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Qualified Opportunity Zones and Tax Credits: New IRS Proposed Regs, Capital Gain Deferral Mechanisms, Section 1400Z

IRC 45D(e) Requirements, Step-Up in Basis, Appreciation Exclusion, Tax Planning Strategies for Investors and More

THURSDAY, JULY 18, 2019

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

Today's faculty features:

Alan M. Blecher, JD, Principal, **Marks Paneth**, New York

Elizabeth C. Crouse, Partner, **K&L Gates**, Seattle

Michael I. Sanders, Partner, **Blank Rome**, Washington, D.C.

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Qualified Opportunity Zones and Tax Credits: New IRS Proposed Regs, Capital Gain Deferral Mechanisms, Section 1400Z

Presented by: Michael I. Sanders, Esq.
Blank Rome, LLP
sanders@blankrome.com

Thursday, July 18, 2019
1:00 pm-2:30 pm

Introduction

In April, 2019, the Treasury Department issued a second tranche of proposed regulations, which can generally be relied on by taxpayers. This additional guidance provides answers to many open issues related to the definition of substantially all, the use of qualified OZ business property, treatment of leased tangible property, the sourcing of gross income in a QOZ, a reasonable period for a QOF to reinvest proceeds from the sale of a qualifying asset without paying a penalty and various other topics. However, as with the case with the first set of regulations, there are still a number of unanswered questions (some of which the Treasury Department solicited additional comments on). Some of the key issues follow.

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Eligible Gains: Including Unrecaptured 1250 Gains

- Regulations say Eligible Gains generally are capital gain (long- and short-term) from actual, or deemed sale or exchange "or any other gain that is required to be included in a taxpayer's computation of capital gain."
- Look at K-1, unrecaptured 1250 gain is not ordinary income.
- Unrecaptured 1250 gain is taxed at 25% maximum capital gain rate, relevant to depreciation recapture.

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The 1231 Issue: Netting and Determination On The Last Day Of The Taxable Year (Penalty Box)

- Required to be netted with 1231 losses.
- Applies to partners not partnership, itself.
- Determinable only on last day of taxable year which triggers 180-day period for reinvesting – may impact 7 year holding period.
- No optionality.
- Need to receive all K-1s.
- Reinvestment may be stalled.

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Inconsistent Treatment of Gain After 10 Years: Hot Assets Depreciation Recapture

- **Equity Investor Sale of QOF Interest.** The Regulations clarify that, if an investor in a QOF that is taxed as a partnership (i.e., a QOF partnership) makes the FMV Basis Election upon its sale of QOF interests after 10 years:
  - The investor's basis in its qualifying investment in the QOF is adjusted immediately before the investor sells or exchanges such interest so that its basis equals the fair market value of such interest plus the investor's share of the QOF partnership's liabilities under section 752, and
  - The bases ("inside basis") of the QOF partnership's assets are also adjusted, solely with respect to such investor, in a manner similar to the adjustments that would have been made to the QOF partnership's assets if the investor had purchased the interest for cash equal to fair market value at the effective time of the FMV Basis Election and the partnership had a valid section 754 election in effect. (Assumes 754 election is in effect.)

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The effect of these rules is to eliminate any gain upon the investor’s sale or exchange of a qualifying investment after a 10-year holding period, regardless of whether the investor has used net losses due to depreciation and whether the investor has received leveraged distributions from the QOF.

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- **QOF Asset Sale: Hot Asset Issue.** The Regulations allow an investor in a QOF partnership interest to elect to exclude from gross income its allocable share (to the extent attributable to such investor's qualifying investment) of the capital gain from the disposition of QOZ property by the QOF partnership that is reported on a Schedule K-1, provided that the disposition occurs after the investor has a 10-year holding period in its qualifying partnership interest. This election to exclude amounts from gross income applies only to capital gains allocated or distributed to the QOF investor, and not to amounts characterized as ordinary income (such as depreciation recapture of 1245 assets (non-real property assets). This is in contrast to the direct equity interest sale described above. It is unclear whether this was intentional.

    CAVEAT: Also, it appears that this election applies only to gain from certain dispositions of assets by the QOF itself, and does not technically apply to gain recognized by a QOZB. It is unclear whether this was intentional.

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For Planning Purposes: Comparison of 1031 vs OZ Tax Benefits

- OZFP investments are not restricted to real estate, available to hedge funds.
- Section 1031 deferral to be permanent, basis-step up at death.
- While OZ allows permanent basis step-up (without need to die) if held for 10 years.
- OZ option available for “busted” 1031.
- OZ may do a 1031 rollover, but “substantial improvement” test would likely need to be satisfied.

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Advantages of Leasing Properties by Related Parties

- The Regulations provide specific rules for leased property as follows:

(i) The leased tangible property must be acquired under a lease after December 31, 2017;

(ii) Substantially all of the leased tangible property must be used in a zone during substantially all of the holding period; and

(iii) The leased property does NOT need to meet the original use or substantial improvement requirements but must be a market rate lease.

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If the ground lease is provided at a discount and is not market rate, it will not qualify as OZBP. But so long as its aggregate value does not represent more than 30 percent of total value of all of the tangible assets that the entity owns or leases, it will meet the OZBP requirements.

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Further, Treasury allows the leased property to be acquired from a <u>related lessor</u> (owned before 2018). Treasury introduces a few anti-abuse rules for leases between related parties.

(i) No prepayments are allowed for more than a 12-month period; and

(ii) If the original use of leased tangible <u>personal</u> property in a QOZ does not commence with the lessee, the lessee must become the owner of tangible property that is QOZ business property having a value not less than the value of that leased tangible personal property.

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The regulations also provide guidance for valuing leased tangible property. The taxpayer may either use the applicable financial statement valuation method on an annual basis or use an alternative valuation method which is based on the present value of future lease payments.

As between related parties, it is important to examine the term of the lease:

(i) If the term of the lease is too long, in that it exceeds the useful life of the building, it may be considered a "purchase" for tax purposes thereby triggering the "substantial improvement" requirement in order to be a QOZP or treated as a sale between related parties (and fail the 70 percent test as non-QOZP property).

(ii) However, the longer the term of the lease, the greater the value of the property. And the more potential appreciation that may be excluded from tax on sale after the 10-year hold.

CAVEAT: Any improvements made by a lessee to leased tangible property should satisfy the original use (70 percent test). (The improvements will revert to the ground lessor at the end of lease term.)

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Active Business/Triple Net Lease/Land Banking Limitation

The regulations provide that leasing real property used in a trade or business is treated as the active conduct of a trade or business for purposes of Section 1400Z-2 but stipulate that "merely" entering into a triple-net lease is not considered an active trade or business.

Problem since many industrial leases are NNN. So, need leasing activity that rises beyond "merely" in a NNN lease scenario such as advertising, management and operation of the leased property, etc. (see NMTC – gross income within 3 years).

CAVEAT: Is the leasing of personal property an active trade or business when the leasing involves substantial costs or services, is conducted with regularity and continuity, and the purpose is to generate a profit?

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Provide a look-through to the ultimate tenant with regards to commonly controlled master leases such as HTC master leases.

Incorporate by reference Notice 2006-77 (related to "Go Zone"):

(i) "meaningfully participates (through the activities performed by itself, or by others on behalf of the partnership, limited liability company, or S corporation, respectively) in the management or operations of the trade or business."

(ii) Private Letter Ruling 201618008 (an operating lease is not triple net).

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Treatment of Unimproved Vacant Land

- The proposed regulations require property to be unused for an uninterrupted period of at least 5 years to be considered original use when acquired by the QOF or QOZB. So it does not need to satisfy the substantial improvement requirement.
  - placed in service date
  - asset by asset test (no aggregation)
- An uninterrupted 5-year vacancy period is unnecessarily lengthy and will deter eligible investors from investing in property vacant less than 5 years even when the investment would improve the locality as otherwise intended. Recent studies indicate that the longer a property is vacant, the more significant the negative impact (such as declining property values and increased crime rate) is to the surrounding community.

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- The unimproved land is required to be used in a trade or business of the QOF or QOZB (see Section 162). However, the anti-abuse rules may require the transaction to be recast to treat the land as non-QOZP.
- Note, the land acquisition rules do not apply where the QOF or QOZB acquires the land with the expectation, intention or view not to improve the land by more than an "insubstantial amount" within 30 months. ("Insubstantial" is not defined for this purpose.) It may be difficult to satisfy if it is to require 100 percent of the acquisition price!

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QOZB/Advantages of Two Tier Structure/Working Capital Safe Harbor

- It may be advantageous for the QOF to invest through a second-tier QOZB sub, which may not be a disregarded entity.
- To get the benefit of the 63% qualifying asset rules (as opposed to 90% at QOF tier).
- To take advantage of 31 month safe-harbor.

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The regulations did make two changes to the safe harbor for working capital. First the written designation for planned use of working capital now includes the development of a trade or business in the qualified opportunity zone as well as acquisition, construction, and/or substantial improvement of tangible property.

Second, exceeding the 31-month period does not violate the safe harbor if they delay is attributable to waiting for government action the application for which is completed during the 31-month period.

Third, the regulations also provided clarity that business may benefit from multiple overlapping or sequential applications of the working capital safe harbor.

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July 18, 2019

Opportunity Zone Investing: Practical Points of Updated Regulations

Elizabeth Crouse, K&L Gates LLP
Elizabeth.Crouse@klgates.com

Structuring impacts

- Corporation v. Partnership: More things to think about
  - Depreciation recapture
    - Difference between 1250 and 1245 recapture
    - Better off with just a basis step up on stock?
  - Acceleration (“inclusion”) events
    - Contributions of equity: 721 v. 351
    - Reorganizations
  - Cash flow management
    - Disparity between corporations and partnerships in regard to basis impact of depreciation deductions
      - Capital gain rate is the same
      - But partnership uses 200% and corporate E&P uses SL (even if corporation uses 200% for deduction)
      - Consequence: can withdraw more cash from corporation without triggering an inclusion event

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Structuring impacts

- Corporation v. Partnership: More things to think about
  - Material differences on exit
    - Sell OZ Fund interests
    - OZ Fund sells OZ Business interests
      - 751?
    - OZ Business sells its assets

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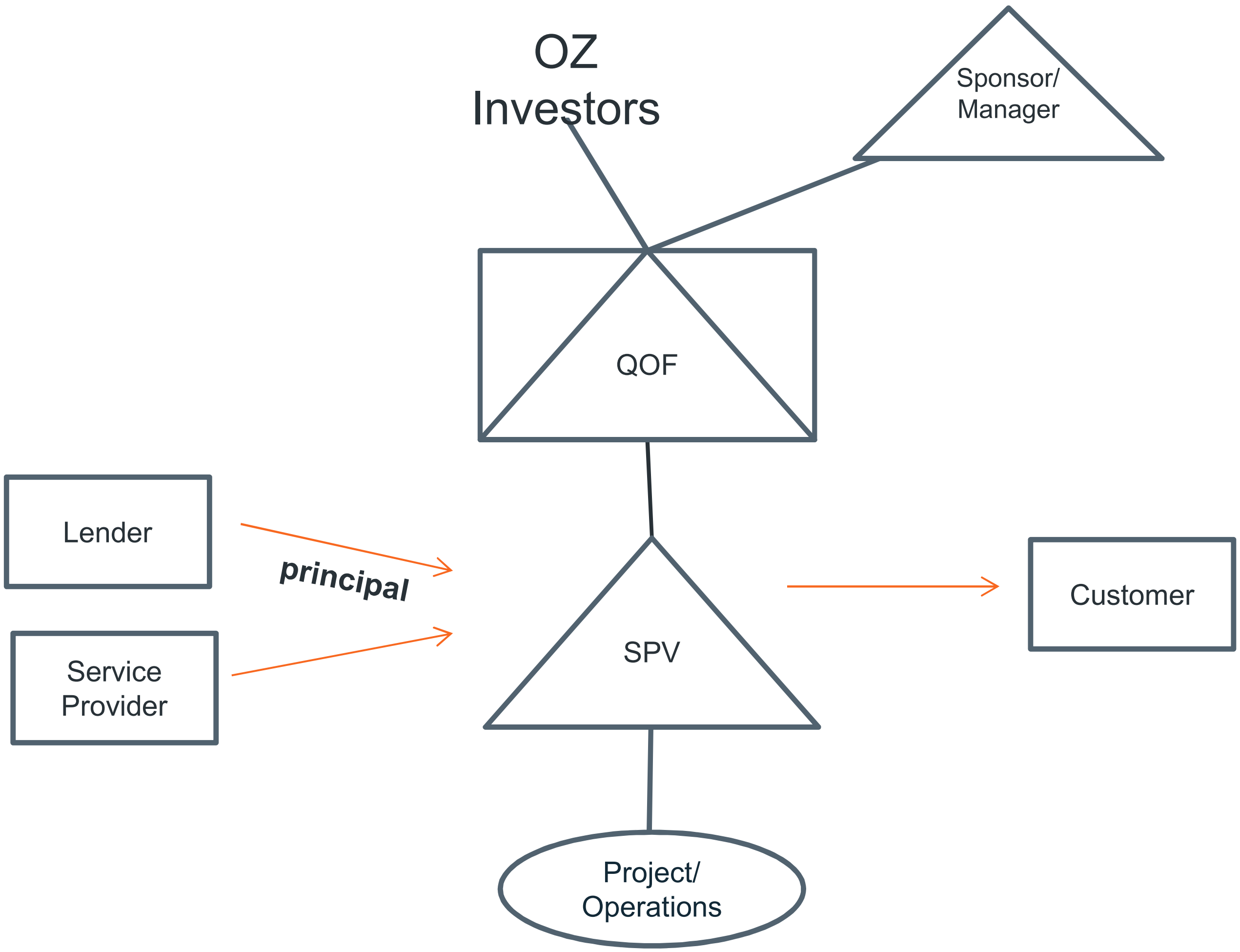
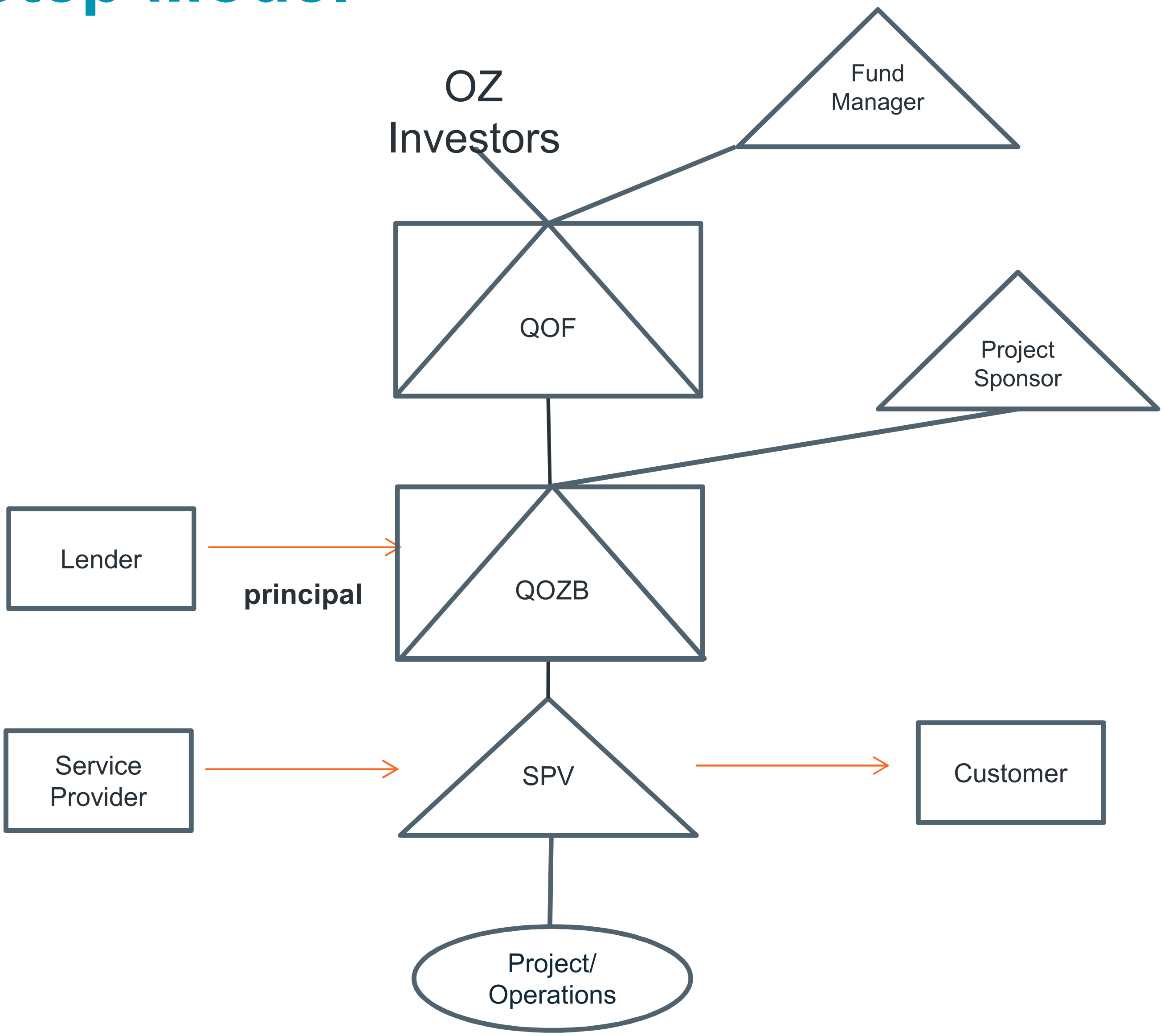
Direct Investment



Two-Step Model



Operation of OZ Business

- Must be an OZ Business at least 90% of the time that OZ Fund owns equity
- What's an OZ Business?
  - An active trade or business, provided that at least 70% of its tangible property be qualified OZ property
  - Qualified OZ property is tangible property that is acquired from an unrelated person after 12/31/2017 and that is either new or substantially improved within 30 months. It must be used at least 70% of the time in the OZ for at least 90% of the time the OZ Business holds that property.
  - Qualified OZ property may be leased
    - No requirement for leased property to be new
    - No requirement for leased property to be substantially improved
    - Related party leases are okay, but restrictions on prepayments and options to acquire

Operation of OZ Business

- What's an OZ Business? (Cont'd)
  - At least 50% of its gross income must be derived from an active trade or business in the OZ**
    - Three safe harbors based on:
      - (1) hours worked by employees and contractors inside v. outside the OZ;
      - (2) compensation paid to employees and contractors for work inside v. outside the OZ; and
      - (3) combination of location of tangible property used in the active trade or business of OZ Business and location of management or operational functions
    - If safe harbors are unavailable, then may meet standard based on applicable facts and circumstances

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Operation of OZ Business

- At least 40% of intangible property must be used in the active trade or business in the OZ**
  - Not clear what this means
- Less than 5% of its assets may be debt, equity interests, and certain passive investments; exceptions for reasonable amounts of working capital**
- If time is needed to stand up OZ Business' operations, it must have a written "working capital plan" for deployment of capital invested by OZ Fund during the 31 months following the OZ Fund's investment in OZ Business. Capital *must* be used to develop OZ Business' active trade or, as described in working capital plan.
  - May have multiple working capital plans for multiple tranches of capital
  - Gross income, intangible property, and cash limitations (marked **) are deemed satisfied during working capital plan period if working capital plan meets requirements

Considerations for Operators

- Although the gross income requirement is effectively suspended during the 31-month working capital plan period, it will be important to ensure that sufficient work is done by employees ***and*** independent contractors of OZ Business in an OZ following that period.
  - To reflect different timelines, multiple working capital plans may be created for multiple tranches of capital. Consider segregating relevant capital and operations into separate limited liability companies that are *wholly* owned by OZ Business.
  - Work performed outside the United States is work performed outside of an OZ.
  - Work performed by employees or contractors located in an OZ anywhere in the United States will be helpful.

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Considerations for Operators

- OZ Business must create monitoring mechanisms to ensure that:
  - During working capital plan period, OZ Business deploys capital in accordance with working capital plan;
  - Requirements concerning gross income generation, use of intangibles, and limitations on cash and similar assets are met at all times outside of a working capital plan period; and
  - At least 70% of OZ Business' tangible assets are used in an OZ at least 90% of the time that an OZ Fund holds an interest in OZ Business.
  - But no reporting mechanism yet
- Consider qualification AND valuation impact on operation of multiple business lines by OZ Business
  - Ensure ongoing qualification during OZ Fund holding period
  - OZ investors still expect at least some appreciation in value after 10 years so that they recognize material ROI after tax savings

Considerations for Operators

- What does the OZ Business' term sheet look like?
  - Acquisition by OZ Fund of *equity* (preferred?) issued by OZ Business
    - Anticipate that investors will want a right to preferred return of capital, plus a multiple upon conversion or liquidation? Or, are tax benefits enough?
  - Conversion into parent equity? (What is an inclusion event?)
    - Expect OZ Fund to dictate terms of conversion based on its interpretation of the Regulations and OZ Fund's legal structure because conversion should be an otherwise *taxable* transaction
  - Should expect to be required to make at least commercially reasonable efforts to cause OpCo to qualify as an OZ Business at all relevant times
    - Some investors may demand that a fund sponsor guarantee that obligation.
  - Other standard terms of equity issuance
    - Voting rights, control, board presence, etc.

Considerations for Operators

- How will property be moved to OZ Business?
  - Transfer or license any intangible assets owned by parent or affiliated company to the extent needed
  - Monitor relative value of any tangible assets transferred to OZ Business to ensure that at least 70% of OZ Business' assets are qualified OZ property (which generally must be acquired from unrelated persons)
    - Intangible property is not subject to this restriction
- When to call capital?
  - Within six month period specified by OZ Fund (this time period will vary depending on the facts applicable to the relevant OZ Fund)

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Considerations for OZ Fund Managers

- Multi-asset funds
  - In general, multiple OZ Businesses may be held by one OZ Fund
  - Consider likely form and time horizon of exit
    - Now clear that an OZ investor can enjoy benefit of 10 year basis step up upon OZ Fund's disposition of OZ Business equity
    - Ensure clear allocation of OZ investor's contributions to OZ Fund and OZ Fund's relative allocation to various OZ Businesses

MARKS PANETH

ACCOUNTANTS & ADVISORS

Section 1400Z-2
Opportunity Zones
Selected Tax Accounting Issues
Proposed Regulations – Round 2

July 18, 2019

Al Blecher, JD

ablecher@markspaneth.com

Selected Tax Accounting Issues

- Many QOFs will be taxed as partnerships. Under the general partnership tax accounting rules, a partner’s basis in its partnership interest is equal to the partner’s initial capital contribution to the partnership, and is subsequently increased by its distributive share of the partnership’s income and decreased (but not below zero) by distributions by the partnership to the partner and the partner’s distributive share of the losses of the partnership

- Section 752 provides that if the partnership incurs debt, the partner’s share of the debt allocated to it under the special rules pertaining to such allocations is deemed to be a contribution by the partner to the partnership; a decrease in the amount of debt allocated to the partner is deemed to be a distribution by the partnership to the partner

Tax Accounting (continued)

- However, the QOF rules state that "except as otherwise provided" therein, the taxpayer's basis in its eligible-gain investment shall be zero

- The statutory otherwise provided exceptions to the zero basis rule are that basis is increased by 5-year, 7-year, December 31, 2026 and 10-year sale adjustments

- The October 2018 proposed regulations provide that the Section 752 partnership basis increase is not a partner contribution of money that is subject to the mixed investment bifurcation rules for non-gain QOF investments. The April 2019 proposed regulations clarify that the investor nevertheless generally receives the corresponding tax basis increase in the QOF interest. This may allow the investor to received debt-financed distributions or use allocations of tax losses. There is a modified disguised sale rule (2 year rule) for distributions. (Caveat: An actual or deemed distribution of cash or other property with a fair market value in excess of the partner's basis in its qualifying QOF partnership interest is an *inclusion event*)

Tax Accounting (continued)

- Under general partnership tax accounting rules, when a partner's basis is increased due to the allocation of partnership debt, and this leveraged basis is used to support the deduction of partnership losses and/or the receipt of debt-financed distributions, such cumulative leveraged losses and distributions are "recaptured" into income via the inclusion of the liabilities in the amount realized upon the disposition of the partnership interest

- The April 2019 proposed regulations clarify that, with a QOF taxed as a partnership, when the QOF investor makes the FMV Basis Election upon the sale of its QOF interest after 10 years: (a) The investor's basis in its qualifying investment in the QOF is adjusted immediately prior to the sale or exchange, so that its basis equals the fair market value of such interest plus the investor's share of the QOF's liabilities under Section 752, and (b) The bases of the QOF's assets are also adjusted, solely with respect to such investor, in a manner similar to the adjustments that would have been made to the QOF's assets if the investor had purchased the QOF interest for cash equal to the fair market at the time of the FMV Basis Election and the QOF had a valid Section 754 election in effect

Tax Accounting (continued)

- The impact of these rules is to eliminate any gain upon the investor's sale or exchange of its QOF interest after the 10 year holding period, regardless of whether the investor has deducted net losses allocated by the QOF and/or received debt-financed distributions. Also, the creation of offsetting capital losses and ordinary income items under the technical partnership tax rules is avoided

- The April 2019 proposed regulations confirm that an investor may contribute property in exchange for an interest in a QOF. With a tax-free (Section 721) contribution of appreciated property, the investor is treated as making an eligible-gain investment (qualifying for the OZ benefits) equal to the adjusted tax basis of the property in its hands immediately prior to the contribution. The investor is also treated as making a non-eligible gain investment equal to the unrealized appreciation in the property. It is not clear how useful this provision is, since a property contribution is generally not treated as an acquisition by "purchase" for purposes of the OZ property rules

Tax Accounting (continued)

- The second round of proposed regulations provide two special rules that treat a taxpayer as having a mixed-funds investment. First, this will result if an investor contributes to a QOF, in a nonrecognition transaction, property that has a fair market value in excess of the property's adjusted tax basis (as per the above). Second, a mixed-funds investment will result if the amount of the investment exceeds the amount of the taxpayer's eligible gain. In each instance, that excess (that is, the excess of fair market value over adjusted basis, or the excess of the investment amount over eligible gain, as appropriate) is treated as the portion of the investment ineligible for the OZ benefits

- A QOF partnership interest received in exchange for services (for example, a carried interest) is likewise not eligible for the OZ benefits (even if all of the partnership's investments are qualifying investments). (Some commentators suggest that a fund manager may be allowed to benefit from the 10 year gain exclusion election made by an upper-tier partnership in which the fund manager holds a carried interest)

Tax Accounting (continued)

- The second round of proposed regulations adopt the approach that a partner holding a mixed-funds investment will be treated as holding a single partnership interest with a single basis and capital account for all purposes of *subchapter K* (the partnership taxation provisions), but *not* for purposes of *Section 1400Z-2*

- *Solely* for purposes of Section 1400Z-2, a mixed-funds partner will be treated as holding two interests. All partnership items, such as income and debt allocations and property distributions, affect qualifying and non-qualifying investments proportionately, based on the relative allocation percentages of each interest. Allocation percentages would generally be based on the relative capital contributions for the qualifying and non-qualifying investments. Special rules apply to a partner who receives a profits interest for services, with the percent attributable to the profits interest being treated as a nonqualifying investment to the extent of the highest percentage interest in residual profits attributable to the interest

Tax Accounting (continued)

- Consistent with the general unitary basis rules of subchapter K, a distribution of money would not result in gain under Section 731(distribution in excess of basis) unless it exceeds the partner's total basis in its partnership interest. Example: Partner contributes $200 to a QOF partnership, half of which is eligible gain, and $20 of partnership debt is allocated to the partner. Its total basis is $120 (zero for the qualifying investment, plus $100 for the non-qualifying investment and $20 under Section 752(a)). Only a distribution of money in excess of $120 triggers gain under subchapter K

- *However*, for purposes of Section 1400Z-2, the qualifying investment portion of the interest would have a basis of $10, with the remaining $110 attributable to the non-qualifying investment. A distribution of $40 is divided between the two investments and would not result in gain under Section 731. But it would constitute an inclusion event under Section 1400Z-2, and the partner is required to recognize gain in the amount of $10 (the excess of the $20 distribution attributable to the qualifying investment over the $10 basis in the interest)

Tax Accounting (continued)

- Under the October 2018 proposed regulations, an investor could claim the 10 year gain exclusion only by selling its interest in the QOF. The April 2019 proposed regulations provide that if a QOF sells a directly owned Opportunity Zone property, the allocated capital gain can be tax-free to the investor, if it has held its interest in the QOF for the 10 year holding period. However, unlike most other rules in the second round, taxpayers are not permitted to rely on this particular proposed rule until it is finalized.

- The rule for exempting gain at the QOF level applies only to capital gain from the disposition of qualifying property. Therefore, it does not by its terms apply to any ordinary income recognized (such as depreciation recapture for personal property) nor to any gain recognized with respect to assets that do not qualify under the 90% test

- In the “two tier” structure, this exemption applies to gain that the upper tier QOF recognizes from selling interests in the lower-tier entity, but it does not appear to apply to gain recognized by the lower-tier entity from selling its assets