# QUALIFIED OPPORTUNITY FUNDS

# AMBIGUITIES AND UNCERTAINTIES


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# Partnership Issues

- There is significant uncertainty regarding the interplay between Subchapter K and the Qualified Opportunity Fund ("QOF") provisions.
- It is unclear whether and to what extent the Section 705(a) partnership basis computation rules apply to a QOF classified as a partnership.
- Section 1400Z-2(b)(2)(B)(i) provides that a taxpayer's basis in a QOF investment is zero except for the 10% basis increase for deferred gain after five years, the additional 5% basis increase after seven years, and the basis increase to fair market value after ten years.



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# Partnership Issues

- Under Section 705(a), a partner's adjusted basis in a partnership is increased by his distributive share of the partnership's taxable income, and decreased by his distributive share of partnership distributions and losses.
  - Under Section 752, any increase in a partner's share of partnership liabilities is treated as a cash contribution to the partnership which increases the partner's tax basis in the partnership, and any decrease in a partner's share of partnership liabilities is considered as a cash distribution to the partner by the partnership.



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# Partnership Issues

- If the Section 705(a) basis computation rules do not apply to a QOF because of Section 1400Z-2(b)(2)(B)(i), and a partner's basis is not increased for his distributive share of partnership income, then income derived by the QOF would be subject to double taxation, thus vitiating the tax incentive nature of the QOF.



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# Partnership Issues

## Section 704(d) – Partnership Loss Limitation Rule

Under Section 704(d), a partner's distributive share of partnership losses cannot exceed his adjusted basis in the partnership at the end of the partnership year in which the loss occurred. If the Section 705(a) and 752 basis rules do not apply to a QOF, then QOF losses may be suspended.



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# Partnership Issues

- Commenters have asked the IRS and Treasury to confirm that the Section 705(a) and 752 basis computation rules apply to a QOF partnership, and that Section 1400Z-2(b)(2)(B)(i) merely provides for an original zero basis for the contribution of rollover tax-deferred gain.



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# Partnership Issues

- Should the ten-year basis increase reflect the "gross fair market value" of QOF assets, to account for partnership liabilities, or "net fair market value"? If the Gain Exclusion Election increases basis to "net fair market value" (i.e., the net equity value of the QOF interest), the taxpayer may recognize gain in connection with an ultimate sale, because the amount realized would include his share of partnership liabilities. If outside tax basis in the QOF is increased to "gross fair market value," then the taxpayer should not recognize gain or loss in connection with an ultimate sale.



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# Partnership Issues

- The Gain Exclusion Election should arguably increase basis to reflect "gross fair market value," in light of the fact that under the proposed regulations, a deemed contribution of money under Section 752(a) does not result in the partner having a separate investment under Section 1400Z-2(e)(i). See Proposed Regulation Section 1.1400Z-2(e)(1)(a)(2).



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# Partnership Issues

- Assume that a QOF partnership holds depreciable personal property. How would Section 751 apply following the ten-year basis step-up?
    - Would the increase in outside tax basis trigger a correlative increase in inside tax basis, or would the taxpayer recognize ordinary income (in connection with the sale of Section 751 "hot assets") and a corresponding capital loss?



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# Partnership Issues

## Debt-Financed Distributions from a QOF Partnership

- Even if the IRS and Treasury confirm that Sections 705(a) and 752 apply to a QOF partnership, it is unclear whether a debt-financed distribution to a QOF partner would be treated as a sale or exchange of the QOF investment under Section 1400Z-2(b)(1)(A), thus triggering the recognition of gain.
  - While it is uncertain whether a QOF partnership can refinance its debt and distribute the proceeds on a tax-free basis to its owners, Proposed Regulation Section 1.1400Z-2(a) -1(b)(3)(ii) allows an eligible taxpayer to pledge its equity in a QOF partnership as collateral for a loan.



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# Partnership Issues

- If a partnership does not make a deferral election, can a partner make a deferral election with respect to his distributive share of the partnership's gross capital gains, and carry forward his distributive share of the partnership's gross capital losses?
- Can the holder of a profits interest qualify for the ten-year basis step-up by contributing some capital gain proceeds to the QOF partnership?



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# Partnership Issues

## Non-Pro Rata Distributions

- Section 1400Z-2(e)(4)(c) allows the IRS to issue anti-abuse regulations. These regulations may possibly limit non-pro rata waterfalls with respect to a QOF partnership.



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# Partnership Issues

## Interplay Between Section 704(c) and QOF Provisions

- There is uncertainty regarding the interplay between Section 704(c) and the QOF provisions. Assume that (1) a QOF partnership owned equally by x and y realizes $100 of capital gain in connection with the sale of an asset; (2) the asset was previously contributed to the partnership by x with $80 of built-in gain under Section 704(c); and (3) the partnership elects to defer the recognition of gain pursuant to Proposed Regulation Section 1.1400Z-2(a)-1(a). Query whether the deferred gain would be allocated equally to the partners or disproportionately to x, thus reflecting Section 704(c).



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# Partnership Issues

## Interplay Between Section 704(c) and QOF Provisions

- It is unclear how the "cost" of property is determined for purposes of the 90%-asset test where (1) the property is contributed to the QOF in a non-recognition transaction under Section 721; (2) the fair market value of the property on the date of contribution is greater than its tax basis; and (3) the QOF does not have "applicable financial statements," within the meaning of Regulation Section 1.475-4(h).
  - Commenters have recommended that "cost" in such a case should reflect the asset's Section 704(b) book value (i.e., its contributed value).



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# Working Capital Safe Harbor

- The 31-month working capital safe harbor appears to apply only to a "Qualified Opportunity Zone Business," i.e., a subsidiary corporation or partnership owned by the QOF, and not to a QOF directly investing in real estate or business assets.
  - It is uncertain whether Congress intended to make this distinction between single-tier and two-tier structures. Commenters have recommended that the working capital exception should apply to both single-tier and two-tier structures.



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# Working Capital Safe Harbor

- A QOF that fails to meet the 90%-asset test is generally subject to a monthly penalty, see Code Section 1400Z-2(f)(1), unless the failure is due to "reasonable cause," see Code Section 1400Z-2(f)(3).
    - Assume that a QOF intends to satisfy the 31-month working capital safe harbor, but fails to do so. Would the entity be treated as never having qualified as a QOF, or would the "reasonable cause" exception limit the potential downside risk?
- Should the 31-month working capital safe harbor be expanded beyond real property development to fund operating costs of a new business?



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# Loss Attributable to Basis

- Deferred gain is includible in income on December 31, 2026 (or the earlier date of sale), in an amount equal to the excess of (1) the lesser of (i) the deferred gain and (ii) the fair market value of the investment over (2) the taxpayer's basis.
    - Assume that a taxpayer invests $1,000 of deferred gain in a QOF, his tax basis is increased to $150 after seven years, and the investment becomes worthless. Would the taxpayer be allowed to claim a $150 loss?



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# Qualified Opportunity Zone Business ("QOZB")

## Income Source Rule

- To qualify as a QOZB, Section 1397C(b)(2) must be satisfied, which requires that "at least 50 percent of the total gross income of such entity is derived from the active conduct of such business."
- The proposed regulations are far more restrictive, by requiring that at least 50 percent of gross income must be derived from the active conduct of a trade or business within a Qualified Opportunity Zone (a "QOZ"). Proposed Regulation Section 1.1400Z-2(d)-1(d)(5).



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# Death of Taxpayer Owning Interest in a QOF

- It is uncertain what happens if a taxpayer dies while holding an interest in a QOF. Would the taxpayer's heirs receive a tacked holding period for purposes of the five-year and seven-year basis step-ups and the ten-year appreciation exclusion?



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# Consolidated Group

- Will an “eligible taxpayer” include all members of a consolidated group as a single taxpayer when any member recognizes “eligible gain”?



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# Availability of Basis Step-up in Connection with Asset Sale by QOF

- Will the benefits of the ten-year basis step-up election be available where the ultimate disposition of the investment is structured as a sale of assets by the QOF, as opposed to the sale of the QOF investment by the taxpayer?
  - What about a redemption of the partnership interest?



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# Multi-Tiered Entities

- Section 1400Z-2(d)(2)(A) defines “Qualified Opportunity Zone Property” to mean QOZ Stock, a QOZ Partnership Interest, or QOZ Business Property. In the case of QOZ Stock and a QOZ Partnership Interest, such entity must conduct the QOZ Business. It is unclear whether a QOZ Stock company or a QOZ Partnership can own a subsidiary entity.



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## Classification of Rental Real Estate as a "Trade or Business"

- The term "trade or business" appears in Section 1400Z-2 twice. Under Section 1400Z-2(d)(2)(D)(i), the term "Qualified Opportunity Zone Property" is defined as "tangible property used in a trade or business of the QOF if… ." Section 1400Z-2(d)(3)(A) defines the term "Qualified Opportunity Zone Business" as a "trade or business in which …_____." The statute and the regulations do not define the term "trade or business" for QOF purposes.



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## Classification of Rental Real Estate as a "Trade or Business"

- It is unclear whether real estate leased under a triple net lease would be treated as a "trade or business" for QOF purposes.
- Similar uncertainty arises under Sections 199A and 163(j). For Section 199A purposes, IRS Notice 2019-07 sets forth a safe harbor under which a rental real estate enterprise will be treated as a "trade or business," but real estate leased under a triple net lease is not eligible for the safe harbor.
- Query whether the "trade or business" standards that apply under Sections 199A and 163(j) also apply for QOF purposes.



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**Reinvestment of Deferred Gain –**

If a taxpayer reinvests deferred gain in a second QOF in a tax-deferred transaction (see Proposed Regulation Section 1.1400Z-2(A)-(1)(B)(4)(ii), Example 4), it is uncertain whether the five-, seven-, and ten-year basis step-up holding periods would be tacked from the date of the original investment or restart from the date of the second QOF investment.



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## Do Limitations Regarding a "Qualified Opportunity Zone Business" Apply to a QOF that Directly Owns the QOZ Business Property?

It is uncertain whether the limitations imposed on a "Qualified Opportunity Zone Business" under Section 1400Z-2(d)(3)(A)(ii) and (iii) apply to a QOF that directly owns the QOZ Business Property under Section 1400Z-2(d)(2)(D).



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## Interplay Between Like-Kind Exchange and QOF Provisions

It is uncertain whether tax-deferred gain under Section 1031 could be reinvested in a QOF following the sale of Section 1031 replacement property.



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## Section 1231 Gains

- Gain is generally eligible for tax deferral if it is treated as capital gain. See Proposed Regulation Section 1.1400Z-2(a)(1)(b)(2). Under Section 1231, gains from the sale of business property held for more than one year are treated as long-term capital gain if the Section 1231 gains exceed the losses from the sale of Section 1231 property during the taxable year. If the Section 1231 losses exceed the Section 1231 gains for the taxable year, then the gains and losses are treated as ordinary in nature.
- A taxpayer who recognizes Section 1231 gain in the middle of the taxable year may not be able to determine whether the gain will ultimately be characterized capital gain or ordinary income.

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