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Legal Update

Qualified Opportunity Fund Update: The IRS Releases Updates and Corrections to QOF/QOZB Regulations

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As the uncertainty caused by the COVID-19 pandemic continues to ravage worldwide markets, on April 1, 2020, the US Internal Revenue Service ("IRS") showed its resilience by issuing an update to, and clean-up of, the qualified opportunity fund ("QOF") regulations originally issued in December 2019.[2] This Legal Update focuses on the key takeaways from these amendments (the "Amendments"), including disincentives for tax reporting failures, guidance on the 62-month start-up safe harbor and illustrations of the rules prohibiting related persons from selling properties to QOFs. The Amendments should make it easier to navigate the tax considerations applicable to investing in and operating QOFs.

I. Brief Background

The legislative history accompanying the enactment of the QOF rules states that the provisions are intended to benefit low-income communities by encouraging investments in such communities. The IRS has promulgated a list of communities (by census tracks) that qualify as opportunity zones.[3] A QOF that invests in one or more opportunity zones provides the tax benefits described below for its investors.

Broadly speaking, the QOF rules operate as follows. An eligible taxpayer invests an amount equal to the gross capital gain that the taxpayer desires to defer into a QOF within 180 days from the date of the actual or deemed recognition of the capital gain. The QOF must be a partnership or corporation. The QOF then must make an investment in qualified opportunity zone property. Qualified opportunity zone property may be qualified opportunity zone stock, qualified opportunity zone partnership interests or qualified opportunity business property (each, a "QOZB"). The QOF rules effectively compel the use of two-tier structures: the QOF serves as a holding company and the QOZB houses the operating business.

Mechanically, the statute operates on two separate tracks. One track governs the deferred gain and the second track governs the investment in the QOF. If the QOF investment is made prior to 2022 and the taxpayer holds the QOF investment for at least five years, he or she reduces the amount of the deferred gain by 10%.[4] In 2026 (or earlier if the investment is disposed of or there is another "inclusion event"), the lesser of the deferred gain (adjusted for the prior increases

in basis) and the excess of the fair market value of the QOF investment over the taxpayer's basis is then recognized and subject to tax at the then applicable tax rate.

Substantial tax benefits are available for the investment in the QOF itself as well. The taxpayer is initially deemed to have a zero tax basis in the QOF, despite having invested cash (or property). Then, leveraging the rules for the deferred gain, the basis in the investment is increased by 10% after five years and by another 5% after seven years. The basis increase frees up losses deferred by the lack of basis in a QOF partnership interest (up to the amount of the increase). If the investor holds its QOF investment for at least 10 years, the taxpayer may elect, on the date of disposition, to increase his or her basis to the fair market value of the investment. This rule provides a tax-free return on gains recognized with respect to QOF investments held at least 10 years. In all cases, however, the income earned by the QOF during its life is taxed to the investor (or the QOF itself if it is a corporation) under the regular tax rules; that is, the QOF rules do not reduce tax on current income from the QOF investment.

II. Clarifications and Changes Made by the Amendments

A. MORE INFORMATION NOW REQUIRED IN ANNUAL FILING OF FORM 8997

The final regulations prescribe rules regarding the election to defer eligible capital gains, including the method by which eligible taxpayers may make deferral elections.[5] The final regulations create an annual reporting obligation for taxpayers investing in QOFs. Specifically, an eligible taxpayer must report whether the gains that have been deferred remain deferred at the end of each taxable year, including the year of deferral.[6] Taxpayers are required to file an IRS Form 8997, Initial and Annual Statements of Qualified Opportunity Fund Investments, to report such information to the IRS.[7]

The Amendments revise and broaden the information that an eligible taxpayer must report. Now, pursuant to the Amendments, eligible taxpayers must report any qualifying investment held at any point during the taxable year. A qualifying investment is defined as an eligible interest, or portion thereof, in a QOF to the extent that a deferral election is made.[8]

B. CLARIFICATION OF PURCHASE REQUIREMENT

At least 90% of the assets of a QOF must be comprised of QOZB property (the "90% investment standard").[9] There are two methods under the final regulations for valuing assets on a semiannual basis for purposes of measuring compliance with the 90% investment standard: the applicable financial statement valuation method and the alternative valuation method.[10] The QOF must consistently apply the same valuation method to all assets with respect to the taxable years.[11] Under the alternative valuation method, the value of each property owned by a QOF is the QOF's unadjusted cost basis of the asset.[12] The final regulations provide that unadjusted cost basis may be used only with respect to property acquired by purchase or constructed for fair market value; assets not purchased or constructed for fair value are valued at fair market value.[13]

The Amendments add a clarification to this rule. Specifically, the Amendments provide that solely for purposes of calculating the value of the property owned by an eligible entity using the alternative valuation method, the acquisition by a QOF of qualified opportunity zone stock or a

qualified opportunity zone partnership interest is treated as a purchase of such interest by the QOF.

C. 62-MONTH WORKING CAPITAL SAFE HARBOR CLARIFIED & EXPANDED TO DEBT CAPITAL

As noted above, the operation of the QOF rules compels investors to use two-tier structures. One of such instances revolves around the lengths of time that a QOF and a QOZB have to acquire business property with the contributions that they receive. The QOF has a very limited time to put the investor contributions to work. Specifically, calendar-year QOFs must have at least 90% of their assets invested in a QOZB on each of June 30th and December 31st (each, a "testing date").[14] Cash contributions made to a QOF, however, may be excluded from the testing date immediately succeeding the contribution (provided that such contributions are held in cash or short-term debt instruments).[15]

A two-tier structure can be employed to extend the amount of time that a transaction has to put investors' contributions to work. In such a structure, the QOF contributes the investors' contributions to a QOZB (which can be either a partnership or a corporation). The QOZB partnership interest or stock counts towards satisfaction of the 90% investment standard for the QOF.[16] The QOZB partnership or corporation is then entitled to a very generous period of time during which it can invest the contributions in an operating business.

The final regulations require that less than 5% of the property held by the QOZB consist of "nonqualified financial property."[17] Reasonable amounts held as working capital are not treated as nonqualified financial property.[18] The final regulations allow a QOZB to designate *any* amount as working capital if several requirements are met:[19]

1. The amount of working capital must be designated in writing for the development of a trade or business in a qualified opportunity zone, including when to appropriate the acquisition, construction, and/or substantial improvement of tangible property in such a zone.
2. There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets.
3. Under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the cash.
4. The working capital assets are actually used in a manner that is substantially consistent with the writing and written schedule.

If additional working capital is contributed to the QOZB, two related events occur. First, for the subsequent contribution(s), the 31-month period is measured from the date of the subsequent contribution.[20] Second, the 31-month period for the original contribution is restarted on the date of the subsequent contribution, provided that the aggregate period during which the working capital is held in a trade or business does not exceed 62 months.[21]

If an Opportunity Zone has been designated as a part of a federally declared disaster area, the QOZB may receive not more than an additional 24 months to consume its working capital assets.[22] President Trump's declaration that the COVID-19 pandemic is a *nationwide* disaster should provide QOZBs with additional time to consume their working capital assets.[23] The Amendments change the standard from "receive up to," to "receive not more than," 24 months.

The Amendments break out and clarify the limitations on the ability of QOZBs to take advantage of the 62-month rules:[24]

1. Each contribution independently satisfies all of the requirements described above;

2. The working capital assets from the original contribution period were expended in accordance with the written plan developed by the taxpayer;
3. The subsequent infusions of working capital assets form an integral part of the plan covered by the initial working capital safe harbor period; and
4. Each overlapping or sequential application of the working capital safe harbor includes a substantial amount of working capital assets.

Furthermore, the Amendments specifically extend the rules for working capital to intangible assets.[25]

The Amendments reorder and clarify an existing example illustrating the rules for subsequent capital contributions that is important to real estate developers in navigating the working capital rules. In this example, a QOF forms a QOZB corporation. The QOZB corporation will build a mixed-use commercial and residential development over 55 months. Specifically, the commercial development will be developed over 30 months and then the residential development will be built over the next 25 months. Following the completion of the commercial development at the 30-month mark, the QOF makes an additional capital contribution to the QOZB corporation to fund the residential development. The example concludes that all working capital, including borrowed amounts, qualifies for the working capital safe harbor and the commercial development qualifies as QOZB property from its development, regardless of whether it is opened for use during the residential construction phase.

D. CIRCULAR CASH FLOW ILLUSTRATION ADDED TO ANTI-ABUSE RULE EXAMPLES

The final regulations contain a general anti-abuse rule that allows the IRS to deny benefits to taxpayers whose investments are inconsistent with the objective making of long-term investments of new capital in those qualified opportunity zones and to spur the economic growth of such qualified opportunity zones.[26] The final regulations contain examples to illustrate the application of the anti-abuse rules.[27]

The Amendments add a new paragraph to one of the examples regarding circular cash flow and purchases of QOZB property from related parties. In the new paragraph, a QOF owns qualified opportunity zone stock in a domestic corporation (“Corporation C”). The QOF also owns stock in another corporation (“Corporation D”), which is not qualified opportunity zone stock, and is less than 10% of the assets of the QOF. These stock holdings cause the QOF to be related to both corporations under the QOF rules.

In an example revised by the Amendments, an unrelated party (“Individual S”) sells tangible property to Corporation C for $100 for use in its QOZB and sells a second asset for $75 to Corporation D. Both items sold were capital assets and had an adjusted basis of $0. Individual S acquires an interest in the QOF with the $175 of gain realized from both sales, thereby making Individual S a related party with respect to the QOF. The QOF contributes the $100 and $75 received from Individual S to Corporations C and D, respectively. The example explains that under the step transaction doctrine and circular cash flow principles, this circular movement of cash is disregarded for federal income tax purposes, including for purposes of the QOF rules. Therefore, the transaction is treated as a contribution by Individual S of both assets to the QOF in exchange for an interest in the QOF, followed by a contribution by the QOF of both assets to Corporations C and D. Thus, the purchase is disregarded. The example concludes that the same result would occur even if Individual S was not related to the QOF immediately following his or her acquisition of the QOF interest.

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Endnotes

[1] The authors are tax lawyers with the New York office of Mayer Brown LLP.

[2] To see our prior coverage of these regulations, please see https://www.mayerbrown.com/en/perspectives-events/publications/2019/12/irs-issues-final-qualified-opportunity-fund-regulations.

[3] IRS Notice 2019-48.

[4] If the investment was made before 2020, and the taxpayer holds the QOF interest for at least seven years, another 5% of the originally deferred gain is reduced and the tax on such additional 5% is forgiven.

[5] Treas. Reg. § 1.1400Z2(a)-1.

[6] Treas. Reg. § 1.1400Z2(a)-1(d)(2).

[7] *See* Code § 1400Z-2(c)-1(b)(1)(ii)(B)(2).

[8] Treas. Reg. § 1.1400Z2(a)-1(b)(34).

[9] Code § 1400Z-2(d)(1).

[10] Treas. Reg. § 1.1400Z2(d)-1(b)(2).

[11] *Id*.

[12] Treas. Reg. § 1.1400Z2(d)-1(b)(4)(ii)(A).

[13] *Id*.

[14] Code § 1400Z(d)(1); Treas. Reg. § 1.1400Z2(a)-1(b)(4). The dates are adjusted to the semi-annual and annual dates for non-calendar year QOFs.

[15] Treas. Reg. § 1.1400Z2(d)-1(b)(2)(i)(B).

[16] Code § 1400Z(d)(1); Treas. Reg. § 1.1400Z2(a)-1(b)(4).

[17] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(iv).

[18] *Id*. In addition, income earned on reasonable working capital assets counts towards the satisfaction of the requirement that at least 50% of the gross income earned by the QOZB be earned from business conducted in the opportunity zone. Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vi)(B).

[19] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(A)-(C).

[20] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(E).

[21] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(F).

[22] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(v)(D).

[23] *See* Code § 165(i)(5); https://www.whitehouse.gov/briefings-statements/letter-president-donald-j-trump-emergency-determination-stafford-act/.

[24] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vi)(A)(1)-(4). These rules were previously contained in Treasury Regulation § 1.1400Z2(d)-1(d)(3)(v)(F).

[25] Treas. Reg. § 1.1400Z2(d)-1(d)(3)(vi)(C).

[26] Treas. Reg. § 1.1400Z2(f)-1(c)(1).

[27] *See* Treas. Reg. § 1.1400Z2(f)-1(c)(3).

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