CohnReznick
ADVISORY • ASSURANCE • TAX

“AND YET THERE’S MORE . . .” THE SECOND ROUND OF OZ GUIDANCE

Steven M. Friedman
Steve.friedman@cohnreznick.com

May 16, 2019

NATIONAL MULTIFAMILY HOUSING COUNCIL SPRING BOARD OF DIRECTORS MEETING

May 16, 2019

CohnReznick LLP

TODAY’S AGENDA

- Speaking a common language.
- When we last met, we wondered . . .
- Helpful guidance.
- Less helpful guidance.
- New concept: “Inclusion events.”
- More things to consider.
- Q+A.

CohnReznick

SPEAKING A COMMON LANGUAGE . . .

- An <u>Investor</u> contributes cash or property . . .
  - The investor can be any one the following:
    - Individual
    - Corporation
    - S corporation
    - Estate or trust (including a grantor trust)

- . . . to a <u>Qualified Opportunity Fund</u> (“**QOF**”). . .
  - The fund (or **QOF**) can be any one of the following:
    - Partnership or limited liability company treated as a partnership.
    - C corporation or S corporation.
    - Real estate investment trust (“**REIT**”)

NMHC

SPEAKING A COMMON LANGUAGE . . .

- The **QOF** can invest directly in Qualified Opportunity Zone Business Property (“**QOZP**”) or through a Qualified Opportunity Zone Business (“**QOZB**”).
  - The qualifications for **QOZP** and a **QOZB** can differ . . .
  - The **QOZB** can be any of:
    - A partnership;
    - A limited liability company treated a partnership for tax purposes; or
    - A corporation
  - Generally, the **QOZB** likely will be a joint venture.
  - The **QOZB** needs to have a trade or business.

WHEN WE LAST MET, WE WONDERED . . .

- Importance of the 5- and 7-year holding periods for the 10% and 5% basis increases.
- Treatment of acquisition debt.
- Treatment of distributions of refinancing proceeds.
- Considering the related party rule and managing the 20% related party testing.
  - Property sale into the QOF.
    - Measuring ownership.
    - Treatment of gain.

WHEN WE LAST MET, WE WONDERED . . .

- Do carried interests qualify for the OZ benefits?
- Capital recycling.
  - Investor can sell QOF interest and reinvest in another QOF within 180 days.
  - Can the QOF dispose of its investment and reinvest with continued deferral?
- Meeting the QOZBP rules.
  - What is “substantial improvement”?
  - What’s the meaning or “original use”?

WHEN WE LAST MET, WE WONDERED . . .

- QOZB questions we asked . . .
  - How does the working capital rule work?
  - Exactly when does the 30-month period for the exception apply?
  - How is idle cash treated for purposes of the 90 asset test?
  - What is an “active trade or business”? Does triple-net qualify?
- Some other questions we had . . .
  - Statute allows investor to sell interest in QOF with no tax.
  - What if QOF holds multiple assets?

HELPFUL GUIDANCE

- Second set of proposed regulations: 169 pages; lots of technical detail.

- 10-year gain and diversified funds.
  - Prior guidance: Gain elimination applied only if the investor sold his/her interest in the QOF after a 10-year hold.
  - Change for the better: If the QOF is treated as a partnership, the QOF can sell good assets, pass the gain to the investor and the investor can elect to eliminate the capital gain.
  - But its not perfect.
    - Ordinary income through the fund is still taxed to investor.
    - Sale of a good asset by the QOF does <u>not</u> avoid depreciation recapture.
    - Unrecaptured “§1250 gain” not taxed.

CohnReznick

HELPFUL GUIDANCE

- Basis and borrowing.
  - The general rules on allocating debt to partners for basis purposes do apply.
  - The zero basis rule only applies to the capital gain capital contributed to the fund.
  - Thus, the fund can distribute refinancing proceeds generally without triggering gain to the distribute-partners.
  - Why “generally”?
    - Investor still needs positive tax basis subsequent to the distribution (from his/her share of debt).
    - Timing: The distribution cannot be a “disguised sale,” so generally a 2-year hiatus from date of investor’s eligible investment.
  - This may solve the funding issue for the deemed distribution on 12/31/2026.

NMHC

CohnReznick

HELPFUL GUIDANCE

- Capital deployment and the 90% asset test.
  - “Ready, fire, aim” timing issue mitigated.
  - QOF can now hold contributed capital for up to 6 months prior to having it invested.

- QOZB.
  - Owning and operating (including leasing) income-producing real estate is the active conduct of a trade or business.
  - But, leasing property under a “triple-net lease” doesn’t rise to level of a trade or business.
    - Guidance says “triple net lease,” but doesn’t define it.
    - How much activity to avoid “triple net” status?

NMHC

CohnReznick

HELPFUL GUIDANCE

- Leases of tangible property.
  - Statute: Tangible property must be “acquired by purchase.”
  - New guidance clarifies that leased tangible property is QOZB property.
  - Requirements:
    - Lease entered into after 12/31/2017;
    - Substantially all of the leased property used in an OZ during substantially all of the lease term; and
    - Lease must have market rate terms.
  - Lessor can be related to the lessee (but no lease prepayments > 12 months).
  - Leased tangible property need not be “substantially improved” or “original use” property to the lessee.
  - Any improvements made by lessee are original use property acquired by purchase.

NMHC

HELPFUL GUIDANCE

- Land.
  - Is undeveloped land a good asset for QOZB and QOZBP purposes?
    - Only if it's used in a trade or business.
  - Land generally does not have to be "substantially improved."
  - Can a QOF "land bank" (that is, hold land for investment)? No, if the land is:
    - Held for investment (not used in a trade or business);
    - Not improved or minimally improved;
    - Not intended to be substantially improved within 30 months from purchase; or
    - Held with a "significant purpose of achieving a tax result inconsistent with the Opportunity Zone" rules.

CohnReznick

LESS HELPFUL GUIDANCE

- Gains realized by a QOF <u>cannot</u> be rolled over by the QOF.
  - Gain passes through to investors; investors can reinvest in another fund.
  - An investor cannot roll over recapture amounts from taxable dispositions by a QOF.
  - The QOF sponsor suffers a disincentive to sell at the fund level – AUM declines.
  - QOFs can do like kind exchanges of real estate.
  - The QOF can hold the cash proceeds from a sale for up to 12 months before the cash needs to be redeployed into other qualifying assets.

NMHC

CohnReznick

LESS HELPFUL GUIDANCE

- Carried interests.
  - A QOF partnership interest issued for services does not qualify for OZ benefits.
  - When is a profits interest issued for services?
  - Example.
    - Service Partner contributes “gain dollars” equal to 10% of the QOF’s capital.
    - Service Partner receives a 2% management fee.
    - All capital receives a preferred return of 8%.
    - Third party investors receive a priority return through a waterfall.
    - As that priority return reaches higher amounts, the priority shifts to the Service Provider.

NMHC

NEW CONCEPT: “INCLUSION EVENTS”

- What is an “inclusion event”?
  - Acceleration of an investor’s otherwise deferred gain.
  - Transfer of QOF interest that reduces an investor’s equity interest in the QOF.
  - Statute: Deferred gains accelerated on sale/exchange of the QOF interest.

- Other examples of inclusion events.
  - Gifts of an eligible interest
  - Distribution by a QOF corporation in excess of the QOF investor’s basis in QOF stock.
  - Distribution by a QOF partnership in excess of the QOF investor’s basis in QOF partnership interest (including §752 share of debt).
  - Dissolution of the QOF or claiming worthlessness of the QOF interest.

NEW CONCEPT: “INCLUSION EVENTS”

- Important exclusions from “inclusion events.”
  - Transfers by death.
  - A contribution by a QOF investor of the QOF interest to a partnership as a nontaxable capital contribution under §721(a).
    - Might this allow investor to aggregate his/her QOF interests into an upper-tier investment partnership?

MORE THINGS TO CONSIDER

- Do capital gains include "§1231 gains"? If so, how?
  - Generally, §1231 gains and losses result from sales of income-producing rental real estate.
  - Baseline: Capital gains invested in a QOF within 180 days of the gain generally qualify for the OZ benefits.
  - Recall the special rule for capital gains through partnerships.
    - Generally, gains clock can start as late as last day of the partnership's tax year.
  - Guidance now requires investors to net §1231 gains and losses incurred during the year.
    - Only that net §1231 gain qualifies.
    - Clock starts on the last day of the taxpayer's year.
    - Tick, tock . . . Check the clock - June 28 may give investors a second chance.

MORE THINGS TO CONSIDER

- A "qualifying investment" is now more flexible, but also more complex.
- Property contributions, other than cash, can qualify.
- If the property contributed to the QOF is appreciated, only the portion attributable to the adjusted tax basis counts as qualifying investment.
  - Balance is non-qualifying, so no OZ benefits.
  - Contributed property is not a good asset for the qualifying asset test.
    - QOZB property must be acquired by purchase.

MORE THINGS TO CONSIDER

- The new regulations foreclose the “sell and roll” strategy.
  - The good news: A property owner can sell property to a QOF in a fully taxable transaction in exchange for an eligible interest in the QOF.
  - The bad news: The seller’s gain on the sale is not eligible for deferral.
- Secondary purchases of existing QOF interests qualify.
  - A new investor can purchase an existing investor’s QOF interest.
  - The purchaser’s eligible investment (the realized gain deferred) is the purchase price of the eligible interest.
  - This should lead to some form of secondary market, which will aid liquidity.
  - Multiple unanswered questions.
    - Buyer’s 10-year clock starts later . . .

CohnReznick

MORE THINGS TO CONSIDER

- Easier valuation for purposes of the 90% asset test. Choice:
  - Audited financial statement valuation; or
  - Unadjusted tax basis (cost).
- “Original use” for tangible property begins when the property is placed in service for purposes of claiming depreciation.
  - Solves the question for acquisitions of property under construction.
- Vacant property can qualify under “original use” test.
  - Property must be unused or vacant for an uninterrupted 5-year period before any person first places it in service in the OZ.

NMHC

MORE THINGS TO CONSIDER

- 31-month working capital safe harbor.
  - Safe harbor now includes costs and expenses of developing a trade or business; and
  - Safe harbor can be applied serially to each capital contribution made by a QOF to a QOZB, rather than a single, 31-month period.

CohnReznick

Q+A

NMHC