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An In-Depth Guide To Latest Opportunity Zone Regs: Part 1

By **Marc Schultz** (June 14, 2019, 1:22 PM EDT)

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On April 17, 2019, the United States Department of the Treasury released a second tranche of proposed regulations with respect to the opportunity zone provisions set forth in Section 1400Z-2 of the Internal Revenue Code of 1986, as amended, as it relates to the federal qualified opportunity zone incentive.

The release of the second tranche could not arrive soon enough. Many investors have been anxiously waiting on the sidelines for this guidance. The big question to be answered now is whether the second tranche provided enough certainty to unleash this capital.

The second tranche is 169 pages of extremely technical content and takes the approach that the opportunity zone provisions are really layered upon other provisions in the code. This means that one needs to have a good understanding of general provisions in the code such as the Subchapter K rules in order to fully analyze a transaction involving the opportunity zone incentive. This is certainly good news for tax professionals — as they remain in high demand — partly due to the Tax Cut and Jobs Act of 2017.

There will be a public hearing on July 9, 2019, with respect to the second tranche. Comments are due no later than July 1. The **first tranche** of proposed regulations was issued on Oct. 19, 2018 and has not been finalized. So, it is possible that all of the tranches of the proposed regulations will be finalized at the same time.

The following is Part 1 of an analysis of the second tranche. This article focuses on transactions involving qualified opportunity funds formed as partnerships rather than corporations and explores the second tranche's impact upon investors. Any references in this article to partnerships refer to entities taxed as partnerships for federal income tax purposes such as limited liability companies and limited partnerships with two or more equity holders.

Part 2 of this article will focus on the provisions in the second tranche that pertain to the compliance requirements for qualified opportunity funds, clarification regarding the requirements for an asset to be qualified opportunity zone business property, the new rules for leases of real and tangible personal property, the new rules with respect to the requirements for qualified opportunity zone businesses (which includes operating businesses) and the special rules with respect to real estate.

Three Tax Benefits

The opportunity zone incentive provides three primary income tax incentives to eligible taxpayers who invest in a qualified opportunity fund, or a QOF, as defined in Code Section 1400Z-2(d), and meet certain requirements.

First, an eligible taxpayer may elect to defer recognition to a date that is no later than Dec. 31, 2026, on some or all of its eligible gains to the extent that the taxpayer timely invests in a QOF. From a timing standpoint, the eligible taxpayer must generally invest in a QOF within the 180-day period beginning on the date of the sale or exchange of the asset generating the eligible gain (taking into account special rules when an eligible gain is generated by a pass-through entity or from capital gain net income related to a sale of property described under Code Section 1231). An eligible taxpayer still needs to make an election to defer the eligible gain.

Second, to the extent that the eligible taxpayer's holding period in the investment in the QOF with respect to the deferred gain is at least five to seven years on or prior to the deferred gain recognition date (defined below), the amount of the deferred gain to be included in income on the deferred gain recognition date (defined below) may be reduced by up to 15% of the deferred gain (i.e., 10% for five years and an additional 5% for seven years).

The third major benefit of the incentive occurs when the eligible taxpayer holds an investment in the QOF related to the deferred gain for at least 10 years. In such a case, the eligible taxpayer may make an election to increase the income tax basis of his or her investment (which is zero at the time that such investment is made) in the QOF to the investment's fair market value on the date of a sale or exchange of such investment, thereby eliminating any taxable gain (the "10-Year Benefit"). The second tranche expanded the 10-year benefit in a very taxpayer-friendly manner and is discussed later in this article.

Gains From Section 1231 Property

The second tranche provides that with respect to property described in Code Section 1231, only the capital gain net income for a taxable year from 1231 property is considered to be eligible gain for purposes of the opportunity zone incentive. Section 1231 property effectively means either depreciable property held for more than one year that is not inventory or real property held in a trade or business for more than one year. This means that a taxpayer needs to determine the net amount of 1231 gains in a taxable year by taking into account the 1231 gains and the 1231 losses for such year. Effectively, this would not be known until the end of the taxable year. The second tranche provides that the 180-day period for the net 1231 gain begins on the last day of the taxable year.

This provision has caused some controversy because it is possible that an eligible taxpayer could miss an opportunity to invest in a QOF in the same taxable year in which the 1231 gain is incurred as a result of requiring the eligible taxpayer to wait until last day of the taxable year to commence his or her 180-day period. It is expected that upcoming comment letters regarding the second tranche will request a similar special rule that was provided in the first tranche with respect to pass-through entities that incur an eligible gain.

The first tranche provided that, to the extent that a pass-through entity, such as a partnership, does not make a taxpayer election with respect to some or all of the eligible gain for which it could make a taxpayer election, the partners may make a taxpayer election with respect to some or all of such remaining eligible gain. Partners have the ability to make an investment in the QOF in exchange for an eligible interest during the 180-day period commencing on the last day of the partnership's taxable year in which the partner's share of the allocated eligible gain is taken into account. Still, a partner may elect to use the same 180-day period that the partnership has with respect to the eligible gain so that it does not have to wait until the end of the partnership's taxable year to invest in the QOF.

It would make sense for eligible taxpayers to be able to invest in a QOF within 180 days of a 1231 gain. Obviously, it is possible that the taxpayer will have subsequent 1231 losses in the same taxable year that will offset such 1231 gain — and result in a net 1231 gain that is less than the amount invested in the QOF for such taxable year. In such a case, a portion or all of the taxpayer's investment in the QOF will not be considered a qualifying investment (defined below). This would be a risk for a taxpayer that the taxpayer would need to manage properly.

Qualifying Investments

The second tranche introduced the concept of an interest in a QOF held by an eligible taxpayer that qualifies for the tax benefits described above. A qualifying investment means an eligible interest, or portion thereof, in a QOF to the extent that a taxpayer election applies with respect to such eligible interest or portion thereof.

Noncash Contributions

The second tranche provides that by timely transferring cash or other property to the QOF partnership with respect to an eligible gain in exchange for an eligible interest in a QOF partnership, a taxpayer should have a qualifying investment, to the extent that the taxpayer election applies. This means that a contribution to a QOF partnership is not limited to cash. However, the portion of the eligible interest in the QOF that represents appreciation from the contribution of noncash property that is contributed on a tax-free basis to the QOF partnership cannot be a qualifying investment.

The second tranche provides a fair amount of coverage with respect to contributions of noncash property to QOFs. The relevancy here is unclear because obtaining noncash property from a tax-free contribution does not help the QOF satisfy the requirement that it needs to hold at least 90% of its assets in qualified opportunity zone property, or OZP, as defined in Code Section 1400Z-2(d)(2). Noncash tangible property held by a QOF can be treated as OZP only if it satisfies the definition of qualified opportunity zone business property, or OZBP, as defined in Code Section 1400Z-2(d)(2)(D). Aside from other requirements, OZBP is tangible property that must be acquired by purchase pursuant to Section 179(d)(2). The receipt of a tax-free contribution of property by the QOF partnership would not be considered to be an acquisition by purchase for these purposes.

Interests Issued for Services — Carried Interests

The second tranche also provides that the rendering of services to the QOF or to a person in which the QOF holds a direct or indirect equity interest in exchange for an eligible interest in the QOF cannot be a qualifying investment. This is important for fund managers because it implies that the 10-year benefit (defined below) will not be applicable with respect to the portion of equity in a fund representing the manager's carried interest in a QOF.

Where a fund manager is being issued a carried interest (i.e., a profits interest) for services rendered to or for the benefit of the QOF, and is contemplating the making of a timely capital contribution to the same QOF as it relates to a deferred gain where a taxpayer election will apply, the fund manager will be considered to have two separate interests: (1) a non-qualifying investment with respect to the carried interest, and (2) a qualifying investment with respect to the interest received in exchange for timely capital contributions related to a deferred gain where a taxpayer election will apply. The amount of a non-qualifying investment for the carried interest is based upon the highest share of residual profits that the fund manager will receive with respect to such profits interest. The application of this provision in the second tranche is a bit confusing. As a result, it may be good practice to avoid having a fund manager who has been issued a carried interest from the QOF also make a capital contribution to the QOF in efforts to obtain a qualifying investment. Instead, it may be better to have an affiliated entity of the fund manager or the individual owners of the fund manager timely invest directly into the QOF with respect to any of their eligible gains.

A Cross-Purchase Could Be a Qualifying Investment

The second tranche provides that an eligible taxpayer with an eligible gain to defer can acquire an eligible interest in a QOF from someone other than the QOF and such acquired eligible interest can thereafter satisfy the requirements of a qualifying investment. The amount of such eligible taxpayer's qualifying investment is the amount of cash and the fair market value of the other property exchanged for the eligible interest, as determined immediately before such exchange. This allows for the creation of a secondary market for interests being held in QOFs and provides potential liquidity for holders of such eligible interests in QOFs.

It is interesting to note that the second tranche only requires the eligible taxpayer to acquire an eligible interest from an equity owner in a QOF rather than a qualifying investment from such equity owner. An eligible interest in a QOF is an equity interest issued by the QOF, which includes preferred stock or a partnership interest with special allocations. An investor that contributes proceeds to a QOF (with no related eligible gain) in exchange for an equity interest in the QOF has an eligible interest in a QOF but not a qualifying investment. This investor can now sell such interest to an eligible taxpayer with eligible gains to defer and the eligible taxpayer can timely acquire such an interest thereby having a qualifying investment, to the extent that the taxpayer election applies. It also appears that the fund sponsor can sell its carried interest in the QOF to an eligible taxpayer on a timely basis and the taxpayer would thereby have a qualifying investment, to the extent that a taxpayer election applies.

For example, assume that a QOF is currently seeking bridge financing of $5 million. An investor with no eligible gains to defer makes a capital contribution to the QOF of $5 million in exchange for an equity interest in the QOF. Subsequently, an eligible taxpayer with a $10 million eligible gain to defer timely acquires the investor's interest in the QOF for $10 million. The eligible taxpayer would have a qualifying investment in the QOF in the amount of $10 million to the extent that a taxpayer election applies.

Distributions Made Within Two Years of a Capital Contribution

The second rranche provides that to the extent that any contribution of cash or other property is transferred to a QOF partnership and the contribution is recast as a partnership disguised sale under certified modified rules, a portion or all of the interest received in the QOF will not be considered to be a qualifying investment. Such a recasting could be the result of the eligible taxpayer receiving certain distributions of cash or property from the QOF within two years of the taxpayer's contribution to the QOF. In such a case, such portion of the interest in the QOF will not be eligible for the three tax benefits described above including the original deferral of the eligible gain.

The second tranche modifies the application of the partnership disguised sales rules by treating a contribution of cash to the QOF partnership as a contribution of noncash property. Accordingly, any distributions made to a taxpayer within two years of making a timely contribution to a QOF partnership and obtaining a qualifying investment must be carefully examined under the partnership disguised sale rules because the contribution and related distribution would be presumed to be a disguised sale under the modified rules resulting in all or a portion of the qualifying investment being recharacterized as a non-qualifying investment from the date of the original contribution.

There are certain exceptions to the disguised sale rules for reasonable preferred returns, reasonable guaranteed payments for the use of capital, operating cash flow distributions and reimbursement of preformation expenses. Note that the requirements for these exceptions are extremely technical and failure to comply with these exceptions could have disastrous consequences to a taxpayer since a portion or all of the taxpayer's investment in the QOF could be considered a non-qualifying investment. This means that the taxpayer would not be eligible for any of the three tax benefits, including the deferral of the original eligible gain, with respect to the portion of the qualifying investment being recharacterized as a non-qualifying investment.

Debt-Financed Distributions From the QOF Partnership

Until the second tranche was issued, folks were speculating that an eligible taxpayer with an eligible gain to defer could timely contribute cash to a QOF partnership so that it would have a qualifying investment, to the extent that the taxpayer election applies. Then, shortly after making such cash contributions, the QOF could obtain a loan and distribute the proceeds from the loan to the eligible taxpayers thereby effectively returning a portion of the original capital contributions to the taxpayers. The second tranche limits the ability for taxpayers to engage in this type of transaction by again invoking a modified form of the partnership disguised sales rules.

For purposes of the modified partnership disguised sale rules, the second tranche treats contributed cash as a contribution of noncash property and the taxpayer's allocation of the partnership debt is treated as being zero. This means that any distribution of debt financed proceeds within two years from making a cash contribution would be presumed to be a disguised sale under the modified rules for purposes of the opportunity zone provisions. As a result, all or a portion of the taxpayer's interest in the QOF partnership would be recharacterized as being a non-qualifying investment from the date of the original contribution (even though the distribution would probably satisfy the leverage distribution exception to the partnership disguised sale rules for other tax purposes). However, any distributions occurring after such two-year period are presumed not to be disguised sales under these modified rules. Both of these presumptions are rebuttable.

For example, eligible taxpayers incurred an aggregate $5 million eligible gain. The eligible taxpayers timely invest $5 million of aggregate proceeds in a QOF partnership on Oct. 1, 2019 in order to obtain a qualifying investment in the amount of $5 million. On Oct. 2, 2019, the QOF acquires real property consisting of land and a newly constructed building that has not yet been placed in service. On Dec. 1, 2019, the QOF partnership borrows $4 million from a commercial bank on a nonrecourse basis and immediately distributes the proceeds to the eligible taxpayers in proportion to their allocated share of the debt for tax basis purposes.

Under the second tranche, $4 million of the $5 million investment in the QOF would be presumed to be a disguised sale under the modified partnership disguised sale rules for purposes of the opportunity zone provisions. Further, $4 million of the aggregate $5 million qualifying investment in the QOF would be recharacterized as a non-qualifying investment on the date of the original contribution as a result of the presumed disguised sale. Accordingly, the taxpayers will only have an aggregate qualifying investment in the amount of $1 million even though they incurred an eligible gain in the aggregate amount of $5 million.

Assume the same facts but that on Sept. 1, 2021, the QOF partnership borrows $4 million and immediately distributes the proceeds to the taxpayers. This is also presumed to be a disguised sale in the amount of $4 million under the modified disguised sale rules resulting in $4 million of the aggregate $5 million qualifying investment in the QOF being recharacterized as a non-qualifying investment on the date of the original contribution. This is also problematic because the taxpayers will have already filed income tax returns with respect to their deferred gain. The taxpayers will likely have to file amended income tax returns and pay income tax on their deferred gain with interest and penalties. Further, the 180-day period for the taxpayers will have expired with respect to their original eligible gain.

It is interesting to note that the first tranche provided that an interest in a QOF can be an eligible interest where the interest is collateral for a loan even as part of a purchase-money borrowing as long as the taxpayer is the owner of the equity interest for federal income tax purposes. This means that an eligible taxpayer with a $5 million eligible gain can borrow $4 million from a bank on a recourse basis and combined with $1 million of his or her own funds make a $5 million capital contribution to a QOF where the taxpayer would have a qualifying investment in the amount of $5 million, to the extent that the taxpayer election applies. This structure is similar to the situation described above where immediately after a taxpayer makes the $5 million contribution to a QOF, the QOF partnership obtains $4 million of debt proceeds, guaranteed by the taxpayer, which is then immediately distributed by the QOF to the taxpayer. Perhaps, comment letters will address the fact that we have these analogous situations with different outcomes.

Inclusion Events for Deferred Gains

The taxpayer will take deferred gain into income in the taxable year which includes the earlier of the date that the qualifying investment is sold or exchanged, or Dec. 31, 2026 (each, an inclusion event). The second tranche provides rules as to the definition of inclusion events (aside from Dec. 31, 2026, being an inclusion event with respect to any remaining deferred gain) with respect to the deferred gain and as to the amount to be included in income by the eligible taxpayer from an inclusion event.

Partnership Inclusion Event Rules

The second tranche provides that, aside from Dec. 31, 2026, the following are examples of inclusion events involving partnerships (and this is not an exclusive list):

- A taxable disposition of all or part of a qualifying investment in a QOF partnership;
- In certain cases, a transfer by a partner of an interest in a partnership where such partnership, directly or indirectly, through one or more partnerships holds a qualifying investment;
- A transfer by gift of a qualifying investment;
- A distribution to a partner of a QOF partnership of property that has a value in excess of basis of the partner’s qualifying investment in the QOF partnership; or
- The cessation of the existence of the QOF partnership for federal income tax purposes.

The second tranche also provides that an inclusion event occurs when and to the extent that a transaction has the effect of reducing the amount of remaining deferred gain of one or more direct or indirect partners. Generally, the transfer of a qualifying investment by reason of the eligible taxpayer's death is not an inclusion event, subject to certain exceptions. In such a case, the transferee would receive a tacked holding period for purposes of the provisions related to the opportunity zone incentive. The second tranche mentions that a transfer to a grantor trust is not an inclusion event because the grantor trust is disregarded as being separate from its owner for federal income tax purposes. However, a change in the status of the grantor trust could result in an inclusion event.

Certain Tax-Free Transactions Involving Partnerships Are Not Inclusion Events

A contribution to a partnership by an owner of a qualifying investment in a QOF in a manner that qualifies for tax-free treatment under Section 721(a) is not an inclusion event. This means that a taxpayer can generally contribute his or her qualifying investment in a QOF to a partnership on a tax-free basis without resulting in an inclusion event. This allows an eligible taxpayer to transfer multiple qualifying investments in QOFs into a single partnership (that is not a QOF) in exchange for interests in such a partnership thereby consolidated all of his or her qualifying investments into a single entity.

The new frontier with respect to the opportunity zone incentive appears to be with respect to the taxpayer's newly found ability to aggregate numerous qualifying investments into one single partnership. The ability to consolidate these qualifying investments into a single entity is almost like a master feeder fund structure, but in reverse order. This would allow the manager of the transferee partnership to manage all of the qualifying investments. In these cases, the transferee partnership becomes subject to the opportunity zone provisions with respect to the deferred gain and the contributed qualifying investments. The transferee partnership must allocate and report the gain with respect to the contributed qualifying investment to the contributing partner to the same extent that the gain would have been allocated if the contribution to the transferee partnership did not occur.

The same treatment applies where the contribution involves a partner of a partnership that owns, through one or more upper-tier partnerships, a qualifying investment in a QOF, and such partner contributes its direct or indirect partnership interest in a qualifying investment to a partnership in a tax-free manner where Code Section 721(a) applies in whole or part. Similar rules apply in the case of a tax-free mergers or consolidations under Section 708(a)(b)(2)(A) of a partnership that holds a qualifying investment in a QOF, into another partnership, or the tax-free merger of a partnership that owns such an investment through one or more partnerships into another partnership.

Partnership Distributions Can Be Inclusion Events

The second tranche provides that an actual or deemed distribution of property (including cash) by a QOF partnership to a partner with respect to such partner's qualifying investment is an inclusion event only to the extent that the distributed property has a fair market value in excess of such partner's basis of its qualifying investment.

There are circumstances where a reallocation of partnership debt among the partners of a partnership could cause a deemed distribution. However, it is unclear whether the Department of the Treasury and the IRS intended for such a deemed distribution to result in a possible inclusion event. Specifically, a member of a limited liability company is generally allocated a share of debt of the limited liability company unless another member guarantees such debt (and such guarantying member will generally be allocated such debt). Such a member will obtain tax basis in his or her membership interest in the limited liability company as a result of this allocation of debt.

A reduction in an allocation of partnership debt to a partner causes a deemed distribution to such partner. This could happen in the event that a new member is admitted into the limited liability company and the debt of the limited liability company is not guaranteed by any of the members. Outside of the opportunity zone provisions, a partner that is subject to a deemed distribution could have income tax consequences where such partner's tax basis in his or her interest in the partnership is less than the amount of the deemed distribution occurring from the reduction of the allocated debt (or the deemed liability relief). This could be the case where tax losses from the partnership were incurred and allocated to a partner thereby reducing a partner's basis in his or her interest. Again, it is unclear based upon the second tranche as to whether an inclusion event would result from such a deemed distribution.

The Amount of the Inclusion

What is the Inclusion Amount (But Not With Respect to Distributions)

In the event of an inclusion event (including the inclusion event that occurs as of Dec. 31, 2026, with respect to any remaining deferred gain) not involving a distribution from a QOF partnership, the amount of deferred gain included in the gross income of the eligible taxpayer shall be equal to the lesser of:

1. The product of (a) the percentage of the Qualifying Investment that gave rise to the Inclusion Event, and (b) the remaining Deferred Gain, less any basis increases as result of holding the Qualifying Investment for five years (10% of the Deferred Gain) and seven years (an additional 5% of the Deferred Gain), or

2. The gain that would be recognized in a fully taxable disposition of the Qualifying Investment that gave rise to the Inclusion Event. This attempts to take into account the fair market value of the Qualifying Investment at the time of the transaction causing the Inclusion Event.

The following is an example demonstrating these provisions:

> In 2019, a taxpayer has an eligible gain of $200,000 and makes a timely investment in a QOF partnership in 2019 thereby obtaining a qualifying investment in the amount of $200,000, to the extent that the taxpayer election applies. In 2024, the taxpayer's basis in the qualifying investment is increased from zero to $20,000 because the taxpayer has held the qualifying investment for at least five years. In 2025, the taxpayer sells 40% of his or her qualifying investment in the QOF partnership for $240,000 cash. The taxpayer will have an inclusion event with respect to such transfer because the taxpayer's qualifying investment has been reduced from 100% to 60%. The inclusion amount will be $72,000. This amount is determined by taking the lesser of: (a) $72,000, which is 40% of the amount that is the difference between the remaining deferred gain of $200,000 and the $20,000 basis in the qualifying investment, and (b) $232,000, which is the cash consideration of $240,000 minus 40% of the $20,000 basis in the qualifying investment.

What Is the Inclusion Amount With Respect to Distributions

In the event of a partnership that makes a distribution to its partners resulting in an inclusion event because the distributed property had a fair market value in excess of the tax basis of the qualifying investment, the amount of gain included in gross income is equal to lesser of: (1) the remaining deferred gain, or (2) the amount that gave rise to the inclusion event. The amount that gave rise to the inclusion event appears to be the amount that the fair market value of the distributed property exceeds the tax basis in the qualifying investment. As noted below, in certain cases, regular operating cash flow distributions could result in an inclusion event with some or all of the deferred gain being included in income of the taxpayer.

Basis Adjustments From an Inclusion Event

The inclusion of the deferred gain from an inclusion event results in an increase of the eligible taxpayer's basis in the qualifying investment. The second tranche provides that the basis increase from an inclusion event (aside from Dec. 31, 2026, being an inclusion event with respect to any remaining deferred gain) occurs before determining the other income tax consequences of the inclusion event. However, the basis increase from the inclusion event that occurs on Dec. 31, 2026, with respect to any remaining deferred gain, occurs after the inclusion of the remaining deferred gain is taken into account.

The second tranche provides a special rule for distributions made by QOF partnerships. This provides that the taxpayer will increase his or her basis in the qualifying investment in the QOF partnership from the inclusion event before determining the income tax consequences of the distribution. Again, an inclusion event occurs here as a result of the fair market value of the property distributed by the QOF partnership exceeding the basis in the taxpayer's qualifying investment.

Investors need to be aware that it is possible for distributions of regular operating cash flow by a QOF partnership to result in an inclusion event — especially where debt financing has not been obtained. For example, assume the following:

> On Aug. 1, 2019, three eligible taxpayers sell an asset generating an eligible gain in the amount of $2 million each. On Dec. 31, 2019, the three taxpayers each invest $2 million in a QOF partnership thereby obtaining qualifying investments in the aggregate amount of $6 million, to the extent that a taxpayer election applies. On Feb. 1, 2020, the QOF makes a cash investment in a qualified opportunity zone business, or OZB, as defined in Code Section 1400Z-2(d)(3), in the amount of $6 million, in exchange for a 99% membership interest. Another entity contributes approximately $60,000 to the OZB in exchange for a 1% membership interest. The OZB acquires unimproved land for approximately $1 million and constructs a building on the land for approximately $5 million which is placed in service in early 2022. The OZB does not borrow any proceeds.
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> The eligible taxpayers will each have an income tax basis of zero in his or her qualifying investment unless the QOF or the OZB incurs debt (to the extent such debt is allocated to each of the eligible taxpayers). In 2022, the OZB generates $100,000 of income tax depreciation deductions. Also, in 2022, the OZB generates $100,000 of taxable income which is offset by the $100,000 of income tax depreciation. In 2022, the OZB receives operating cash flow in the amount of $100,000 and distributes $99,000 of the cash flow the QOF which makes a proportional distribution of such cash to the taxpayers.
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> The cash distribution in the aggregate amount of $99,000 by the QOF to the taxpayers causes an inclusion event for each of the taxpayers in the aggregate amount of $99,000 because the distribution of $99,000 is in excess of the tax basis of the qualifying investments for each of the taxpayers — which remained at zero. Accordingly, there is some "slippage" of the deferred gain incentive.

The 10-Year Benefit

The 10-year benefit is available when an eligible taxpayer sells or exchanges a qualifying investment in a QOF partnership that has been held for at least 10 years, or when the QOF partnership disposes of OZP and generates capital gain from such sale, after the 10-year holding period has been obtained by an eligible taxpayer. In order to receive the 10-year benefit, an eligible taxpayer is required to make an election.

It must be noted that the provisions from the second tranche regarding the 10-year election are only applicable to taxable years of the QOF partnership that end on or after the date of publication in the Federal Register adopting these proposed rules as final regulations.

Sale of a Qualifying Investment in the QOF

In the event that an eligible taxpayer sells or exchanges his or her qualifying investment in the QOF partnership after obtaining the 10-year holding period, the 10-year election will increase the eligible taxpayer's basis of such qualifying investment to an amount that is equal to the fair market value of such investment, which includes debt, immediately prior to the sale or exchange. The second tranche further provides that the 10-year election with respect to a QOF interest sale has the effect of increasing the tax basis of the QOF partnership's assets as calculated in a manner similar to a Code Section 743(b) adjustment had the eligible taxpayer purchased its interest in the QOF partnership for cash equal to the fair market value immediately prior to the sale or exchange and assuming a Section 754 election was in place.

Under Code Section 751, when a partner sells an interest in a partnership, a deemed sales transaction takes place at the partnership level with respect to assets that would generate ordinary income if sold directly by the partnership. Prior to the release of the second tranche, it was unclear how this deemed sale of assets at the partnership level under Section 751 interacted with the basis step-up of the qualifying investment in the QOF under a QOF interest sale where a 10-year election is made. The speculation was that a taxpayer may have some ordinary income where the QOF partnership or the OZB was holding hot assets with a corresponding capital loss upon the QOF interest sale. This was a not a great result for a taxpayer.

By making an adjustment increasing the tax basis of each of the QOF partnerships assets, it appears that the potential impact of a deemed sale of assets at the QOF partnership level resulting in ordinary income for a taxpayer under Section 751 can be avoided. This is important where a QOF partnership owns hot assets, which includes, but is not limited to, inventory and assets with depreciation recapture. This could be impactful for the energy industry where energy equipment has a long useful life and a short tax depreciation period but retains a good portion of its value after all of the tax depreciation has been taken (resulting in income tax depreciation recapture).

Also, under the second tranche, it appears that losses generated by the QOF from debt financing of the QOF partnership (causing a negative capital account for the taxpayer) should not result in gain for the taxpayer with respect to a sale of a taxpayer’s qualifying investment under the QOF interest sale. This is because it appears that the taxpayer will increase his or her basis in the qualifying investment to include the amount of partnership debt allocated to such taxpayer as a result of the 10-year election. When a partner sells an interest in a partnership, the amount realized from such sale includes the amount of the partnership debt allocated to the partner which the taxpayer will be deemed to be relieved of as a result of such sale. To the extent that tax losses were generated from this partnership debt and allocated to the selling partner (which would have resulted in a negative capital account for such partner), the amount realized from such deemed liability relief would exceed the partner’s tax basis in the interest being sold. This would result in a gain.

Still, caution should be exercised here. Most opportunity zone incentive transactions are structured using a two-tier structure where a QOF will make a cash investment in an OZB. At this point, it is unclear how the adjustments described above affects the bases of the assets that are held by an OZB.

Sale of Assets by a QOF

The second tranche provides that an eligible taxpayer that has held a qualifying investment for more than the 10-year holding period can make a 10-year election to exclude from gross income some or all of the capital gains arising from the disposition of OZP by the QOF partnership as reported on the Form K-1 issued by the QOF partnership and attributable to a qualifying investment.

These provisions in the second tranche are particularly important to QOF partnerships that will make multiple investments. Multiasset QOFs want the ability to liquidate by selling different assets to different buyers at different times. This provision in the second tranche provides multiasset QOFs with the ability to orderly sell each of its assets at the end of its expected operating term.

Still, caution should be exercised here. First, this provision only applies where the QOF sells OZP which results in a capital gain. This means that it would not apply where the QOF partnership sells a non-OZP asset. It also would not apply to any portion of a sale of OZP that results in ordinary income which appears to include a portion of a membership interest in an OZB when the OZB is holding hot assets. Note that intangible property held by the QOF would not qualify as OZP. Accordingly, the QOF could not sell intangible property that it holds directly and have the taxpayers obtain the 10-year benefit with respect to such sale.

Second, this provision appears to only apply to a direct sale of assets by the QOF partnership and not to the sale of assets by the OZB. This is problematic because, as stated above, most opportunity zone incentive transactions are structured using a multientity approach whereby the QOF invests cash into an OZB. Accordingly, the QOF partnership would need to sell its equity interest in the OZB to a purchaser (rather than the OZB selling its assets) and allocate any capital gain from such sale to the taxpayers on Form K-1. To the extent that the sale of the equity interest in the OZB results in any ordinary income (which could result from the OZB holding hot assets, such as inventory), such allocation of ordinary income would not be eligible for the 10-year benefit.

In certain situations, it could be advantageous, after the 10-year holding period, to have the QOF sell its equity interest in the OZB to a third party even if the 10-year benefit were to be extended in the future to the sale of assets by the OZB. The 10-year benefit does not apply when a QOF sells non-OZBP tangible property to a third party. Presumably, any upcoming guidance that extends the 10-year benefit to a direct sale of assets by an OZB will provide that the 10-year benefit is not applicable to the sale of non-OZBP tangible property by an OZB. However, up to 30% of the tangible property that the OZB leases or owns can be non-OZBP, and the second tranche does not appear to look-through the OZB to any non-OZBP tangible property that it leases or owns with respect to obtaining the 10-year benefit. Accordingly, by having the QOF sell its equity interest in the OZB where the OZB leases or owns a certain amount of non-OZBP tangible property, the QOF is indirectly selling such non-OZBP and the taxpayer appears to obtain the 10-year benefit on the sale of the equity of the OZB by the QOF as long as such sale generates a capital gain.

Anti-Abuse Provisions

The second tranche emphasizes the ability of the IRS to recast a transaction where a significant purpose of a transaction is to achieve a tax result that is inconsistent with the purposes of the opportunity zone provisions. A looming question remains as to what transactions would be perceived as being abusive thereby triggering these anti-abuse rules. It would be helpful to have future guidance on the anti-abuse rules including perhaps safe harbors.

Conclusion

The Treasury and the IRS deserve praise for providing extremely flexible guidance here. Again, the big question that remains to be answered is whether the second tranche provides enough clarity for investors to commence investing all of the capital that is sitting in the sidelines into QOFs. Fortunately, we will not have to wait too long to see whether this will be the case.

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