MEMO

Subject: **Opportunity Zones – Structuring Exit After 10-Year Holding Period**
From: **John Lettieri, President & CEO, Economic Innovation Group**
Date: **September 20, 2019**

Background

Section 1400Z-2, added by Public Law 115-97 (the Tax Cuts and Jobs Act), provides tax incentives for investors to make equity investments in qualified opportunity funds (QOFs) that will in turn invest in qualified opportunity zone business property (QOZ Business Property), either directly or indirectly through qualified opportunity zone businesses (QOZ Businesses) operating in qualified opportunity zones (QOZs). Under the statute, in the case of any investment in a QOF held by the taxpayer for at least 10 years, the taxpayer may elect to increase the basis to the fair market value of such investment on the date that the investment is sold or exchanged.[1] The proposed regulations provide that, when a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z-2(c), the basis of the partnership interest is adjusted to an "amount equal to the fair market value of the interest, including debt."[2] This 10-year basis step-up rule is potentially the most significant of the QOZ tax incentives and has been a focus of investors.

The statute anticipates that investors will exit from an investment in a QOF by selling their interest in the QOF. However, the typical investment fund disposes of all or a portion of its assets (either by selling equity interests in a portfolio company or causing the portfolio company to sell its assets) and distributes the proceeds to its investors. Recognizing this, the proposed regulations provide some flexibility to structure exits as sales at the QOF level. The proposed regulations provide relief by allowing a QOF investor who has held its investment in a QOF for at least 10 years to make an election to exclude from gross income capital gain from the sale or disposition of QOZ Property by the QOF that is reported on the investor's Schedule K-1 (the "K-1 Rule").[3] Just as important, the K-1 Rule preserves the investor's increase in the basis of its QOF interest from such gain, which prevents a subsequent distribution of the sales proceeds from generating additional gain to the investor.[4]

The proposed regulations also mitigate the potential negative consequences of the so-called "hot asset" rules. The hot asset rules require recognition of ordinary income instead of capital gain upon the sale of a partner's interest to the extent the amount received is attributable to hot assets of the partnership.[5] Then the transferor's capital gain or loss on the sale of the partnership interest is equal to the difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under section 751(a).[6] Thus, if there would be no gain on the sale of a partnership

---

[1] I.R.C. § 1400Z-2(c).
[2] Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i).
[3] Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii).
[4] *See* Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii)(C) (last sentence).
[5] I.R.C. § 751(a). In addition, ordinary income is recognized upon a distribution of property from the partnership that changes the partner's respective share of hot assets. I.R.C. § 751(b).
[6] Treas. Reg. § 1.751-1(a)(2).

interest in the absence of section 751 as a result of the application of section 1400Z-2(c), a partner still would recognize its distributive share of ordinary income on any hot asset and would be deemed to have a capital loss equal to the amount of such ordinary income. Hot assets are generally assets of a partnership that would generate ordinary income, including inventory, unrealized receivables, and depreciation recapture.[7]

The application of the hot asset rules to the sale of a QOF interest or QOZ Property could undermine the benefit of the 10-year basis step-up rule, because many taxpayers cannot make current use of the offsetting capital loss, effectively leaving them with full or partial inclusion of the 10-year appreciation. This issue is particularly critical for investments that would generate depreciation recapture, such as solar, wind, and other clean energy investments, machinery and equipment, and real estate. The proposed regulations address this issue by providing that, when an investor sells a qualifying investment in a QOF partnership after the 10-year holding period, a special deemed adjustment is made to the inside basis of QOF partnership assets immediately before the sale so as to mimic a cash purchase of the investment when a section 754 election is in effect, with the result that ordinary income is not triggered (the "Deemed Section 754 Election").[8]

<u>The Problem: Although Proposed Regulations Provide Some Relief, There Are Gaps That Do Not Fully Facilitate Sales of QOZ Businesses or QOZ Business Property</u>

Exit issues have been some of the most significant factors preventing deals from going forward. Investors have been concerned that they will not receive the benefit of the 10-year basis step-up intended by Congress because of the above-described disconnect between the way funds and their investors typically exit investments and the interaction between section 1400Z-2 and the hot asset rules. We applaud both the K-1 Rule and the Deemed Section 754 Election and believe they establish a practical framework to address problems that are seriously affecting the market. However, there are some gaps in these rules that need to be filled if these rules are to fully achieve their purpose.

In particular, investors still believe that the only transaction that fully preserves the 10-year basis step-up where hot assets are involved is the sale of the QOF interest by the investor (and, even in that scenario, it is not clear that the Deemed Section 754 Election applies to the sale of a QOF interest if the hot assets are held at the QOZ Business level). As discussed above, however, that is not the natural exit strategy if a QOF holds multiple businesses, as investors may not want to dispose of their interests in all of the businesses and a buyer may not want to acquire all of the businesses. Although the proposed regulations permit sales of QOZ Business interests through the K-1 Rule, the rule does not protect gain attributable to hot assets. Thus, investors are forced to incur the cost of forming multiple stand-alone QOF structures (and to avoid multi-tier QOF structures) so that they can sell a QOF interest upon exit after 10 years.

In creating the Opportunity Zone incentive, Congress created a two-tiered structure consisting of QOFs as investment vehicles organized for the purpose of investing in QOZ Businesses. When Congress used the term "fund," it was likely thinking of traditional

---

[7] I.R.C. § 751(c), (d).
[8] Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i).

investment funds, which are instruments for investors to pool capital and spread risk across a portfolio of investments.[9] At the moment, the majority of QOFs we have seen are not funds in the traditional sense, but rather are single-project entities, primarily because of the uncertainty in exiting the investments after 10 years. If Congress had intended for QOZ investments to occur only through single-project entities, it would not have needed to create a two-tiered structure.

As discussed further below, the questions that remain unanswered are: (1) how sales of property by QOZ Businesses after the 10-year holding period are treated under the K-1 Rule; (2) whether ordinary income from hot assets sold by the QOF or QOZ Business could be excluded by the investor under either the K-1 Rule or the Deemed Section 754 Election; and (3) whether the Deemed Section 754 Election applies to the sale of a QOF interest if the hot assets are held at the QOZ Business level. In addition, the final regulations should clarify that the phrase "including debt" in Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i) results in a step-up in basis under section 1400Z-2(c) of the full amount realized by an investor, as described below.

Finally, the proposed regulations do not permit reliance on the proposed 10-year basis step-up rules. Investors have expressed concern that they need to make investment decisions now and need clarity on how to achieve the 10-year benefit described in these rules in the future. In particular, some investors are trying to pre-negotiate terms of exits from QOF investments during the transaction stage in order to provide long-term certainty and transparency for both the investor and investee.

<u>Recommended Approach to 10-Year Basis Step-Up Rules</u>

We believe that the proposed regulations adopt the appropriate framework to resolve these issues by enabling taxpayers to exclude certain tiered-up asset gains (the K-1 Rule) and to step up the inside basis of assets to avoid ordinary income from hot assets as a result of sales of partnership interests (the Deemed Section 754 Election). We believe that final regulations should simply fill in the gaps in these rules, as discussed below.

1. <u>Final Regulations Should Clarify that the K-1 Rule Applies to Asset Sales by a QOZ Business</u>

A QOF may structure an exit from an investment in a QOZ Business either by disposing of its equity interest in the QOZ Business or by causing the QOZ Business to dispose of its assets, but it is not clear how the latter is treated under the K-1 Rule. The proposed K-1 Rule only applies when a "QOF partnership or QOF S corporation disposes of qualified opportunity zone property." A disposition of an equity interest in a QOZ Business is clearly a disposition of QOZ property by the QOF. Under the current proposed rule, however, it is not clear whether causing a disposition of assets by a lower-tier QOZ Business partnership can qualify for the K-1 Rule. Because this kind of asset sale is commonly used by investment funds in structuring exits, it should be accommodated by the final regulations.

[9] When not otherwise defined, Congress intends that words be given their ordinary meaning. *See, e.g.*, *Bd. of Cty. Comm'rs of Kay Cty., Okla. v. Fed. Hous. Fin. Agency*, 754 F.3d 1025, 1028–29 (D.C. Cir. 2014) ("Moreover, where a statute's terms are undefined, our interpretation is guided by the terms' 'regular usage,'" citing *Lopez v. Gonzales*, 549 U.S. 47, 53 (2006)).

We believe that Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii) could be expanded to include such capital gains, which also would be ultimately reported on the Schedule K-1 issued by the QOF to the investor (after being reported on the Schedule K-1 issued by the QOZ Business partnership to the QOF).

2. Final Regulations Should Provide Relief from Hot Asset Treatment for Asset Sales Via the K-1 Rule

The Deemed Section 754 Election only applies when "a QOF partner's basis in a qualifying QOF partnership interest is adjusted under section 1400Z–2(c)," so it provides relief from hot asset treatment only upon the sale of a QOF interest. The proposed K-1 Rule works by excluding capital gain that is reported on an investor's Schedule K-1; it does not exclude ordinary income attributable to hot assets, nor does it adjust the asset basis to eliminate such gain. As a result, under the proposed regulations, when a QOF partnership or a QOZ Business partnership disposes of a hot asset, the Deemed Section 754 Election would not apply, and, accordingly, it appears that the QOF or QOZ Business would recognize ordinary income. This ordinary income would then be allocated to QOF investors on a Schedule K-1, and the K-1 Rule would not apply because the income would not be capital gain. As a result, it appears that ordinary income from hot assets sold by the QOF or QOZ Business would not be able to be excluded by the investor under either the K-1 Rule or the Deemed Section 754 Election. This gap in the proposed rules is particularly problematic for depreciation recapture, which cannot be separated from the rest of the asset that generates capital gain.

We believe that this gap can be filled by extending the K-1 Rule to cover not only capital gains but also ordinary income if it is recognized as part of the sale of QOZ Business Property that would constitute a trade or business.[10] The Deemed Section 754 Election technically applies only to the sale of partnership interests, making the K-1 Rule a better fit to address asset sales. In addition, the Deemed Section 754 Election may be overly broad in the context of sales of QOZ Business partnership interests, as it would also eliminate gain allocable to nonqualifying interests in the QOF. Thus, the Schedule K-1 Rule may better address that scenario as well, leaving the Deemed Section 754 Election to apply only to the sale of QOF partnership interests (with the clarification suggested above where the hot assets are held at the QOZ Business level). We note that expanding the K-1 Rule to address these gaps has the added benefit of increasing the investor's basis in its QOF interest for such income to prevent the expected subsequent distribution of cash from the sale to the investor from generating gain.[11]

[10] We anticipate that such a rule would permit a QOZ Business, for example, to sell one or more rehabilitated buildings or an entire operating business. However, we do not believe that sales of inventory in the ordinary course of a QOZ Business' trade or business should be excluded under the K-1 Rule, even if such sales occur after the 10-year holding period.

[11] *See* Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(ii)(C) (last sentence).

3. Final Regulations Should Clarify that the Deemed Section 754 Election Applies when Hot Assets Are Held at the QOZ Business Level

It is not entirely clear whether the Deemed Section 754 Election applies to the sale of a QOF interest if the hot assets are held at the QOZ Business level. This should be clarified by the final regulations. In particular, Prop Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i) should be revised to clarify that deemed adjustments to the basis of assets of a QOZ Business partnership also will be made by applying the ordinary rules for multi-tier partnerships assuming that valid section 754 elections had been in place for the QOF partnership and each QOZ Business partnership.[12] Alternatively, an example could be added to illustrate this point.

4. Final Regulations Should Clarify that a Partner's Basis Reflects Debt

The proposed rule in Prop. Treas. Reg. § 1.1400Z2(c)-1(b)(2)(i) has created some confusion for investors because it is not clear whether the phrase "including debt" results in a gross or net calculation. We believe that the better interpretation is that the basis step-up is to the full amount realized (i.e., the gross calculation), which would include the fair market value of the partner's interest in the QOF plus relief from the partner's share of partnership debt.[13] However, clarity is needed to avoid a net calculation, so that partners of a QOF partnership do not recognize any residual gain resulting from their share of partnership debt after meeting the requisite 10-year holding period, consistent with the intent of the statute that investors do not recognize gain on a QOF investment held for at least 10 years. This could be accomplished by adding an example illustrating the computation of the basis step-up where QOF partnership debt is involved.

Reliance on the Proposed Regulations

The preamble to the proposed regulations provides that taxpayers may generally rely on the proposed rules, except for the rules of Prop. Treas. Reg. § 1.1400Z2(c)-1 relating to the 10-year basis step-up, because these rules do not apply until January 1, 2028.[14] Despite this reasoning, investors have expressed concern that they need to make investment decisions now and need assurance that they will receive the 10-year benefit described in these rules in the future. Accordingly, we recommend that the Department of Treasury and the Internal Revenue Service amend the proposed regulations to permit current reliance on the rules in Prop. Treas. Reg. § 1.1400Z2(c)-1 or retroactive reliance back to the date of publication in the Federal Register, May 1, 2019.

[12] *See* Rev. Rul. 87-115, 1987-2 C.B. 163 (providing that the optional adjustment to basis under section 743 will be available to both an upper-tier partnership (UTP) and a lower-tier partnership (LTP) when there is a sale or exchange of a partnership interest in UTP, and both UTP and LTP have made an election under section 754).
[13] *See* Treas. Reg. § 1.1001-2(a).
[14] 84 Fed. Reg. 18,652, 18,669, *Proposed Effective/Applicability Dates* (May 1, 2019).