NEWS ANALYSIS

Making Subchapter K Play Nice in O-Zones

by Marie Sapirie

Applying the existing partnership rules to the provisions added by the Tax Cuts and Jobs Act is no easy task. Because of the popularity of passthrough entities in the real estate industry, Treasury must draft a strong set of rules for how subchapter K maps onto section 1400Z-2. There is too much uncertainty right now regarding the determination of the basis of an investment in a qualified opportunity fund that is organized as a partnership.

Treasury began reconciling the partnership and Opportunity Zone rules in prop. reg. section 1.1400Z-2(a)-1(c), which contains rules for deferral by partnerships making investments in QOFs. One inference from the public hearing on the proposed regulations is that a later round of proposed regs will attempt to further rationalize the interaction of section 1400Z-2 and subchapter K. (Prior coverage: *Tax Notes*, Feb. 18, 2019, p. 815.)

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Basis-related issues are pronounced in subchapter K, and they become more complex when layered onto the Opportunity Zone statutory scheme in which Congress allowed pretax cash to fund a partnership. That starting point for the Opportunity Zone regime is radically different than the assumptions that underlie subchapter K. Section 1400Z-2(b)(2)(B)(i) provides that the taxpayer's basis in the QOF investment is zero, but, as the New York State Bar Association Tax Section report explained, it doesn't specify the purpose for which the taxpayer's basis in the QOF is zero. In subchapter K, the general rule is that a partner's basis in its partnership interest includes the basis of property and cash contributed to the partnership. Starting with a zero basis and making periodic basis increases of the original deferred gain along the way is a foreign concept in subchapter K, and there isn't an obvious way to bend that regime to accommodate the unique Opportunity Zone scheme.

The basic problem Treasury must confront is that section 1400Z-2 contains no indication about whether or how to apply the subchapter K basis rules to deal with even simple fact patterns, such as whether gain is included in income or basis increases if there's a distribution of income to partners. There are several options for coordinating and reconciling the two regimes, some of which work better and are more consistent with what Congress probably intended than others.

Before Treasury gets to coordination, however, it should decide that's what Congress intended. Treasury could throw out the usual subchapter K basis rules altogether for QOFs. After all, the statute doesn't explicitly say to apply subchapter K in determining the basis of investments in QOFs. But that approach could result in double taxation that Congress likely didn't intend, and it seems unlikely that Treasury will adopt it. The proposed regulations began integrating subchapter K into section 1400Z-2 by explaining that a deemed contribution of money under section 752(a) is not an investment in a QOF.

Finding a middle road where the Opportunity Zone regime works reasonably well with the subchapter K rules is the best bet, but even after Treasury delineates the conceptual approach, solidifying it will mean writing regulations that painstakingly coordinate the subchapter K rules and concepts with the Opportunity Zone regime. Future guidance should address suspended losses, allocations of income, and depreciation.

Hybrid Approach

The NYSBA report advocated a bifurcated approach to basis that divided the basis into two pieces to which the section 1400Z-2 basis rules and the section 705 basis rules, respectively, apply. Section 1400Z-2(b) and (c) features basis increases at five and seven years, and an increase in basis to the fair market value on the sale date for an investment held for at least 10 years. NYSBA suggested applying only the section 1400Z-2 basis rules to determine the amount of deferred gain included in income on the date the interest is sold or at the 10-year mark, and generally not applying the subchapter K basis rules until the five- and seven-year basis increases.

> ***The Opportunity Zone regulations might be modeled on the subchapter S rules instead of the subchapter K rules in order to avoid the complexities regarding liabilities in the partnership rules, Connors said.***

Peter Connors of Orrick Herrington & Sutcliffe LLP said the bifurcated approach in the NYSBA report makes sense. The Opportunity Zone regulations need to treat the section 1400Z gain and the non-1400Z gain differently, as both a conceptual and practical matter, he said. "Completely redoing subchapter K for this is more than anyone wants to do," he said, so a simplified approach that addresses section 1400Z gain separately from other partnership gain or loss is a much more manageable task.

Debt Allocation

Dealing with the liabilities of a QOF is one aspect of the new regime that future guidance will address. Jessica Millett of Duval & Stachenfeld LLP said it's clear that the statutory intent was that the basis bump at the end of the 10-year holding period should cover the taxpayer's share of any liabilities since the taxpayer's basis increase refers to FMV. The 10-year rule doesn't refer back to the eligible gain that the taxpayer invested as the five- and seven-year basis increase provisions do, she explained. Including the share of liabilities in the basis increase means the taxpayer's share of liabilities must be tracked. The NYSBA report argued that including liabilities such that the basis step-up in section 1400Z-2(c) is gross FMV is the "most consistent with the statute and with the principle in the Proposed Regulations to the effect that Section 752 liability allocations do not give rise to Mixed Funds." If the partner's share of liabilities is treated as a distribution, the section 752 rules would mean that the partner is taxed on the deemed distribution, which is inconsistent with the full basis increase in the statute.

Depreciation

Depreciation presents another problem for Treasury because the statute is silent on how to apply section 751 in the QOF context, but ignoring it in regulations probably gives away too much. Section 1400Z-2 is clear that there is an increase in the taxpayer's basis in the QOF interest to its FMV if the interest is held 10 years, but under subchapter K, if a partnership depreciated property and allocated the depreciation to the partners, that depreciation is recaptured when a partner exits. "It doesn't seem right to completely ignore those rules just because you're in a QOF, but Treasury may decide that the statutory language gives them a position to do so," Millett said. NYSBA recommended requiring a partner that sells a QOF interest and makes the election to exclude post-acquisition gain to recognize ordinary income from the prior depreciation deductions. "We do not believe that Section 1400Z-2(c) should be applied in a manner that protects the taxpayer from Section 751 and having to recapture prior depreciation deductions," NYSBA explained.

Suspended Losses

The standard structure for Opportunity Zone investments is a QOF above a joint venture. If the QOF has a section 705 basis in the lower-tier joint venture and the joint venture has a FMV basis in the property that it acquires, suspended losses become a problem because the QOF presumably can't allocate losses from the joint venture to the partners, stemming from their zero basis in the QOF. NYSBA recommended that Treasury temporarily turn off the section 705 basis rules until the basis increases under section 1400Z-2(b) and (c) occur. The suspended loss problem seems to be a casualty of the warp-speed legislative drafting process for the Opportunity Zone regime that Treasury will have to correct in regulations.

Moving Away From Partnerships?

The advent of Opportunity Zones is having the possibly unintended but interesting effect of causing the real estate world to reconsider the default use of partnerships. Most QOFs and qualified Opportunity Zone businesses will still be organized as passthrough entities, but there is some movement toward using other entity types, driven in part by the legislation. Because of the predominance of passthroughs, Treasury will soldier on with its mostly thankless task of fitting the partnership rules and the Opportunity Zone rules together. At the end of the regulatory process, and perhaps also later when investors reach the 10-year holding period requirement, Congress should pause to reflect on the amount of regulatory time that was spent implementing temporary incentives. ■