Qualified Opportunity Zones

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Background: part 1

- Enacted as part of the 2017 Tax Cuts and Jobs Act.
- Meant to spur investment in "downtrodden" census tracts with the goal of kick starting economic development in these areas.
- Tax benefits provide incentive for making long-term investments in these areas.

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Background: part 2

- Many media reports of high interest in investment, but not enough deals to go around.
- Origin Investments, a Chicago-based real estate firm, raised $105 million from 425 investors within 17 hours of launching a qualified opportunity fund.
- Amazon's proposed second headquarters in NYC was going to be located in Long Island City in an opportunity zone.

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Where are the Opportunity Zones?

- More that 8,700 all over the country.
- A map of the entire country can be found at:

  https://eig.org/news/opportunity-zones-map-comes-focus

  (or just google “opportunity zone map”)
- Travis County has 21 opportunity zones and the Austin metro area has 35.

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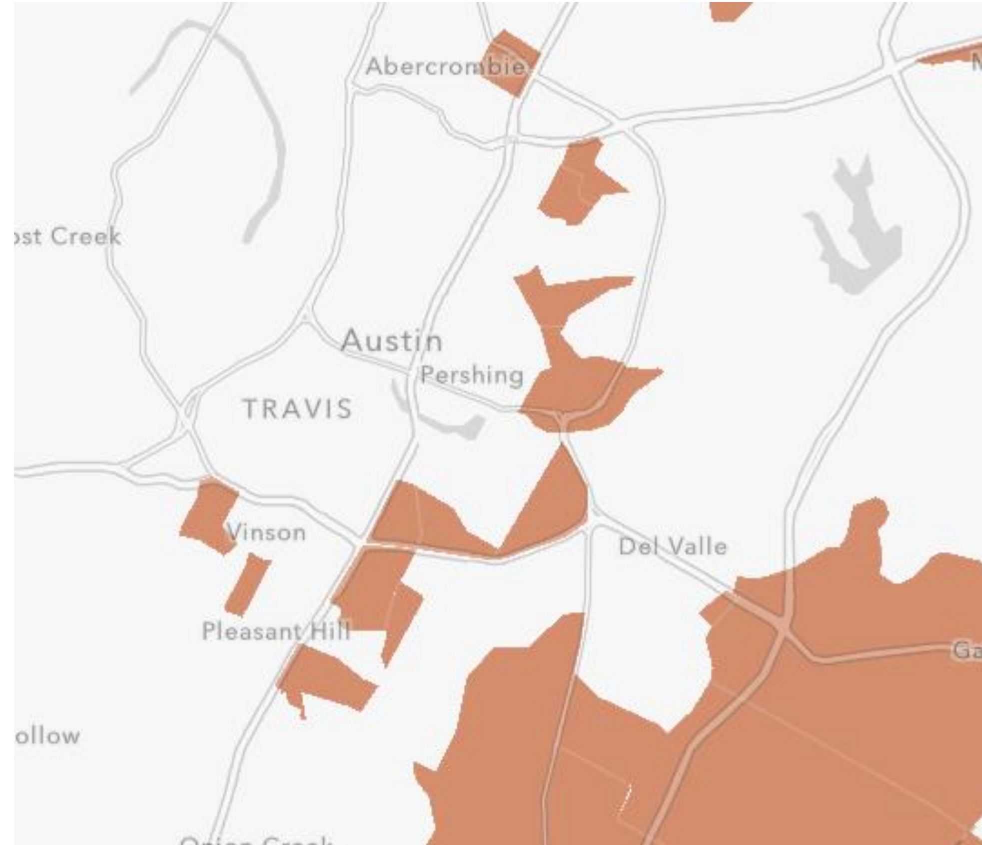
Austin Area O Zone



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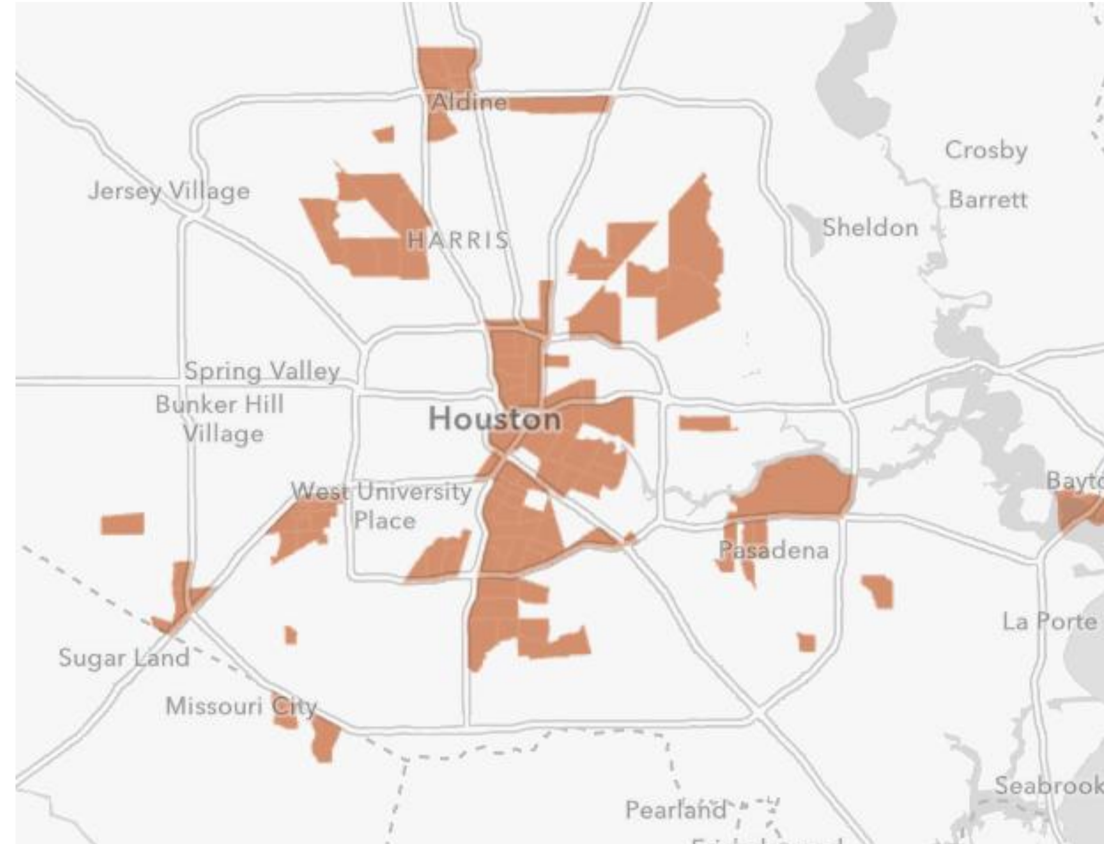
Houston Area O Zone



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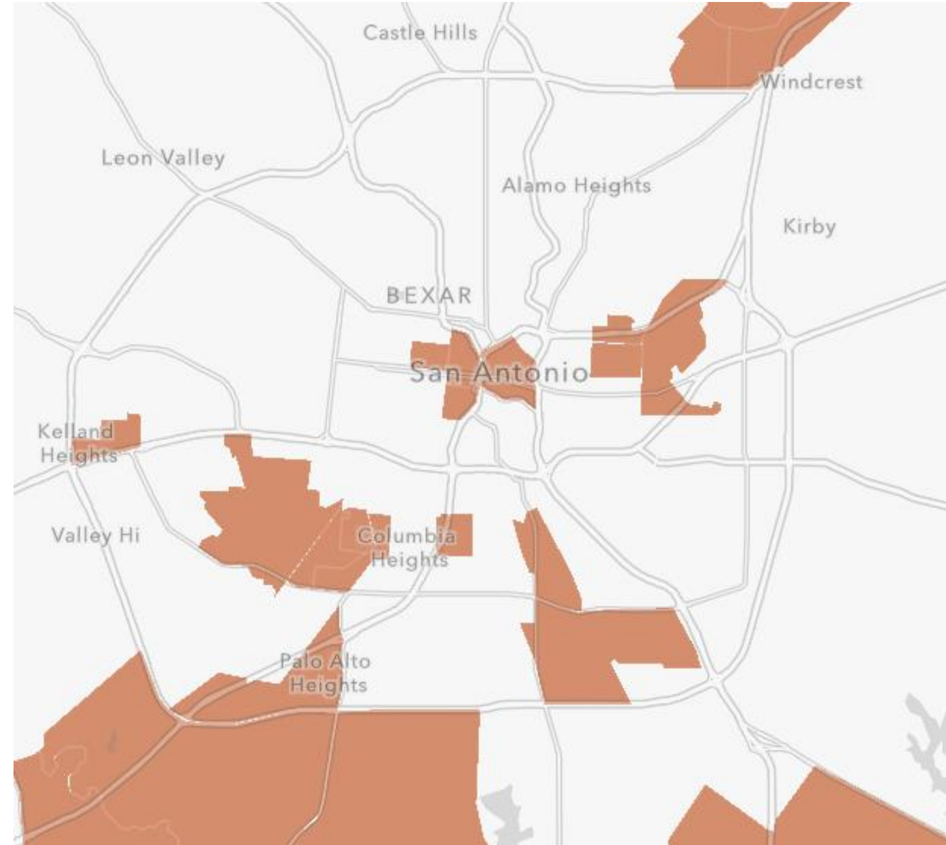
San Antonio Area O Zone



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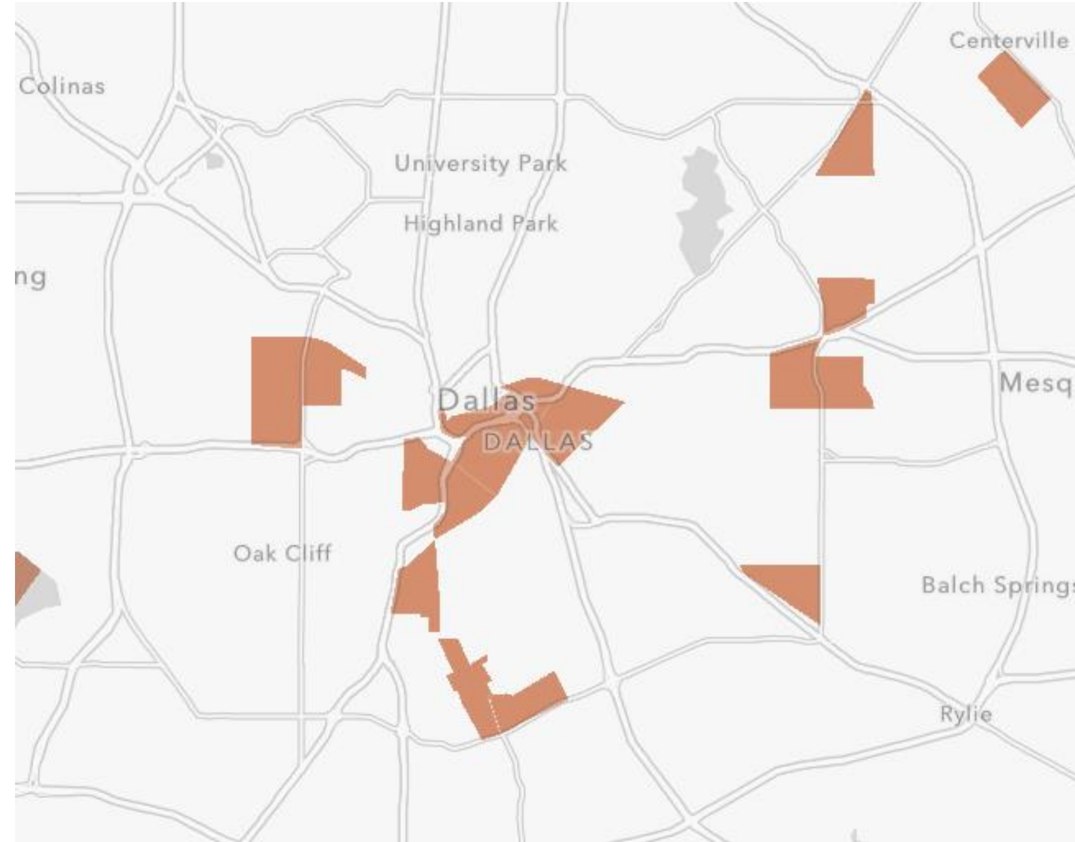
Dallas Area O Zone



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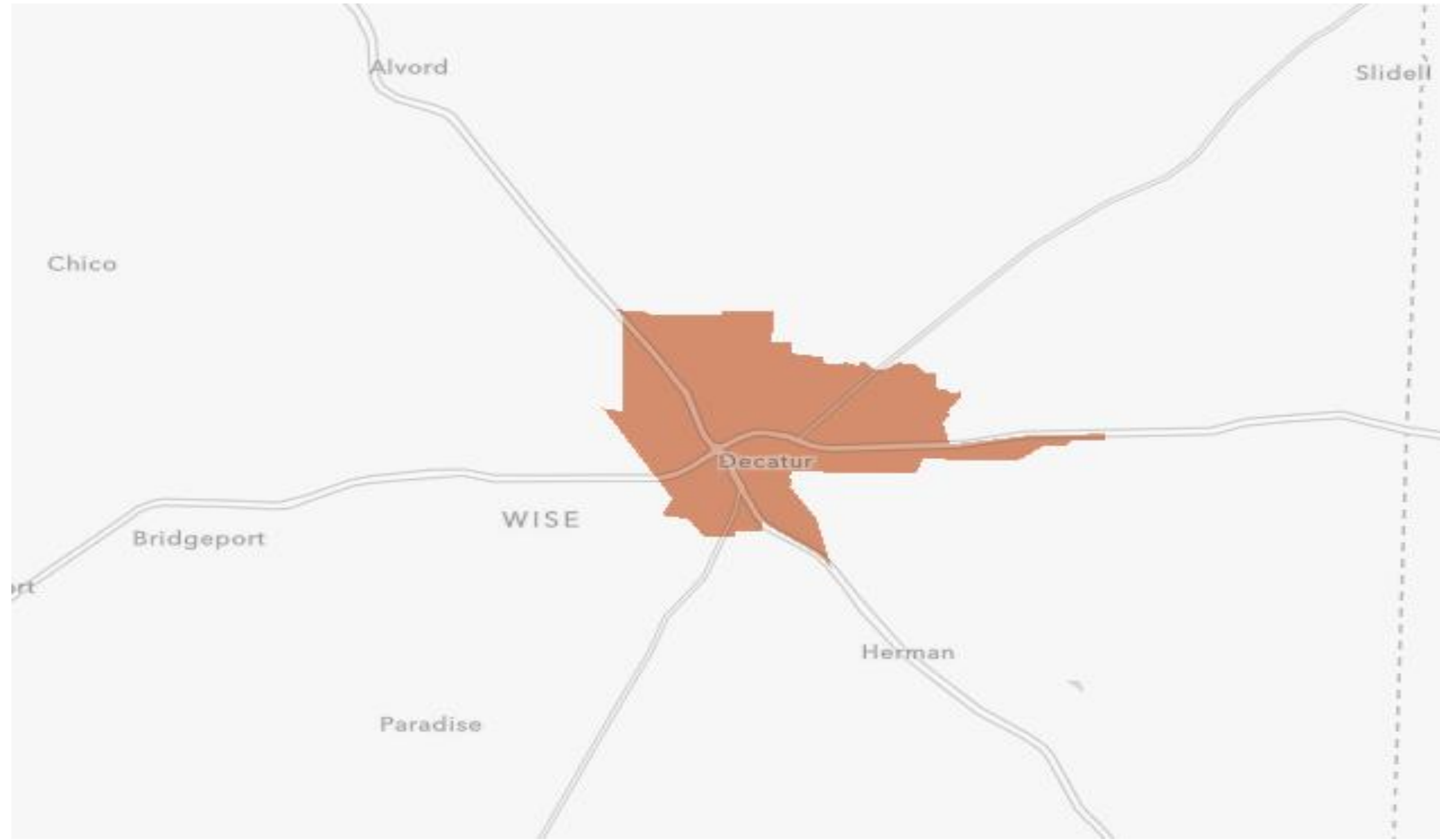
Decatur Area O Zone



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Tax Benefits: Simple Example

- Tim holds Apple stock with a basis of $1 million and FMV of $2 million.
- Tim is in the highest tax bracket, if stock was sold today Tim would have a $1 million gain and would pay (approximately) $230,000 in tax.
- Instead, if after Tim sells the stock, Tim invests an amount equal to his gain ($1 million, not $2 million) in a qualified opportunity fund, Tim may be eligible for 3 tax benefits.

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Tax Benefit 1: Gain Deferral

- If Tim sold his Apple stock and did not invest in a qualified opportunity fund, he would pay $230,000 in tax in the year of the sale.
- If Tim invests the amount of the gain ($1 million) in a qualified opportunity fund, Tim could defer payment of tax on his gain until the earlier of (1) December 31, 2026 or (2) the date Tim sold his investment in the qualified opportunity fund or otherwise has an inclusion event.
- For reference, the present value of a $230,000 payment, 7 years in the future (assuming a discount rate of 4.5%), is approximately $170,000. So, here the gain deferral is worth about $60,000.
- This demonstrates one reason why there is time pressure to get deals done sooner rather than later. There is no deferral beyond 12/31/26. The more time you have to defer gain, the more valuable this benefit is. To the get the maximum benefit, deferred gain must be re-invested before 12/31/2019.

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Tax Benefit 2: Small Basis Step Up

- If Tim holds his investment in the qualified opportunity zone fund for 5 years, some of the gain that is deferred will be eliminated due to a deemed increase in the basis of Tim's Apple stock.
- At 5 years, Tim's basis in his Apple stock will be deemed to increase by 10% of the original gain.
- At 7 years, Tim's basis in his Apple stock will be deemed to increase by an additional 5% of the original gain.
- So, after a 7-year hold, Tim's $1 million basis in his Apple stock will be deemed to increase to $1,150,000. This means that when the deferred gain is recognized, Tim will pay $202,300 of tax instead of $230,000.

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Tax Benefit 3: 100% Basis Step Up on Fund Investment After 10-Year Hold

- If Tim holds his investment in the qualified opportunity fund for 10 years, he may sell it and pay NO tax.
- This is because Tim may make an election to raise his basis in the qualified opportunity fund investment up to the FMV at the time he sells the qualified opportunity fund investment.
- However, this too has a time limit. Such sale must be made before December 31, 2047.

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Timing of Investment in QOF

- After assets generating gain are sold, proceeds must be invested in a QOF within 180 days from such sale.
- In order to take advantage of the 10-year hold basis step up, the gain deferral election must be made with respect to the initial investment in the QOF.
- If the gain that is to be deferred is in a partnership, either the partnership or the partner may make the election to defer the gain.
  - If the partner makes the election, the 180-day period begins on the last day of the partnership's taxable year in which the gain is passed through to the partner.
  - Note the opportunity to delay the 180-day period.
  - Also applies to S-corps, trusts, estates and their shareholders or beneficiaries.

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Eligible Gain

- Gain that is “treated as capital” for federal income tax purposes.
  - Including from actual or deemed sale
  - Including Section 1231 assets, which are not capital assets but their gains are taxed as capital.
- Would be recognized for federal income tax purposes before 1/1/2027.
- Does not arise from a sale or exchange with a related party.
- Does not arise from the sale or other transfer of property to a QOF in exchange for an eligible interest.

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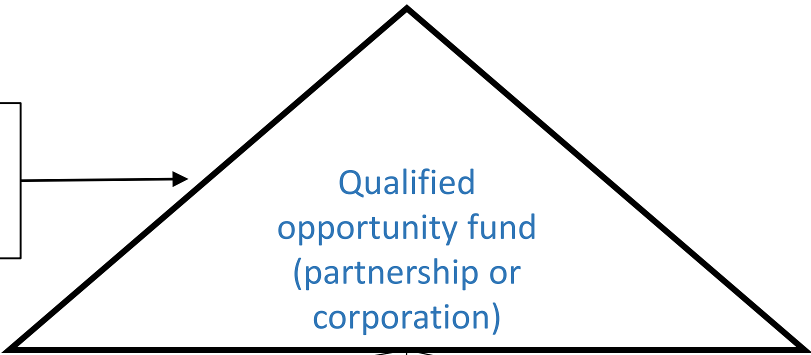
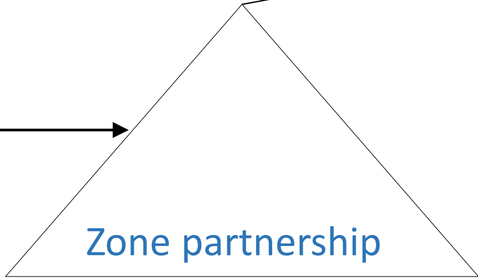
- **90% of assets must be in zone entities or in directly owned zone property**
- **10% may be any other asset**





Directly owned zone property must be "zone business property":
(i) it must be used in a trade or business,
(ii) it must be purchased from an unrelated person after December 31, 2017,
(iii) either the original use of the property in the zone must begin with the fund or the fund must invest at least the amount of the purchase price to improve the property, and
(iv) during substantially all of the holding period (90%) for the property, "substantially all" of the use (70%) of the property is in the zone as part of a trade or business.

For "substantially all" of the zone business's holding period:
(i) At least 70% of the tangible property owned or leased by the zone business must be in zone business property,
(ii) At least 50% of the gross income of the entity must be from the active conduct of the zone business.
(iii) A "substantial portion" of the intangible property (40%) of the zone entity must be used in the active conduct of the zone business,
(iv) Less than 5% of the average of the aggregate unadjusted bases of the zone entity's property may be attributable to "nonqualified financial property" (stock, debt, etc.) unless it qualifies for the "working capital safe harbor," and
(v) The zone entity cannot operate a "sin business."
Tangible property that ceases to be zone business property remains zone business property for five years.

Zone Partnerships and Zone Corporations

- In addition to requirements about the types of income and assets of such entities:
  - The equity in the entity must be acquired after December 31, 2017 at original issue from the entity solely in exchange for cash.
  - At the time the equity is issued, the entity must be a qualifying zone business or, in the case of a new entity, it was organized for the purpose of being a zone business.

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Gotcha! : Redemptions

- For Zone Corporations (but not for Zone Partnerships), certain redemptions could disqualify stock in a Zone Corporation from the 90% test.
- See Section 1400Z-2(d)(2)(B)(ii) and Section 1202(c)(3) and watch out for:
  - If, at any time during the 4-year period beginning on the date 2 years before the QOF acquired the stock, the Zone Corporation purchased (directly or indirectly) **any** of its stock from a related person (e.g., substantial owners or entities related through substantial common ownership), or
  - If, at any time during the 2-year period beginning on the date 1 year before the QOF acquired the stock, the Zone Corporation purchased (directly or indirectly) its own stock exceeding 5% of the aggregated value of all of its stock.

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90% test

- Measured on the last day of the first 6-month period of the fund AND on the last day of the taxable year of the fund.
- If the first month of a QOF's existence is in the 7th month of the year or later, then only the test at the end of the year applies for the first year.
- Valuation of assets is based off of applicable financial statements, if no financial statement applies, then based on the cost of the asset.
- The second set of regulations provide that the test can be applied without taking into account any investments received in the preceding 6 months.

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QOF Structure

- A QOF may not own an interest in another QOF and have it count toward the 90% test.

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Penalty for Failure to Meet 90% Test

- QOF pays a penalty for each month it fails to meet the test.
- Penalty = the underpayment rate times:
  - The excess of 90% of assets less the aggregated amount of qualified opportunity zone property.
- Example: QOF hold 70% qualified opportunity zone property. Total assets worth $1 million.
  - 5% x (90% of $1 million – 70% of $1 million) = $10,000. Then divided by 12 to determine the monthly penalty.
- There is an exception to this penalty for reasonable cause.
- The second set of regulations make it clear that failure to meet the 90% test, by itself, does not cause the fund to lose its QOF status (even on the first testing date).

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QOF Reinvestment Rule

- Proceeds from the sale of
  - QOZBP,
  - QOZ Stock or
  - QOZ Partnership interest
- are treated as QOZBP for purposes of the 90% test so long as
  - The QOF reinvests the proceeds during the 12 month period following the sale, and
  - The proceeds are continuously held in cash, cash equivalents and debt instruments with a term of 18 months or less.
- Also, a sale of the assets listed above will not impact an investor's holding period in the QOF or otherwise trigger inclusion of deferred gain (so long as such investor does not otherwise trigger an "inclusion event").
- Such sales will most likely cause a QOF corporation or the investors in a pass through QOF to recognize the gains resulting from such sales.

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Asset Sales by QOF partnerships or S Corporations

- If a partner in a QOF partnership or shareholder in a QOF S corporation has held their interest for 10-years and has gain from the sale of an asset by the QOF allocated to them on a K-1, the partner or shareholder may make the 10-year hold election to exclude gain.
- The proposed regulations provide no similar election for shareholders in a C corporation QOF.

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Substantial Improvement Requirement

- The Regulations and Revenue Ruling 2018-29 deal with how you substantially improve a parcel of land with a building on it. Essentially, only the building, not the land, need be improved.
- Example:
  - QOF purchases a parcel of land with a building on it for $5 million. The land is worth $2 million and the building $3 million.
  - The QOF must spend $3,000,001 on improvements to the building for it to be considered substantially improved.
- Qualifying expenses must be made within the 30-month period beginning on the acquisition date of the property.

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Original Use

- Second set of proposed regulations make it clear that original use of property begins when purchaser or a prior person places property in service in a QOZ.
- Property is considered placed in service when it is placed in a condition or state of readiness and availability for a specifically designed function (it is generally when property may begin to be depreciated).
- So, tangible property (other than land) that is first placed in service in a QOZ by someone other than a QOF or QOZB does not satisfy the original use requirement. But, if property has not yet begun to be depreciated, then it may be purchased by a QOF or QOZB and begin original use in a QOZ.
- Vacant structures; if a structure was previously placed in service and then purchased after 2017, it may be treated as satisfying the original use requirement if it was vacant for at least five years.
- Improvements to leased property are considered "purchased" for the amount of the cost basis of the improvement and satisfy the original use requirement.

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Unimproved Land

- The second set of regulations make it clear that unimproved land does not need to be substantially improved. Rev. Rul. 2018-19 makes it clear that the original use requirement also does not apply to land. But land will only be treated as QOZBP if it is used in a trade or business. So, a QOF land bank that speculated in land would not qualify.
- An anti-abuse will apply here, so a small operating business on a huge parcel of land may be subject to re-characterization.
- Real property other than land (i.e., structures) that are not newly placed in service will need to be substantially improved.

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Safe Harbor for Inventory in Transit

- Second set of regulations provides a safe harbor for inventory (including raw materials) in transit where such property will not fail to be considered to be "used" in a QOZ solely because it is in transit.

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Leased Tangible Property: 1 of 2

- Property that is leased can be used to satisfy the 70% and 90% QZOBP test. It can be paid for with cash or financed with debt.
- Leased property must be acquired under a lease entered into after December 31, 2017 and substantially all of the use of such property (70%) must be in a QOZ.
- There is NO original use or substantial improvement requirement with respect to leased property.
- There is NO requirement that the lease be from an unrelated person (but, related party leases have additional requirements).

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Leased Tangible Property: 2 of 2

- Requirements for leased tangible property:
  - (1) the lease must be at a market rate (determined under 482 regulations, which, very generally, means the amount of rent that would be paid by arms-length, unrelated parties in similar circumstances)
  - (2) If the lease is between related parties, at no time may a pre-payment be made that relates to a period of use that exceeds 12 months,
  - (3) If the lease is between related parties and a QOF or QOZB leases property, such QOF or QOZB must purchase other tangible property that has a value not less than the value of the leased property. Such purchase must occur in the period beginning with taking possession under the lease and ending on the earlier of the last day of the lease or 30 months from the beginning of the lease.
  - (4) General anti-abuse for improved real property: to prevent the use of the leased property rule to circumvent the substantial improvement requirement, if improved real property is leased and at the time the lease was entered into there was a plan, intent or expectation for the real property to be purchased for other than FMV, then the leased property will not be QOZBP.

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50% Gross Income Requirement

- The second set of regulations provide 3 safe harbors and one facts and circumstances test which are designed to help operating businesses meet the 50% gross income test.
- Safe Harbor 1: Based on number of hours, at least 50% of the services performed by employees, independent contracts and employees of independent contractors are preformed within the OZ.
- Safe Harbor 2: same test, but 50% based on amount paid for such services.
- Safe Harbor 3: (a) the tangible property of the business that is in the QOZ is necessary to generate 50% of income and (b) the management or operational functions performed for the business within the OZ are necessary to generate 50% of the income.
- Facts and Circumstances: based on all the facts and circumstances, at least 50% of the gross income is derived from an active trade or business in an OZ.

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Active Conduct of a Trade or Business

- Second set of regulations make clear that QOFs will use the "active conduct of a trade or business" standard found in Section 162 and the regulations promulgated thereunder.
- Generally, an active conduct of a trade or business requires a profit motive and activities that are "considerable, regular and continuous."
- The second set of regulations also make clear that for QOF purposes, the ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business.

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Working Capital Safe Harbor

- A QOF with a substantial amount of working capital could be problematic for the requirement that no more than 5% of the aggregated unadjusted bases of a zone partnership or zone corporation property may be attributable to "financial property" (i.e., liquid investments and cash).
- So, there is a safe harbor for reasonable amounts of working capital if:
  - There is plan in writing for how the working capital is to be spent (for example, on substantially improving property),
  - This plan has a reasonable schedule for when these amounts will be spent, and
  - The working capital assets are actually used per the plan.
- This safe harbor also applies to income generated by the safe harbor working capital for purposes of the 50% of income being derived from a trade or business requirement.
- Only applies to subsidiaries of a QOF, not to directly held property.
- The Second set of regulations make it clear that this written plan safe harbor may also apply to the development of an operating business as well as real estate development. Also, the safe harbor may be used multiple times, sequentially or overlapping.

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The End of Deferral: Inclusion Events

- If an inclusion event occurs, gains deferred by investment in a QOF will be recognized in the year of the inclusion event.
- Generally, an inclusion event occurs to the extent that a transfer of a qualifying investment (e.g., a direct or indirect equity interest in a QOF) causes a reduction in a taxpayer's direct or indirect interest in a QOF.
- The second set of regulations contain may examples and exceptions. Some examples include:
  - Taxable sale of QOF equity is an inclusion event.
  - Sale of interest in a S corporation that is an investor in a QOF is an inclusion event if this changes ownership in S corporation by more than 25% (measured from time of deferral election).
  - Transfer of a partnership interest that itself directly or indirectly holds QOF equity can be an inclusion event.
  - Gifts of QOF equity is an inclusion event (transfer by death is not an inclusion event).
  - Distribution to a partner in a QOF partnership that has a value in excess of the partner's basis in the QOF equity is an inclusion event.
  - Certain taxable redemption and liquidations are inclusion events.
  - Transfers to a grantor trust or disregarded entity are not inclusion events.
  - Section 368 reorganizations generally are not inclusion events, except to the extent of boot.

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QOFs and Subchapter K

- Second set of regulations go into more detail on how the QOF rules would work with the partnership rules.
- While an QOF investor's initial basis in her investment is zero, such basis does increase for debt of the partnership that is allocated to the partner.
- Also, if an investor sells their interest in a QOF partnership, the assets of the QOF partnership would be stepped up in the same way as Section 743.
- In the event of a mixed-fund investment in a QOF partnership, the partner is treated as having one interest in the partnership and one capital account for partnership purposes. But, for QOF purposes, is treated as having a qualifying interest in the QOF and a non-qualifying interest.

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QOFs and Subchapter K: Example

- Partner contributes $200 to QOF. Partner had $100 of gain eligible for deferral. $20 of QOF level debt was allocated to partner.
- Partner's total outside basis in QOF would be $120 ($0 basis for the qualifying investment, $100 for the non-qualifying investment plus $20 for the debt allocation).
- However, for purposes of determining 1400Z-2 inclusion events, the partner would have a $10 basis in the qualifying investment portion of the QOF (1/2 of the $20 of basis from debt allocation) and the remaining $110 would be attributable to the non-qualifying portion.
- So, a distribution from QOF of $40 would be split between the qualifying and non-qualifying portion. Such distribution would not result in gain under Section 731. However, it would cause an inclusion event and require the partner to include $10 of the deferred gain ($20 of the distribution allocated to the qualifying potion over the $10 basis in that portion).
- Takeaway: just because a distribution does not trigger gain under normal subchapter K rules does not mean that it will not cause an inclusion event.

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QOF direct operation / ownership vs. through a subsidiary

- Direct
  - 90% of assets must be QOZBP
  - No requirement relating to source of income from QOZ
  - No working capital safe harbor
  - No “sin business” restriction
- Subsidiary
  - 70% of assets must be QOZBP
  - 50% of income musty be generated from active conduct of a trade or business in QOZ
  - Working capital safe harbor
  - May not be a “sin business”

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QOF vs. 1031

- Partnership may allocate gain to partners who in turn can choose to elect or no elect to defer by reinvesting in a QOF
  - Much more difficult to allow individual partners to choose deferral or not in under a Section 1031 exchange because under a Section 1031 exchange, the partnership must transfer the relinquished property and hold the replacement property.
  - Only gains needs to be re-invested to defer such gain, not entire sale's proceeds.
    - With QOF, investors can take cash out and defer gains. With 1031 exchange, the entire sale's proceeds must be rolled-over.

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General Anti-Abuse Rule

- A transaction may be recast if a significant purpose of the transaction was to achieve a tax result inconsistent with the purposes of Section 1400Z-2.

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Open Issue: Netting of Gain and Loss in a Partnership

- If a partnership realizes both gains and losses during a year, it may elect to invest the gains in a QOF and pass the losses through to partners.
- However, if the partnership declines to make this election, the gains and losses will be netted and passed through to partners. Now, if the partners elect to invest gains in the QOF, they will only be able to invest the net gains.
- Why should this be different?

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Common Problem: Prior Ownership of Opportunity Zone Property

- To count as "zone business property" property must be purchased from unrelated parties after 12/31/2017.
- Can an taxpayer who has owned property in an opportunity zone prior to 12/31/2017 take advantage of the opportunity zone tax benefits? Yes, but…
  - One common solution is to have the QOF lease the land from the taxpayer and then build and own only the improvements on the land. The second set of regulations make it clear that improvements to a leasehold satisfy the original use requirement.
  - Another would be to bring in partners to the QOF (at least 80% new partners) so that the QOF and the taxpayer would not be considered related.

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