Strafford

*Presenting a live 90-minute webinar with interactive Q&A*

# Avoiding Disguised Sales in Qualified Opportunity Funds: Critical Tax Considerations for QOF Investments

Recent IRS Regulations, Application of Section 707, Exceptions, Assumption of Liabilities, Debt Financed Transfer Considerations

THURSDAY, JANUARY 30, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:


Gene Crick, Jr., Partner, **Nelson Mullins Riley & Scarborough**, Orlando, Fla.

Derek Kershaw, Counsel, **Shearman & Sterling**, New York


The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1**.

**NOTE: If you are seeking CPE credit, you must listen via your computer — phone listening is no longer permitted.**

# *Tips for Optimal Quality*

FOR LIVE EVENT ONLY

*Sound Quality*

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

**NOTE: If you are seeking CPE credit, you must listen via your computer — phone listening is no longer permitted.**

*Viewing Quality*

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

## *Continuing Education Credits*

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For CPE credits, attendees must participate until the end of the Q&A session and respond to five prompts during the program plus a single verification code. In addition, you must confirm your participation by completing and submitting an Attendance Affirmation/Evaluation after the webinar.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

# *Program Materials*

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

# *Program Materials*

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today's program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

# DISGUISED SALES

ISSUES FOR QUALIFIED OPPORTUNITY FUNDS AND QUALIFIED OPPORTUNITY ZONE BUSINESSES

# Qualified Opportunity Fund Basics

## Tax Benefits of Investing in Qualified Opportunity Funds (QOFs)

- *Temporary Deferral*: Eligible capital gain from the sale of property to an unrelated person can be deferred if the person that realized the gain invests the gain in an equity interest in a QOF within the applicable 180 day period.
    - The amount of eligible capital gain timely invested in a QOF is referred to as the "Deferred Gain Amount."
    - The equity interest in a QOF treated as acquired with the Deferred Gain Amount is the "qualifying investment."

The equity interest in the QOF can be acquired from any other person (not just the QOF). But, in certain cases, distributions by a QOF partnership to an investor will reduce the amount of the investor's qualifying investment dollar-for-dollar and on a retroactive basis.

## Tax Benefits of Investing in QOFs (cont'd)

- *Step-up in Basis*: The initial tax basis of the QOF investment will be zero. If the investor has held the QOF investment for at least five years on the date when the Deferred Gain Amount is includible, the tax basis of the QOF investment increases by 10% of the Deferred Gain Amount, and if the investor's holding period reaches seven years before such date, the tax basis increases by an additional 5% (total of 15%).

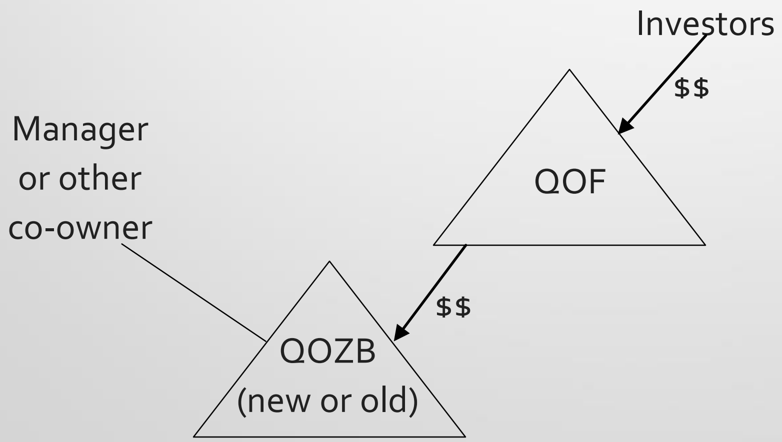
## Tax Benefits of Investing in QOFs (cont'd)

- *Permanent Exclusion*: If the investor holds the QOF investment for at least 10 years, the investor can eliminate the gain otherwise triggered by the investor's exit from the QOF (if such exit is properly structured) such that no U.S. federal income tax is incurred with respect to appreciation in the value of the QOF investment.

  *Example:* X sells a capital asset in 2019 for $1,400,000 in cash, and the asset had a basis in X's hands of $400,000. In 2019 (not more than 180 days after such sale), X contributes $1,000,000 in cash to a QOF in exchange for an interest in the QOF. X sells such interest in the QOF for $2,100,000 in 2030 (i.e., after holding the interest for more than 10 years). Assume the QOF maintained its qualification as a QOF for X's entire holding period. X owes no U.S. federal income tax on the $1,100,000 economic gain from the sale of the QOF investment, realized in 2030.

## Formation of QOF

- *Qualification as QOF*: To qualify as a QOF, an entity must hold at least 90% of its assets in qualified opportunity zone property (QOZP). To do so, a QOF must either (a) directly engage in business in one or more qualified opportunity zones, or (b) invest cash, as an equity investor, in one or more lower-tier entities that use the cash in their business and qualify as qualified opportunity zone businesses ("QOZ Businesses" or "QOZBs") for at least 90% of the period during which the QOF holds its interest as an equity investor.
- *Use of Existing Entity Permitted*: A QOF or QOZB can qualify as such at any time after having been initially formed, but the QOF must meet the QOF asset requirement for the year during which investor(s) first invest their eligible capital gain.



## Formation of QOF (cont'd)

- For the QOF to qualify, the QOZB must hold at least 70% (by value) of its tangible assets in QOZP.
    - Property generally cannot be QOZP unless it is acquired from an unrelated person by "purchase".
- Formation of structure may start with acquisition of QOZP by QOZB, but the funds subsequently invested by the QOF must not be distributed to the QOZB's other owners.

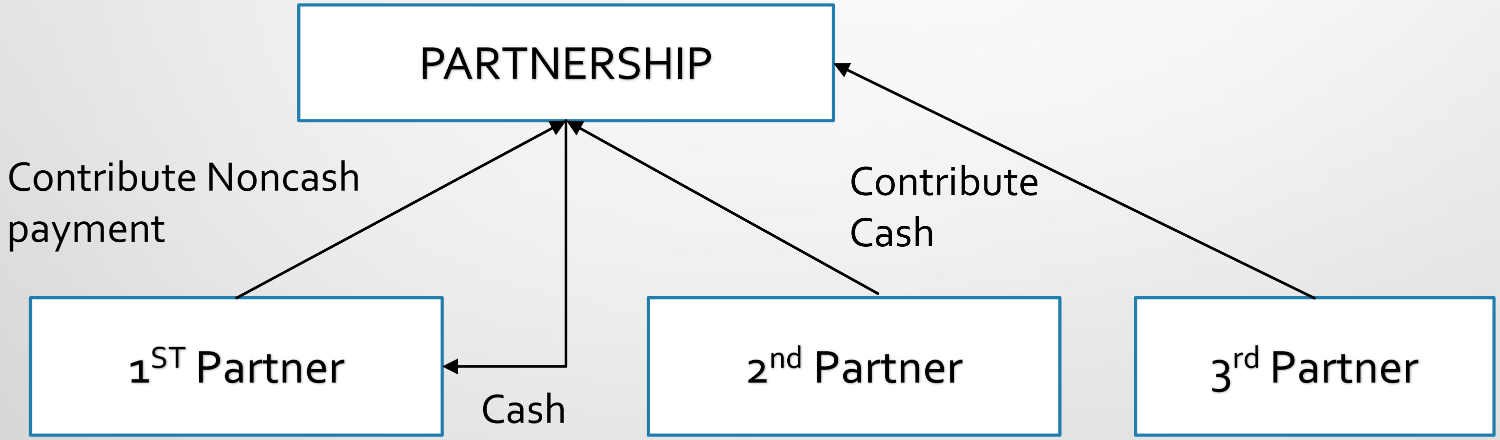
## Formation of QOF: Application of Disguised Sale Rules to Determine Amount Invested in QOF Partnerships

- As mentioned above, in certain cases, distributions by a QOF partnership to an investor will reduce the amount of the investor's qualifying investment dollar-for-dollar and on a retroactive basis.
- Specifically, a partnership interest in a QOF would not be treated as a qualifying investment to the extent the QOF makes a distribution to the investor and the investor's transfer of cash to the QOF and the distribution would be recharacterized as a disguised sale of property to a partnership under section 707 and section 1.707-3 if (i) the cash contributed were non-cash property, and (ii) in the case of a distribution to which section 1.707-5(b) (relating to debt-financed distributions) applies, the investor's share of liabilities were zero
- In applying the disguised sale rules, the IRS cannot apply the debt-financed distribution exception but the IRS will apply the other exceptions as appropriate (e.g., the operating cash flow distribution exception of section 1.707-4(b)).

# Treas. Regulations on Disguised Sales Involving Partnerships

Treas. Reg. Sec. 1.707-3:

QOF Partnership receives in second month of 2018 from the first partner a contribution of non-cash property in return for partnership interest, in ninth month of 2018, second partner contributes cash in return for a partnership interest, and in tenth month of 2019, partnership distributes cash to first partner equal in value to non-cash property.



A transfer of property by a partner to a partnership and a transfer of money by the partnership to the partner generally constitute a sale if based on *all the facts and circumstances* (i) the transfer of money would not have been made but for the transfer of property, and (ii) where the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

Treas. Reg. Sec. 1.707-3(c)(1) provides:

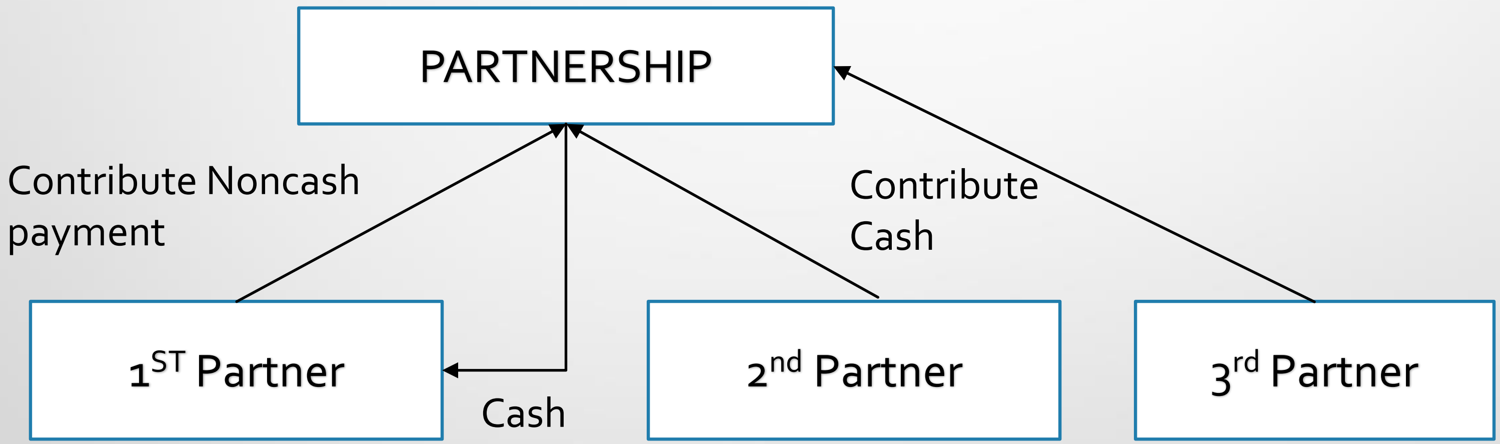
> If within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner, the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances *clearly establish* that the transfers do not constitute a sale.

But transfers are not part of a disguised sale if one of the exceptions in Treas. Reg. Secs. 1.707-4 or -5 apply.

Treas. Reg. Sec. 1.707-3 and -4:

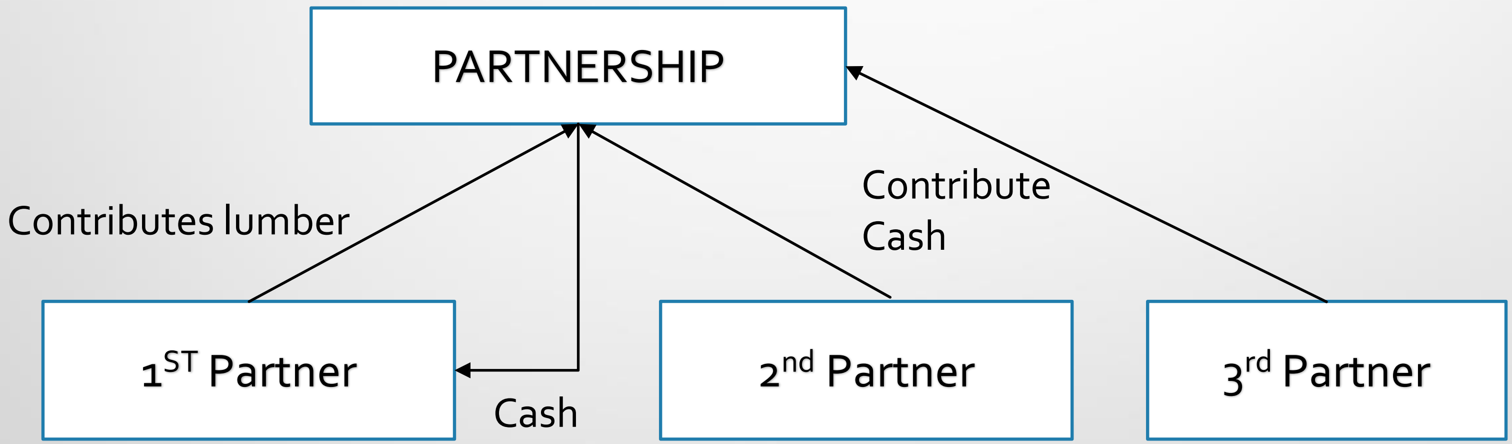
QOF Partnership receives in second month of 2018 from the first partner a contribution of non-cash property in return for partnership interest, in ninth month of 2018, second partner contributes cash in return for a partnership interest and then partnership distributes cash to first partner within two years of its contribution.

Do any of the exceptions in Treas. Reg. Sec. 1.707-4 apply?



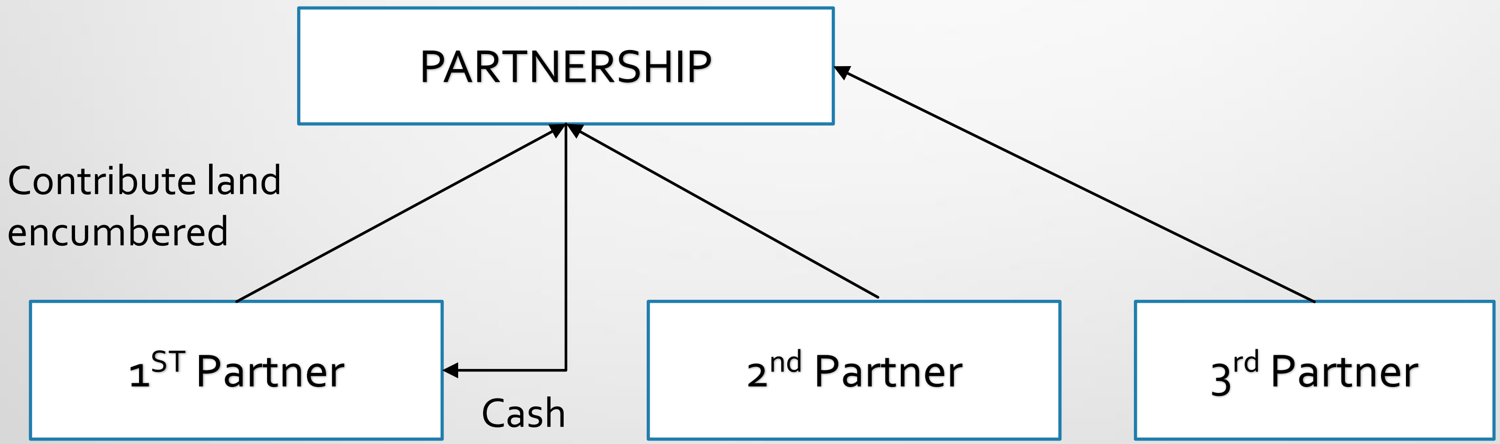
Treas. Reg. Sec. 1.707-4:

QOF Partnership constructing property, in second month of 2018 first partner contributes lumber in return for partnership interest, in ninth month of 2020, second partner contributes cash in return for a partnership interest, and then partnership distributes cash to first partner within two year of contribution of lumber.



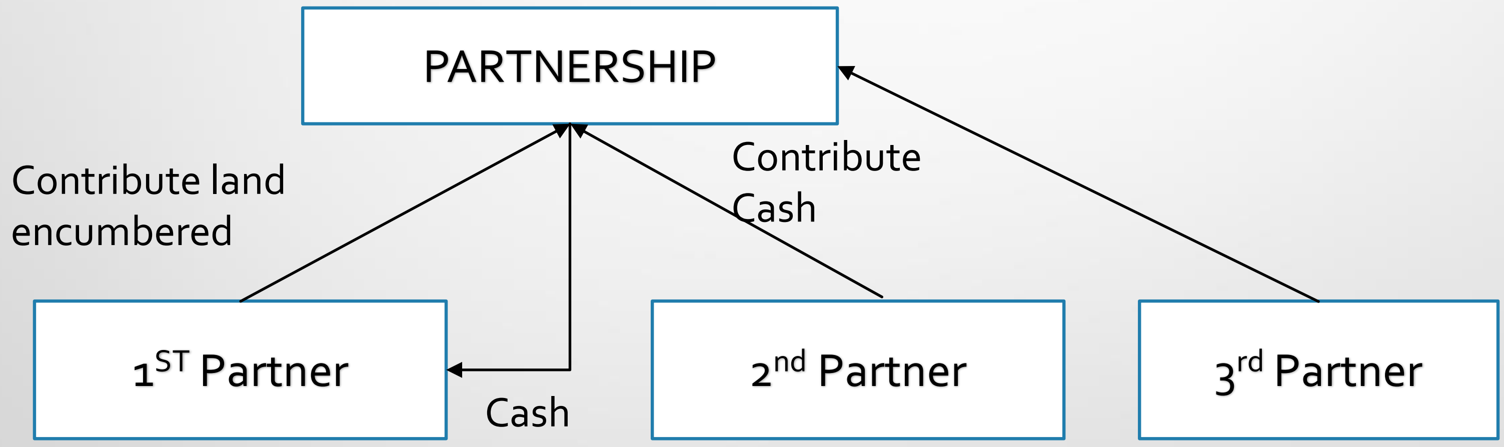
Treas. Reg. Sec. 1.707-5:

QOF Partnership receives in second month of 2019 from first partner a contribution of land encumbered by a $700,000 mortgage with a net value of $1.3M (mortgage placed on property first month of 2017) in return for a partnership interest.



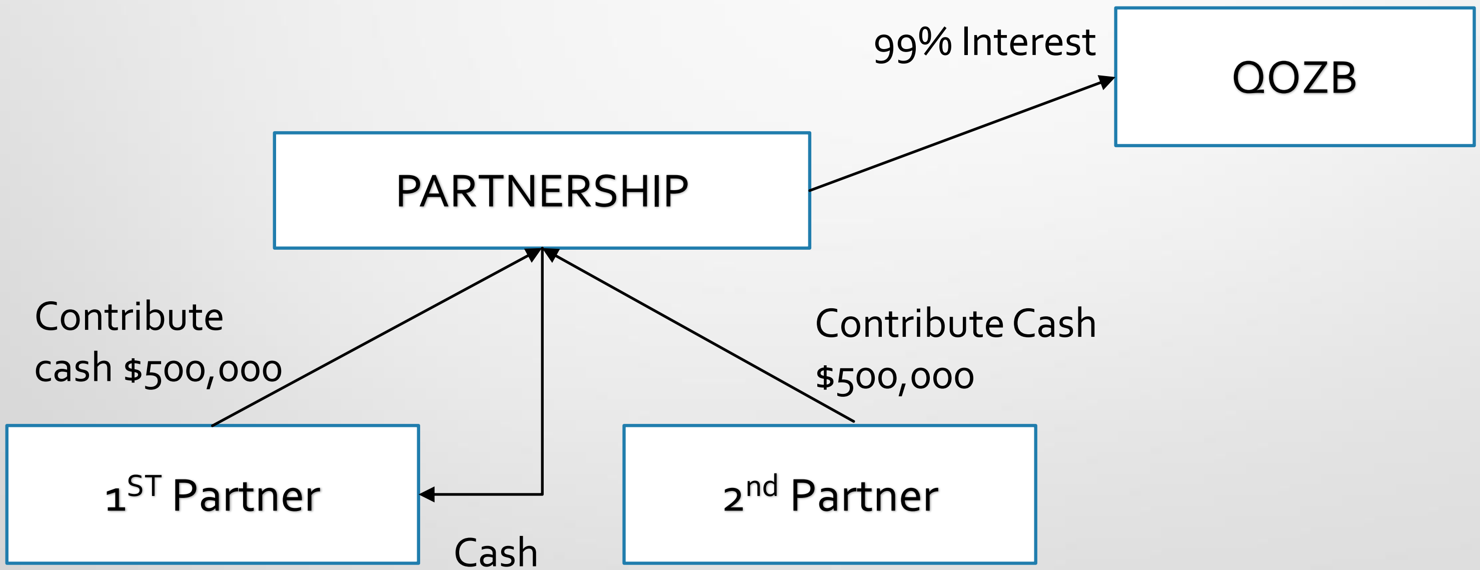
Treas. Reg. Sec. 1.707-5:

QOF Partnership receives in second month of 2019 from first partner a contribution of land encumbered by a $700,000 mortgage with a net value of $1.3M (mortgage placed on property on July 1, 2018) in return for a partnership interest, in ninth month of 2019, second partner contributed cash in return for a partnership interest, and then in second month 2020 partnership distributes $1.3M to first partner.



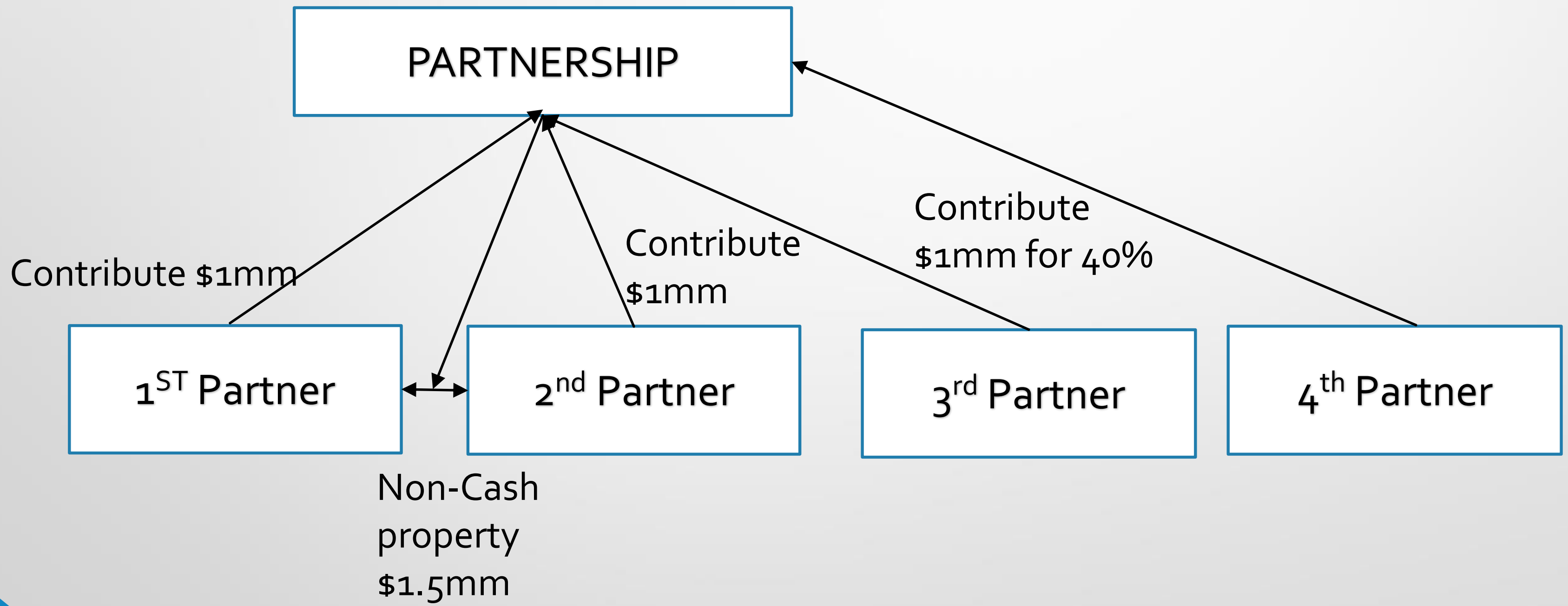
Treas. Reg. Sec. 1.707-5(b):

QOF Partnership has two new partners each contributing $500,000 in cash to the partnership for 10% interest in 2018, QOF partnership uses funds to contribute to a QOZB for a 99% interest and the QOZB borrows construction financing of $8M to build a 150 unit apartment complex. In 2023, the QOF partnership receives excess funds from conversion of the debt to the permanent phase of $12M and within 60 days of partnership distributes $4M to the partners proportionately.



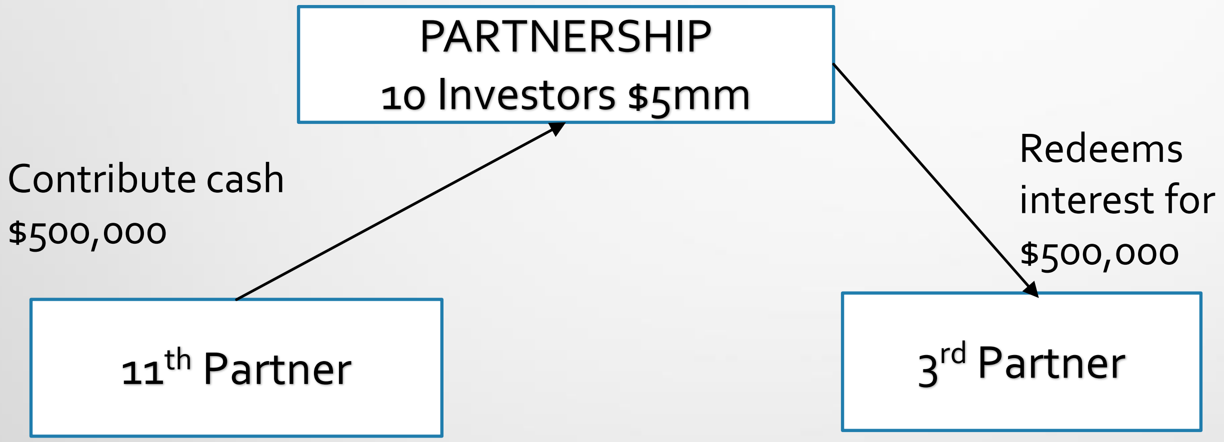
Treas. Reg. Sec. 1.707-6:

QOF Partnership was funded in sixth month of 2018 by 2 partners equally with $1M, in eleventh month of 2019, third partner contributes $1M for 40 percent interest, in January 2020, partnership distributes noncash property with a value of $1.5M to the 2 partners contributing cash in the sixth month of 2018 in redemption of their interests.

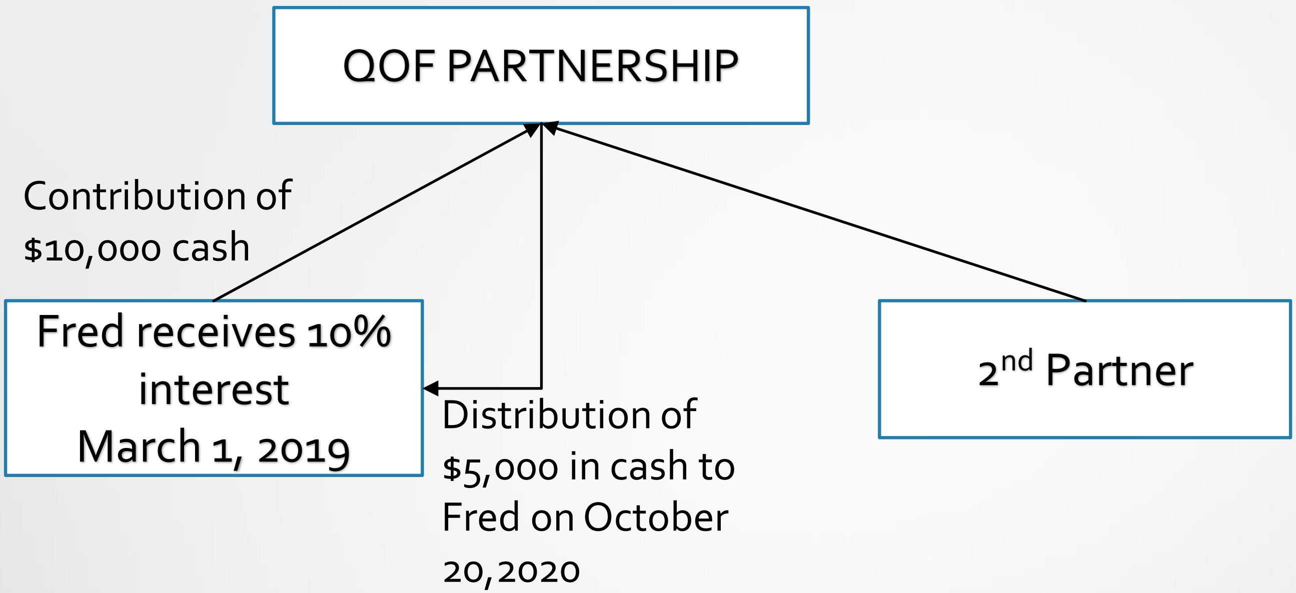


Former Treas. Reg. Sec. 1.707-7:

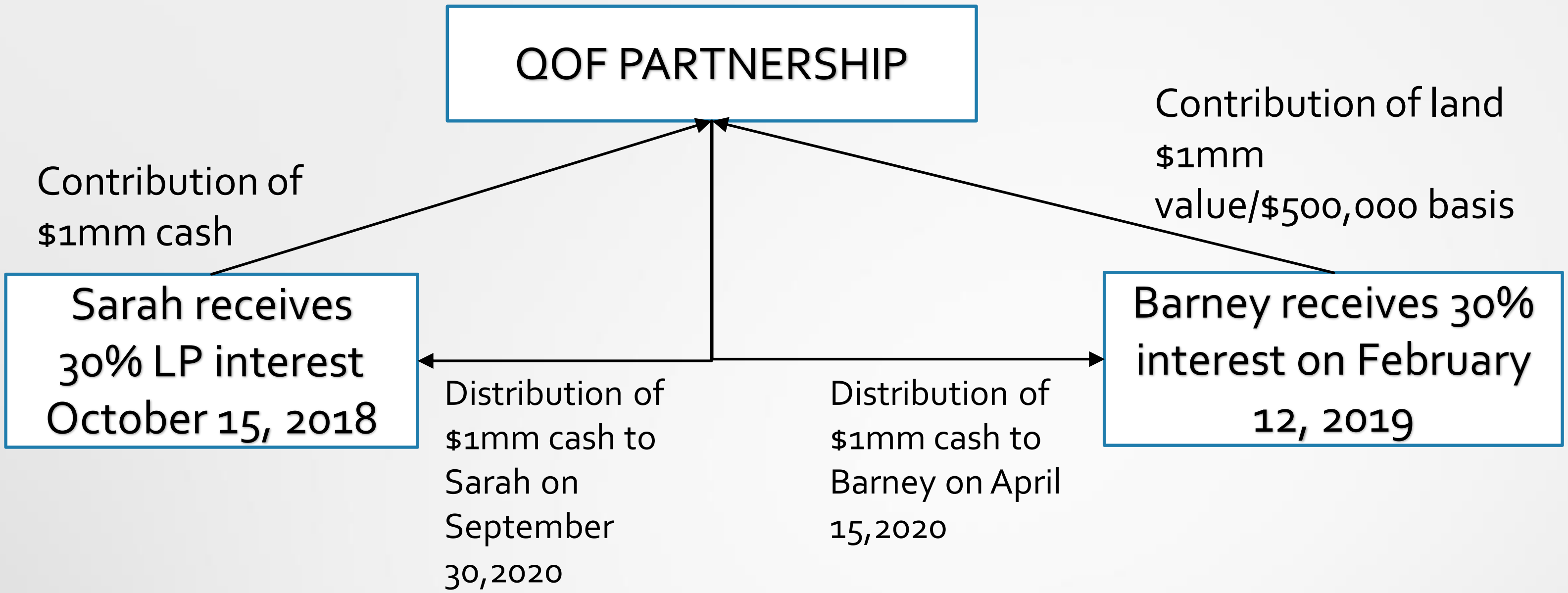
QOF Partnership began with 10 investors in 2017 contributing a total of $5M proportionally, in eleventh month of 2020, partner contributes cash of $500,000 to the QOF Partnership, and in third month of 2021,QOF Partnership redeems interest of third partner for $500,000.



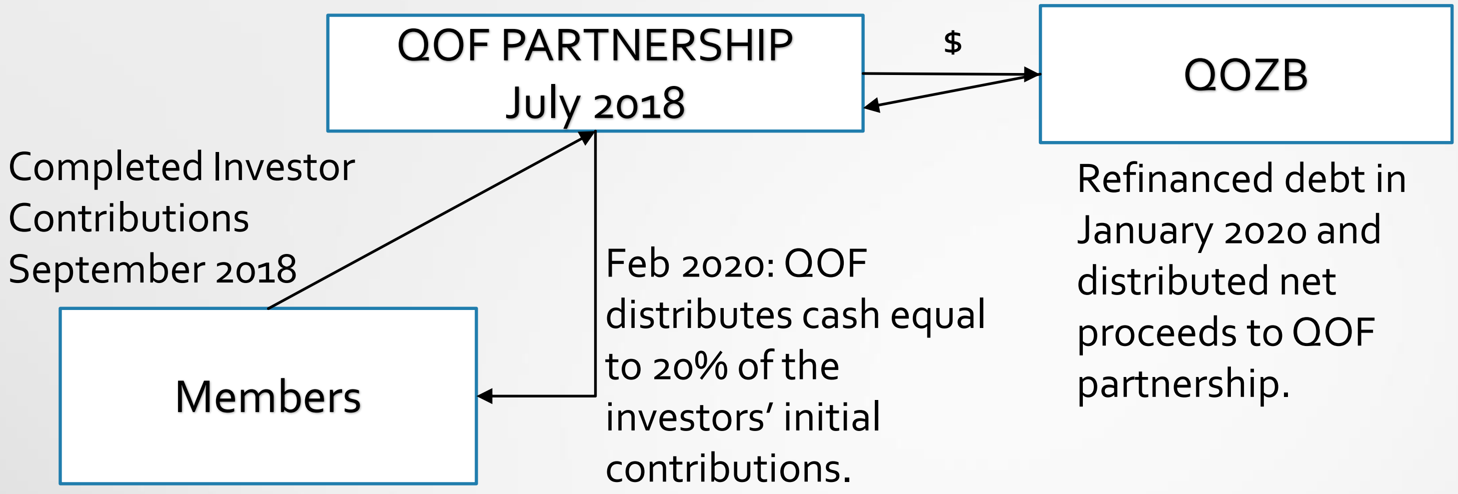
# Examples of Treas. Regulations on Disguised Sales at the QOF Partnership Level



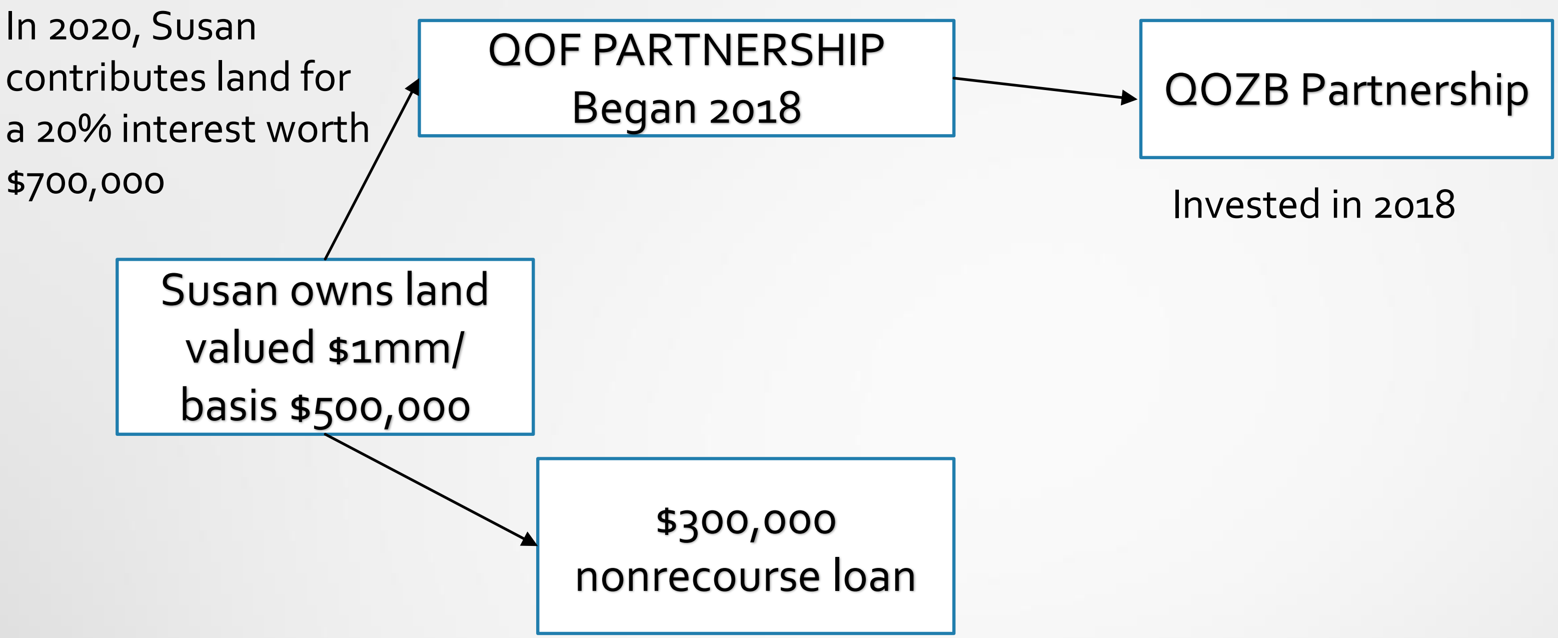

- Treas. Reg. Sec. 1.1400Z-2(a)-1(c)(6)(iii)(A)(2) will treat the cash contributed by Fred to the QOF partnership as noncash property so that the distribution of cash within a two-year period may be treated as part of a disguised sale of property by Fred to the QOF partnership, which would reduce the qualifying investment of Fred by $5,000 leaving Fred with a qualifying investment of $5,000.
- Critical question: Why did QOF partnership distribute $5,000 to Fred on 10/20/2020? - If the distribution is treated like part of a disguised sale under Treas. Reg. Sec. 1.1400Z-2(a)-1(c)(6)(iii)(A)(2), Fred will have to amend his prior returns to reflect the fact that he never held a qualifying investment greater than $5,000.




Treas. Reg. Sec. 1.1400Z-2(a)-1(c)(6)(iii)(A)(1) and Treas. Reg. Sec. 1.707-3 would treat the contribution of property by Barney as part of a disguised sale of the land to QOF partnership, and Barney would have no qualifying investment in QOF partnership. Sarah would have an inclusion event resulting from the redemption under Section 736(b), eliminating her qualified investment in the QOF partnership as of Sept. 30, 2020. Sarah may invest this inclusion amount ($1 million of gain) into a QOF, elect to defer tax on the gain, and receive a new qualifying investment in a QOF.




Assume the QOZB's debt refinancing and the distributions of the net proceeds occur pursuant to a strategy that was announced to the investors when they invested in QOF partnership. The qualifying investment of each partner of the QOF partnership would be reduced retroactively by 20%, because for purposes of Treas. Reg. Sec. 1.1400Z-2(a)-1(c)(6)(iii)(A)(2) the debt-financed distribution exception to the disguised sale rules does not apply.




Assume Susan's interest in excess nonrecourse liabilities of QOF partnership is 20%. If the mortgage debt was incurred in anticipation of the contribution, the QOF partnership is treated as transferring consideration to Susan to the extent the nonrecourse liability of $300,000 exceeds Susan's share of the liability of $60,000 (20% multiplied by $300,000) or $240,000. Therefore, the gain recognized by Susan is $120,000 ($240,000/$1,000,000 multiplied by $500,000). The portion of her contribution that is treated as a disguised sale is 24%. She is treated as contributing 76% of the land to the QOF. Her qualifying investment equals 76% of her basis in the land, making her qualified investment equal $380,000. Her non-qualified investment in the QOF is $320,000.

# Thank You

Gene Crick, Jr., Partner
Nelson Mullins Riley & Scarborough
gene.crick@nelsonmullins.com

Derek Kershaw, Counsel
Shearman & Sterling
derek.kershaw@shearman.com