

Larry's Tax Law

Opportunity Zone Funds – Part I: Overview of the Law

By Larry Brant and Steven Nofziger and Peter Evalds on 1.7.19 | Posted in Legislation, Tax Laws, Tax Planning, Tax Procedure

BACKGROUND

Sections 1400Z-1 and 1400Z-2 were added to the Internal Revenue Code of 1986, as amended (the “Code”) by the Tax Cuts and Jobs Act. These new provisions to the Code introduce a multitude of new terms, complexities and traps for the unwary.

The first new term we need to add to our already robust tax vocabulary is the phrase “Qualified Opportunity Zones” (“QOZs”). The Code generally defines QOZs as real property located in low-income communities within the US and possessions of the US. Additionally, to qualify as a QOZ, the property must be nominated by the states or possessions where the property is located and be approved by the Secretary of Treasury.

To encourage development in QOZs, Congress created potential tax incentives for taxpayers that invest in the development of QOZs. The incentives include: (1) the deferral of gain that would otherwise be realized and recognized; (2) the potential elimination of some of that gain; and (3) the potential elimination of the recognition of gain on appreciation from the investment.

Despite these congressionally mandated incentives, until the past few weeks, few taxpayers were actually embarking on creating Qualified Opportunity Funds (“QOFs”). Instead, they were in a “wait and see” mode. The reason for this phenomena is simple: The new law is complex and leaves many important questions unanswered. Since Treasury had not yet published any guidance on the topic, taxpayers were timid about jumping in waters likely infested with sharks.

Things changed, however, in late October 2018. On October 19, 2018, Treasury promulgated proposed regulations under Code Sections 1400Z-1 and 1400Z-2. At the same time, the Service issued Revenue Ruling 2018-29. Both the proposed regulations and the ruling clarify many of the issues that were frightening the tax community. Additionally, to help create certainty, Treasury took the unusual step of pronouncing that taxpayers may rely on the proposed regulations until final regulations are issued.

This blog post is the first of a multi-part series on Code Sections 1400Z-1 and 1400Z-2. This initial post is intended to provide readers with a broad overview of the new provisions. I, with the help of [Steven Nofziger](#) and [Peter Evalds](#), plan to provide readers with additional posts on various aspects of these new provisions, including: (1) forming QOFs; (2) investing in QOFs; (3) potential pitfalls and traps for the unwary that exist in the QOF arena; and (4) alternatives to QOFs.

BASIC RULES OF THE ROAD

Gain Deferral

Under Code Section 1400Z-2, investors can potentially defer the gain from the sale or exchange of property by investing in a QOF. In order to do so, subject to special rules discussed below, they must invest in a QOF within 180 days of the sale or exchange of property. As provided in the preamble to the proposed regulations, taxpayers are **not** limited to making a single QOF investment. Rather, they may make multiple QOF investments as long as they are made within the 180-day period.

The gain is potentially deferred until the earlier of December 31, 2026 or the subsequent sale or exchange of the investment in the QOF. At such time, the taxpayer will generally realize gain in an amount equal to the **lesser** of: (1) the amount by which the then fair market value of the investment exceeds the taxpayer's basis in the investment; **or** (2) the amount by which the deferred gain exceeds the taxpayer's basis in the investment.

Note: The taxpayer's initial basis in the QOF investment is zero. If the taxpayer holds the investment for five years, the taxpayer may increase his or her basis to 10% of the deferred gain. If he or she holds it for seven years, he or she may increase his or her basis by another 5% of the deferred gain. If he or she holds the investment for ten years, the taxpayer may elect to have the basis equal the fair market value on the date of the sale of the investment, thereby also eliminating gain on any post QOF investment appreciation. Thus, 15% of the deferred gain will escape taxation altogether if the investment is held for 7 years. On December 31, 2026, the taxpayer will recognize gain equal to 85% of the deferred gain (assuming he or she invested in the QOF on or before December 31, 2019). Of course, a subsequent sale after ten years will be free of any additional tax.

Under the proposed regulations, the investment must be sold no later than December 31, 2047 in order for the taxpayer to elect to step up the basis of its investment to fair market value. Treasury and the IRS have requested comments regarding this date, as well as whether taxpayers should be allowed to step up the basis at some point absent disposition. So, the rule may change.

The character of the gain (e.g., long-term or short-term capital gain) is preserved and taken into account upon the later sale of the investment.

The gain to be deferred must arise from the sale or exchange of property to an unrelated party (using the attribution rules under Code Sections 267(b) or 707(b)(1), but substituting 20% for 50%).

Eligible Gain

Under the proposed regulations, eligible gain is any gain treated as capital gain for federal income tax purposes. Thus, eligible gain should include long-term capital gain, short-term capital gain, Code Section 1231 gain, and unrecaptured Code Section 1250 gain. Gain treated as ordinary income, such as depreciation recapture under Code Sections 1245 or 1250, should not be eligible for deferral under Code Sections 1400Z-1 and 1400Z-2.

Eligible Interests

The investment must be in the form of an equity interest. Preferred stock and partnership interests with special allocations are acceptable. **Be Aware:** Debt instruments do not qualify.

Eligible Taxpayers

The proposed regulations and preamble thereto provide that taxpayers eligible to defer gain are any persons that may recognize capital gain, including: (1) individuals; (2) C corporations, including real estate investment trusts and regulated investment companies; (3) partnerships; (4) S corporations; (5) trusts; (6) estates; and (7) certain other pass-through entities, including common trust funds, qualified settlement funds, disputed ownership funds, and other entities taxable under Section 1.468B of the Income Tax Regulations. For disregarded entities, we presumably look at the actual owner to determine eligibility. For limited liability companies, we presumably look to how they are taxed (as a partnership, C corporation or S corporation) to determine eligibility. At first blush, it certainly appears that the list of eligible taxpayers is quite broad. With the exemption of tax exempt organizations, almost all taxpayers appear to have made the list.

Pass-Through Entities

Under the proposed regulations, partnerships can defer gain by making the election. If a partnership does not make the election, each partner can make the election to the extent of their distributive share of qualifying gain (provided the sale or exchange was not with a person related to the partner). If the partnership makes the election, the 180-day period begins with the date of the sale or exchange. If the partner makes the election, the 180-day period begins on the last day of the partnership's taxable year. A partner may, however, elect to begin the 180-day period on the date of the sale or exchange. These rules also apply to other pass-through entities, including S corporations, trusts, and estates. Thus, owners and beneficiaries of pass-through entities have an expanded range of dates. **Be Aware:** This flexibility is not accorded to individuals and C corporations.

Election Mechanics

Treasury expects that taxpayers will make the deferral election on Form 8949, to be attached to the federal income tax return for the year the gain would be recognized but for the election. Draft instructions to the 2018 Form 8949 contain additional guidance.

Subsequent Reinvestment

Taxpayers may defer gain on the sale or exchange of a QOF investment if they reinvest the proceeds in a new QOF investment within 180 days of the sale or exchange of the initial QOF investment. Note that a complete disposition of the original QOF investment is required in order to reinvest the funds in a new QOF investment and obtain the benefits of continued deferral.

RULES FOR THE FORMATION AND MAINTENANCE OF QOFS

QOFs

A QOF is defined as an investment vehicle which is organized as a corporation or partnership for the purpose of investing in “Qualified Opportunity Zone Property” (“QOZP”) of which 90% of its assets are QOZP. The proposed regulations provide that entities other than partnerships and corporations, as long as they, are taxed as partnerships or corporations, may be QOFs. **Be Aware:** A QOF must be organized in a state, the District of Columbia, or a US territory.

Qualified Opportunity Zone Property

QOZP is defined as property which is Qualified Opportunity Zone Stock (“QOZS”), Qualified Opportunity Zone Partnership Interest (“QOZPI”), and Qualified Opportunity Zone Business Property (“QOZBP”).

QOZS is stock in a domestic corporation that meets the following requirements: (1) the stock is acquired by a QOF after December 31, 2017 from the corporation at its original issue solely in exchange for cash; (2) the corporation was a qualified opportunity zone business (“QOZB”) or was being organized for that purpose at the time the stock was issued; and (3) the corporation qualified as a QOZB during substantially all of the QOF’s holding period.

QOZPI is a capital or profits interest in a domestic partnership that meets the following requirements: (1) the interest is acquired by a QOF after December 31, 2017 from the partnership solely in exchange for cash; (2) the partnership was a QOZB or was being organized for that purpose at the time the interest was acquired; and (3) the partnership qualified as a QOZB during substantially all of the QOF’s holding period.

QOZBP is tangible property used in a trade or business of a QOF that meets the following requirements: (1) the property is acquired by a QOF after December 31, 2017 by purchase; (2) the original use in the QOZ originated with the QOF or the QOF substantially improves the property; and (3) substantially all of the property's use was in a QOZ during substantially all of the QOF's holding period. The "substantial improvement" requirement is met if the basis of the property is at least doubled within the 30-month period starting on the date of the acquisition of the QOZBP. Treasury in the proposed regulations and the IRS in Revenue Ruling 2018-29 provide that substantial improvement to a building may be measured by reference to the basis of just the building (and does not need to include the basis of the land).

QOZB means a trade or business that meets the following requirements: (1) substantially all of the tangible property it owns or leases is QOZBP; (2) at least half of its total gross income is derived from the active conduct of a trade or business in a QOZ; (3) a substantial portion of its intangible property is used in the active conduct of a trade or business in a QOZ; (4) less than five percent of the aggregate unadjusted bases of its property is attributable to nonqualified financial property ("NQFP"); and (5) none of its proceeds are used to provide a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or any store that principally sells take-out alcoholic beverages. "Substantially all" for purposes of the first requirement is defined in the proposed regulations as 70%, measured by reference to values used in certain audited or federally required financial statements, or if none, by reference to the cost of the asset(s).

The proposed regulations provide a working capital safe harbor whereby cash will be considered reasonable working capital excluded from the definition of NQFP if the following requirements are satisfied: (1) the amount of the working capital is designated in writing to be used to acquire, construct, and/or substantially improve tangible property in a QOZ; (2) there is a written schedule to spend the working capital assets within 31 months of the QOF's receipt of such assets, which schedule is consistent with the normal start-up of a trade or business; and (3) the working capital assets are in fact used in a manner that is substantially consistent with the first two requirements

90% Test

Testing for the 90% requirement is done by measuring the QOF's assets on two dates: (1) the last day of the first 6-month period of the fund's existence as a QOF; and (2) the last day of the fund's taxable year. According to the preamble to the proposed regulations, if a calendar-year QOF chooses a month after June as its first month as a QOF, then the only testing date for the taxable year is the last day of the QOF's taxable year.

A QOF's failure to meet the test will result in a monthly penalty on the amount by which 90% of the QOF's assets exceeds the amount of QOF property held by the fund. The penalty rate is the underpayment rate under Code Section 6621(a)(2) (currently 6%).

QOF Formation and Certification Mechanics

QOFs may self-certify by using Form 8996, a draft form of which and instructions thereto are available on the IRS's website. The Form 8996 needs to be attached to the tax return, including extensions, of the entity. The entity must identify the first month it wishes to be considered a QOF, which can be other than the month in which it is formed. The same form is expected to be used for annual compliance reporting.

According to the draft Form 8996 and instructions, the organizational documents must include a statement that the purpose of the entity is to invest in QOZP and describe the business or businesses in which it expects to engage (directly or indirectly).

CONCLUSION

We intend to offer more insights and guidance on QOFs. Stay tuned!

Tags: 90-percent requirement, certification, corporations, deferred gain, Form 8949, Form 8996, formation, Internal Revenue Code, Internal Revenue Service, Investment, IRS, nonqualified financial property (NQFP), Opportunity Zone Funds, pass-through entity, Qualified Opportunity Funds (QOFs), qualified opportunity zone business (QOZB), Qualified Opportunity Zone Business Property (QOZBP), Qualified Opportunity Zone Partnership Interest (QOZPI), Qualified Opportunity Zone Property (QOZP), Qualified Opportunity Zone Stock (QOZS), Qualified Opportunity Zones (QOZs), real property, Reinvestment, stock, tangible property, Tax Cuts and Jobs Act, Treasury, working capital