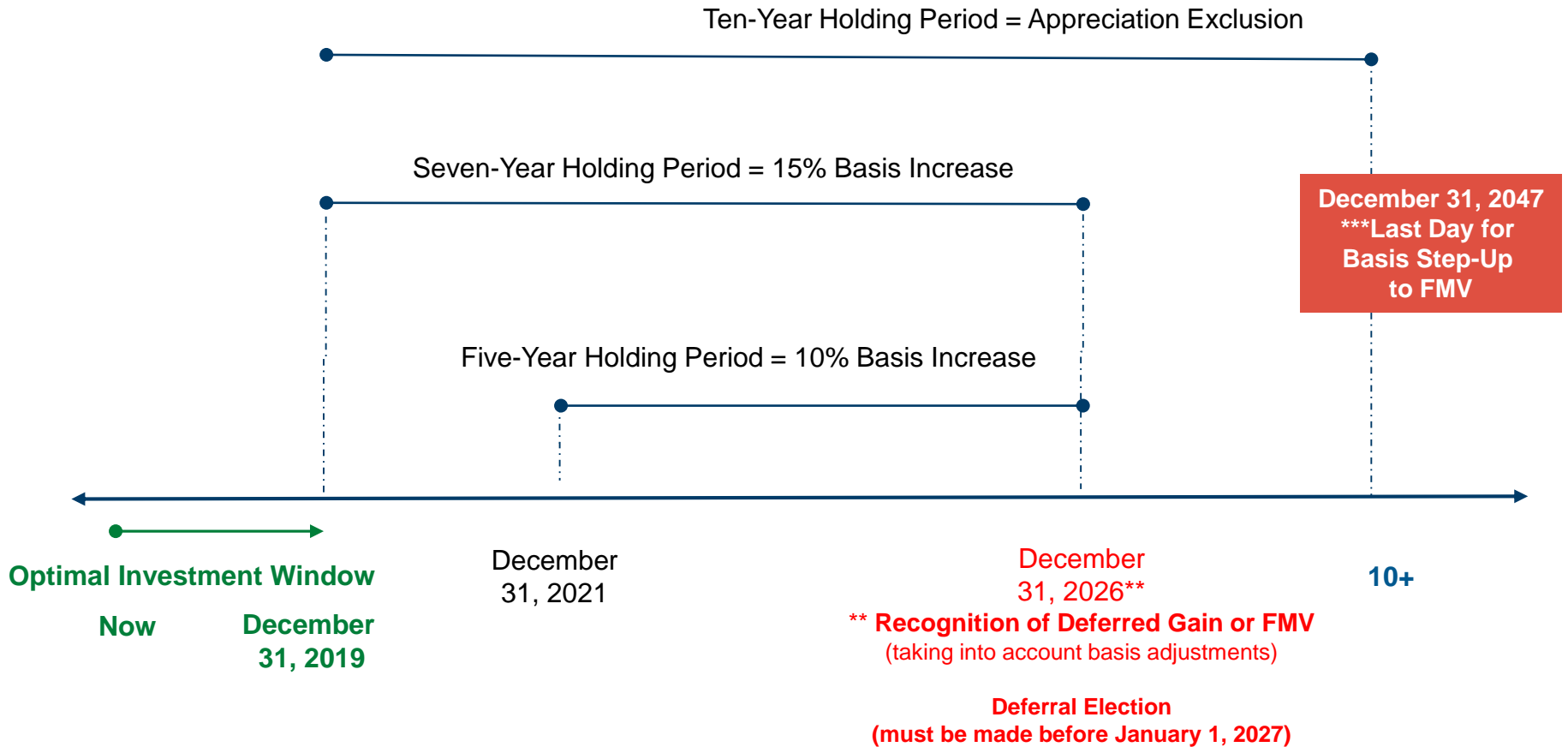
QOF Investment

Temporary  
**DEFERRAL**  
Through 12/31/26  
Or earlier "Inclusion Event"

Permanent  
**TAX REDUCTION**  
Up to 15%

Permanent  
**TAX AVOIDANCE**  
For QOF interests held for 10+ years

# THE WINDOW OF OPPORTUNITY

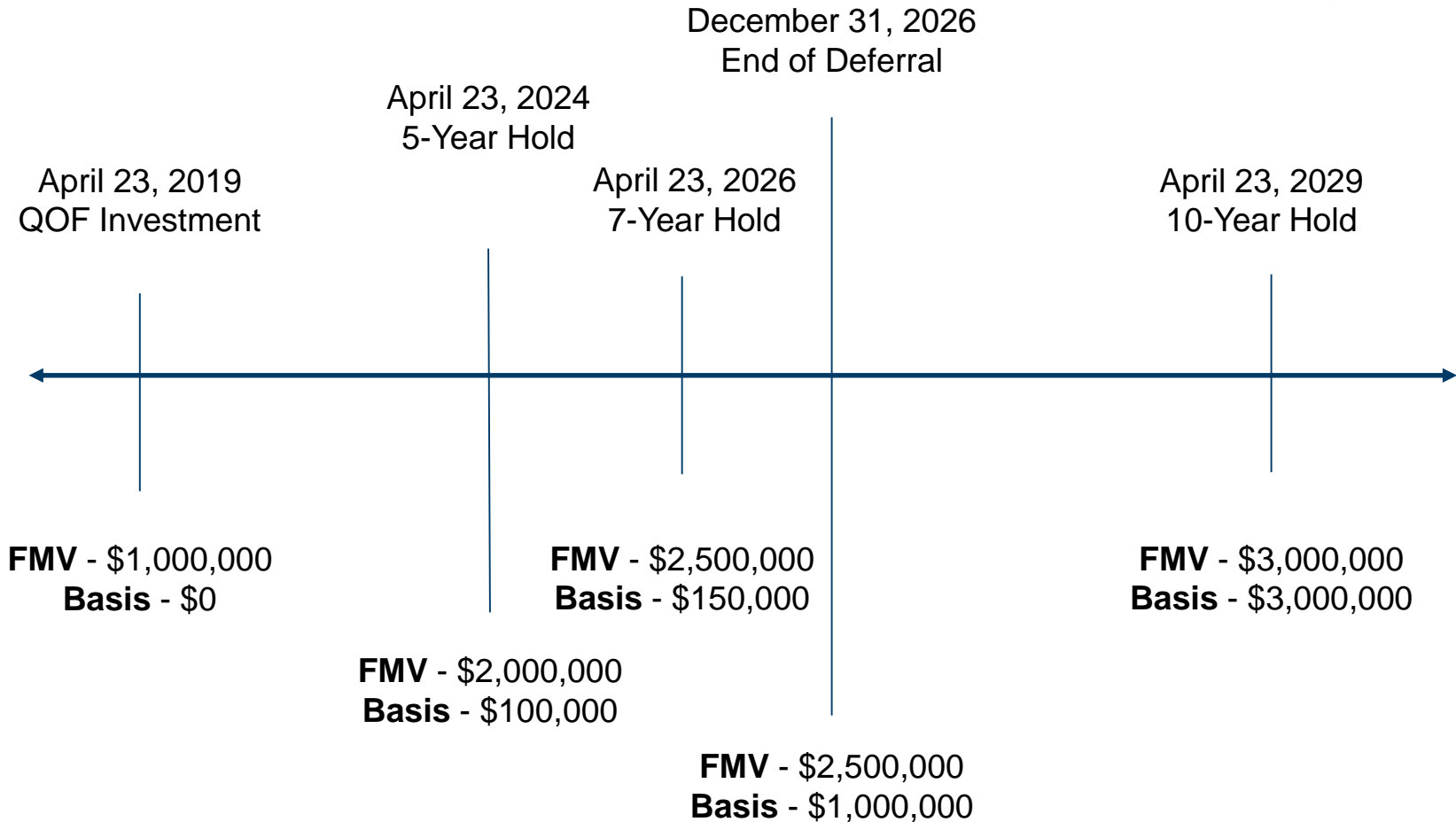




## > Operative Through Basis Adjustments

- Eligible investments in QOFs
  - Initial tax basis = \$0
    - Preserves investor's unrecognized capital gain
  - Holding period basis increases:
    - At least 5 years prior to 12/31/26 = 10%
    - At least 7 years prior to 12/31/26 = 15%
  - FMV basis increase:
    - Basis = FMV on date of sale/exchange of QOF investment
      - » Must hold investment for at least 10 years prior to 12/31/47

# EXAMPLE – BASIS ADJUSTMENTS





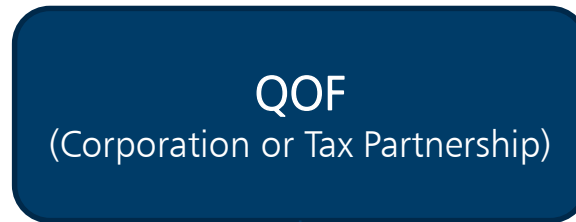
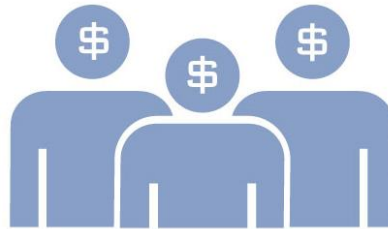
## > QOF Partnership Loss Allocations

- Permitted so long as QOF investor has sufficient basis (including debt basis), and
- QOF investor considered “at risk”
  - QOF leverage critical in real estate partnerships to avoid suspended losses

## > Debt-Financed Distributions

- Especially relevant for real estate QOF partnerships
  - Debt-financed distributions are generally not taxable, so long as taxpayer has sufficient basis in equity interest (including debt basis)
- Q: Can refinancing proceeds be distributed to QOF Investors without triggering sale or exchange of QOF investment?
  - A: Yes, so long as disguised sale rules do not apply and QOF Investor has sufficient basis

# QOF COMPLIANCE



90% of Assets  
**OZ PROPERTY**

- OZ Business Property
- OZ Stock
- OZ Partnership Interests





## > Testing Periods

- Twice annually
  - (1) Last day of the first 6-month period of the QOF's taxable year (e.g., June 30<sup>th</sup> for calendar-year QOF)
  - (2) Last day of the QOF's taxable year (e.g., December 31<sup>st</sup> for calendar-year QOF)
- Adjustments made for QOF's first year, depending on elective date of certification
  - Q: What if QOF receives contribution immediately prior to a testing date?
    - A: A QOF can opt to disregard a contribution made within 6 months of a testing date so long as the contribution is continuously held in cash or cash equivalents



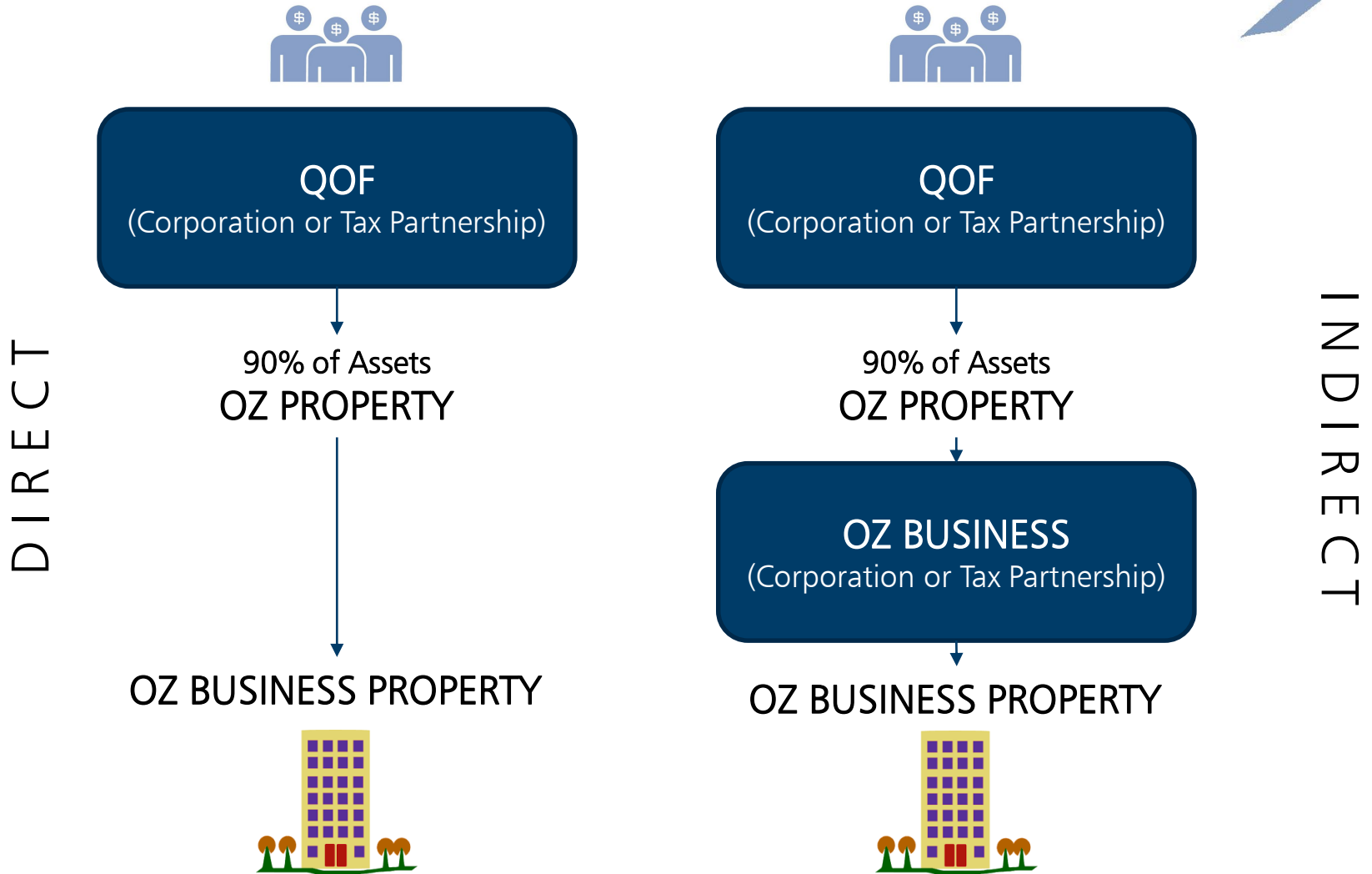
- > Q: Do all QOF Investors have to invest in a QOF with eligible capital gains?
  - A: No. QOFs can be “mixed-use” QOFs
    - QOFs can consist of qualifying and non-qualifying OZ investments
      - OZ incentives only apply to eligible OZ investments
    - Q: Do deemed contributions under Code Section 752 constitute non-OZ investments?
      - No.
        - » Deemed contributions of money to a QOF under 752(a) are not considered a separate investment in the fund



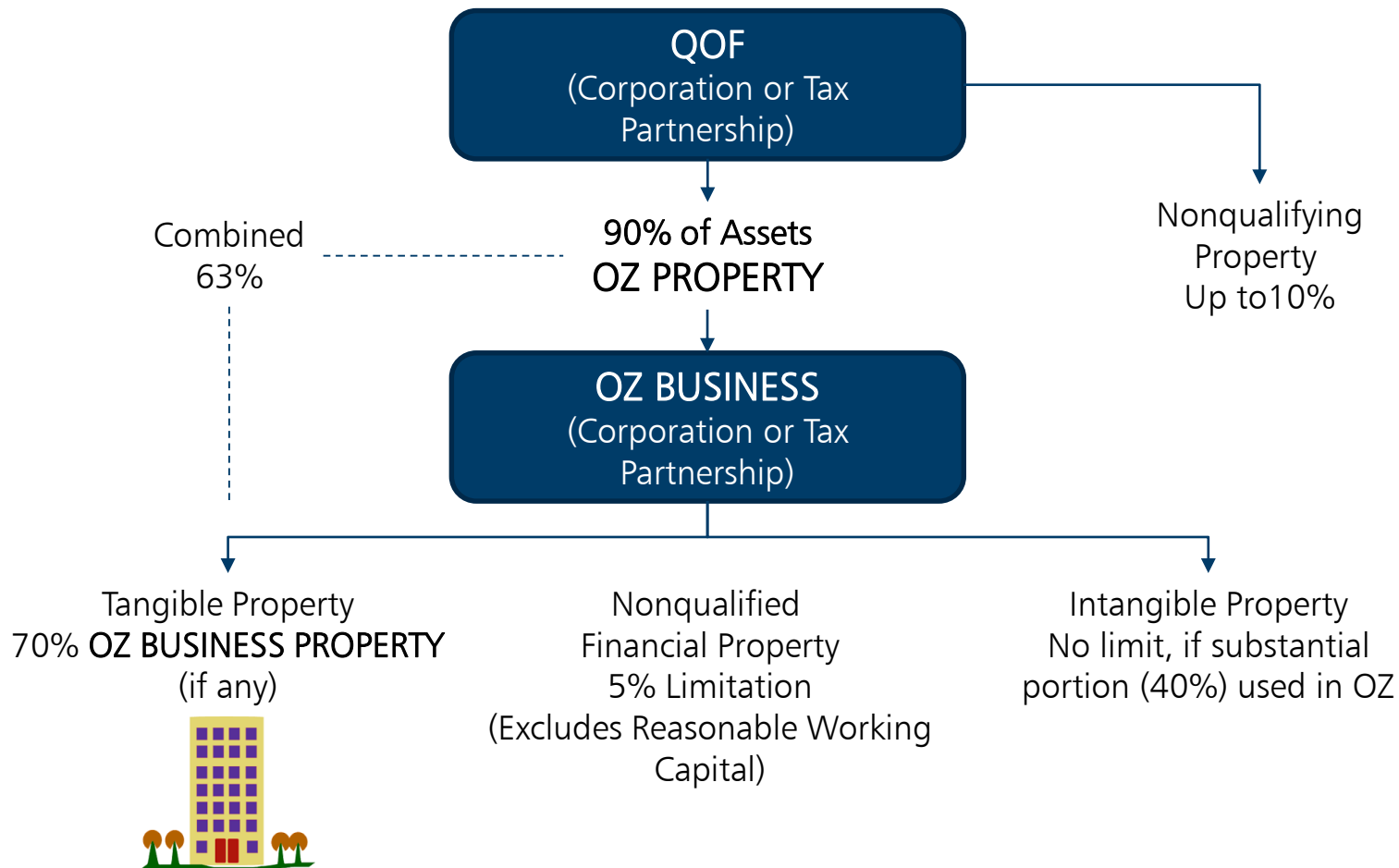
> Q: How do QOF Investors track mixed QOF investments in QOF partnerships?

- A: By tracking qualifying investments versus non-qualifying investments as separate interests
  - All 704(b) allocations of income, gain, loss and deduction, as well as 752 allocations of debt, are made based on the “allocation percentages” attributable to each interest
    - “Allocation percentages” determined based on relative capital contributions attributable to qualifying vs. non-qualifying investment
      - » For profits interests, “allocation percentages” based on highest residual share partner would receive

# OZ INVESTMENT STRUCTURES



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## > Reasonable Working Capital

### – Safe Harbor

- Only available for OZ Businesses (“indirect” structure)
  - Permits OZ Businesses to hold reasonable amounts of working capital for a period of up to 31 months
  - To satisfy safe harbor, must develop a written plan that:
    - » Identifies the financial property
    - » Provides a plan for the financial property
    - » Includes a written schedule for the deployment of financial property consistent with ordinary course of business operations
- No similar safe harbor for QOFs in “direct” structures
  - Working capital subject to 10% asset limitation
  - Limited deployment window



- > Q: What property counts as OZ Business Property requirement?
  - A: Tangible property (real or personal) if:
    - Used in trade or business of OZ Business
    - Acquired by OZ Business by purchase (or leased) after 12/31/17
      - Purchase excludes related-party acquisitions
      - Property can be leased from related party
    - Originally used within OZ by OZ Business or substantially improved by OZ Business
      - Leased property not subject to this requirement (unless related-party lease)
      - Original use is first placement in service for depreciation/amortization purposes OR vacancy/lack of use for 5 year period
    - Substantially all use (70%) is within OZ for substantially all of OZ Business's holding period (90%)



## > Substantial Improvement

- Over 30-month period:
  - Additions to OZ Business Property basis must exceed adjusted basis of OZ Business Property at the beginning of the 30-month period
    - In the case of real estate, cost of land excluded from this calculation, lowering threshold
  - Q: How is substantial improvement calculated for raw land?
    - A: Raw land need not be substantially improved
      - » BUT, must be used in a trade or business, so land banking would not qualify





## > Pre-12/31/17 Property

- Q: Is there a way that tangible property acquired prior to 12/31/17 can be considered OZ Business Property?
  - A: No – must be acquired by purchase or lease after 12/31/17
- Q: What are other options for pre-12/31/17 property?
  - A: Sale to unrelated buyer
    - Related-party rules apply a 20% cross-ownership limitation between buyer and seller
      - » Beware of attribution rules!
    - Maintain an interest in OZ Business (or QOF) buyer of <20%
  - A: Possible utilization of “indirect” structure and 37% allowance for non-OZ Business Property allowance



- > Q: Is there any reason to use the “direct” structure, as opposed to the “indirect” structure?
  - A: Yes.
    - An OZ Business must derive at least 50% of its gross income from the active conduct of a trade or business
      - Q: What does “active conduct” mean?
        - » A: Requires further guidance, BUT....
          - » Active conduct of a trade or business includes leasing of property, but specifically excludes triple net leasing
    - An OZ Business may not engage in a “sin” business
      - No country club, massage parlor, hot tub facility, racetrack, health club, alcoholic beverage store
        - » No prohibition against QOF engaging in “sin” businesses



- > Q: How do I know if 50% of an OZ Business's gross income is derived in an OZ?
- A: The proposed regulations provide three safe harbors:
    - The services test – based on employee/independent contractor service hours performed in OZ versus all service hours performed for OZ Business by employees/independent contractors
    - The compensation test – based on compensation paid to employees/independent contractors for work performed in OZ versus all compensation paid to employees/independent contractors
    - Facts and circumstances test – based on the existence of essential property and managerial functions within OZ



## > Sale of OZ Property

- If QOFs and OZ Businesses sell OZ Property and reinvest proceeds within 12 months of sale, no violation of 90% OZ Property requirement
  - Proceeds must be maintained in cash or cash equivalents
- Gain realized on sale
  - Gains realized on sale can be reinvested without triggering “inclusion event,” BUT
    - QOF Investors must recognize such realized gains in year of sale



## > QOF Exit

- Statute requires a QOF investor to sell its QOF “investment” to get the fair-market-value-step-up benefit
  - Q: Can QOF partners make FMV election when QOF sells OZ Property after 10 years?
    - A: Yes
      - » A QOF investor may make an election after 10 years for separately stated capital gains allocated to it by QOF on Schedule K-1 for sale of OZ Property
  - Q: Does this encourage QOFs to hold diversified assets?
    - Yes – this should permit QOFs to sell assets to different buyers at different times and still allow QOF investors to get OZ benefits



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# QUESTIONS



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