Real Estate
Insights

Special Supplement

Qualified Opportunity Zones—a New Frontier

By Jackie Matsumura and Greg Dresdow

Background

The Tax Cuts and Jobs Act of 2017 (TCJA) created a new tax incentive designed to encourage development and investment in economically distressed communities known as Qualified Opportunity Zones (QOZ). These QOZ are nominated by the individual states and then certified by the Secretary of the Treasury.

The intent of these new tax provisions is to spur economic development by providing tax benefits to investors. An investor can temporarily defer tax on his/her gains on sale of assets by reinvesting in a Qualified Opportunity Fund (QOF). These gains are deferred until the earlier of the date on which the QOZ investment is sold or December 31, 2026. Additionally, if the investor holds the investment for at least 10 years, the appreciation in value of the investment can be excluded from income.

Proposed Regulations and IRS Guidance

The statute providing these new tax benefits raised a myriad of questions which caused paralysis in the creation of QOFs. Then, on October 19, the Treasury Department and the IRS issued proposed regulations and additional guidance regarding these provisions. Questions continue to surface and the government has stated that they will issue further regulations and guidance in the months ahead. However, with the guidance just released, there should now be enough certainty that we should start seeing an increase in the creation of QOFs.

From the Investor's Perspective

The taxpayer/investor may elect to exclude from gross income any gain on the sale of property if the gain is reinvested in a QOF within 180 days from the date of sale ("gain deferral election").

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As stated above, the gain on sale of the property is excluded from gross income until the earlier of the date on which the QOZ investment is sold or December 31, 2026. However, if the investor holds the investment for at least 5 years, he/she is entitled to a 10% basis increase and for at least 7 years, an additional 5% basis increase in the investment, thus reducing the ultimate recognition of the deferred gain.

Furthermore, if the value of the investment is greater than the original amount invested, and the "gain deferral election" is made, the gain on the appreciation is not recognized if the investment is held for at least 10 years. In order to exclude the appreciation from gain, the taxpayer must elect to use the fair market value of the investment on the date of sale as his/her basis in the investment ("fair market value election").

If an investor invests amounts in excess of eligible gains, the investment is treated as two separate investments. In other words, to the extent the investment comes from deferred gains, it will qualify for QOZ benefits. Any additional investment will not qualify for these benefits.

What is a Qualified Opportunity Fund (QOF)?

QOFs are investment vehicles that hold at least 90% of their assets in QOZ property. There are testing dates to ensure compliance with these requirements. These funds must be organized as a partnership or corporation. QOZ property includes 3 items:

- newly issued stock
- newly issued partnership interest
- business property

QOZ business property means tangible property used in a trade or business of a QOF if such property:

- was acquired after 2017
- the original use begins with the QOF or is substantially improved by the QOF
- substantially all of the use of such property was in a QOZ during the its holding period

QOZ business property will be viewed as substantially improved if during the 30-month period after acquisition, the cost of the improvements made to the property exceeds an amount equal to the adjusted basis of the property at the beginning of the 30 month period. Finally, QOZ businesses cannot include certain activities, e.g., golf courses, massage parlors, casinos, racetracks, liquor stores, etc.

Clarification by the Proposed Regulations

Below are selected highlights of clarifications in many key areas provided by the proposed regulations.

Eligible Investors

- Eligible investors for a QOF include individuals, C corporations, REITs, RICs and pass-through entities (partnerships, LLCs, S corporations, etc.) who invest gains from sales of property in a QOF within 180 days after the date of sale.
- The gains must be capital gains (not ordinary income gains).
- If a partnership/LLC or S corporation entity does not make the gain deferral election, the individual partner or shareholder can make the election.

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The 180-Day Period

If the pass-through entity does not make the gain deferral election, the partner's or S corporation shareholder's 180 day period begins on the last day of the pass-through entity's taxable year, unless the partner or S corporation shareholder chooses to start the period on the actual disposition date of the entity.

Electing Gain Deferral

The gain deferral election will be made on IRS Form 8949 attached to your timely filed tax return.

The 5- and 7-Year Holding Period

Whether the taxpayer gets the additional basis step ups at the 5th and 7th year anniversaries is still unclear when those anniversaries occur after December 31, 2026.

The 10-Year Holding Period

If the taxpayer makes the gain deferral election and holds the QOF investment for more than 10 years, then the appreciation in the investment can be excluded from income. There was a concern that the ability to exclude the appreciation from income would cease after 2028 when the Qualified Opportunity Zone designations ends, thereby, negating the 10 year hold benefit. The proposed regulations now permit this benefit if the fair market value election (described above) is made on or before December 31, 2047.

Carried Interest

There is no clarity yet regarding carried interests and how they might be viewed in this context. Some believe that as long as the carried interest holder contributed some capital resulting from eligible gains, this interest should qualify for the gain deferrals. The proposed regulations indicate that an "eligible interest" includes an equity interest with special allocations. However, it remains unclear whether a carried interest acquired in this fashion would be treated as an eligible interest or treated as two separate interests where only the portion acquired in exchange for the cash contribution would be eligible.

Debt Instruments and Deemed Contributions

The proposed regulations clarify that only the equity interests in a QOF qualify for QOZ tax benefits. A debt instrument is not an eligible interest. In addition, deemed contributions of money to a partnership due to a change in debt allocation does not constitute investment.

90% Test

To qualify as a QOF, 90% of the fund's assets must be QOZ property as of certain measuring dates. Initially, there was a concern as to whether cash would be classified as QOZ property. In the context of a new fund with large capital contributions, this was a valid concern. The proposed regulations provide a 31 month working capital safe harbor.

Now, temporarily holding large sums of cash will not disqualify the business as being a QOZ business as long as there is a written plan in place identifying the working capital as being held for the acquisition, development or improvement of property, and there is a written plan or schedule reflecting how the working capital will be spent over the 31 month period. Obviously, the final requirement is that the business has to comply with these written plans/schedule.

Certification as a QOF

There is no pre-approval or action required by the IRS to obtain certification status. A QOF merely self-certifies that it qualifies by filing a Form 8996 with its timely filed tax return.

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Pre-Existing Entities

Pre-existing partnerships and corporations are not precluded from qualifying as a QOF as long as the entity meets the requirements of a QOF.

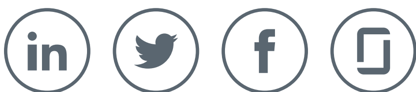
QOZ Property

As stated above, QOZ property must be acquired after 2017 and its original use must start with the QOF or the QOF must substantially improve the property. There was uncertainty as to how a QOF would ever meet the original use test with respect to the land element of the deal. Further, when looking at "substantially improving" the property, there was uncertainty as to how one was to view the land component in this test.

The proposed regulations, along with recently issue Revenue Ruling 2018-29, address the "original use" and "substantial improvement" requirements. In the end, the original use requirement is not applicable to the land and the land will qualify in the 90% asset test as long as the QOF is the original owner of the new building or has substantially improved the building situated on the land.

Summary

While there continue to be many questions as to these new rules, the guidance issued in mid-October should be sufficient to now allow us to see an increase in the creation of QOFs. Further guidance will continue to be developed and released during months ahead. ■



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