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Guidance in Proposed Regulations Expected to Jumpstart the Benefits of Qualified Opportunity Zone Investing

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Summary

The Tax Cuts and Jobs Act of 2017 introduced Opportunity Zone Provisions as an incentive for taxpayer investment in low-income neighborhoods and combined the benefits of both tax deferral and tax elimination. On October 19, 2018, the US Treasury released highly anticipated proposed regulations and Revenue Ruling 2018-29, which addresses certain issues associated with acquisitions of real property located in qualified opportunity zones.

In Depth

For many years the US tax code has enabled income tax deferral in certain situations. For the ordinary taxpayer, tax deferral opportunities include contributions made to employer-sponsored 401(k) and other qualified retirement plans; for investors, tax deferral possibilities are available via IRC § 1031 exchanges of certain types of appreciated property. Income tax deferral provisions are often used by the government to encourage taxpayer behavior. Rarely does the government offer tax elimination as an additional inducement. On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (the TCJA) did just that, introducing IRC § 1400Z (Opportunity Zone Provisions) which serves as an incentive for taxpayer investment in low-income neighborhoods and combines the benefits of both tax deferral and tax elimination. On October 19, 2018, the US Treasury released highly anticipated proposed regulations (the Proposed Regulations) and Revenue Ruling 2018-29, which addresses certain issues associated with acquisitions of real property located in qualified opportunity zones.

Under the Opportunity Zone Provisions taxpayers investing capital gains in a “qualified opportunity fund” (QOF) within 180 days of realization receive three benefits; (1) tax deferral on the initial capital gain invested in the QOF, (2) potential basis step-up in the initial capital gain invested, and (3) tax elimination on the QOF investment appreciation.

Tax on the initial capital gain is deferred until the earlier of (1) the date that the QOF investment is sold, or (2) December 31, 2026. At the conclusion of the deferral, gain will be taxed on the lesser of (1) the amount of the initial capital gain invested, over the taxpayer's basis in the initial capital gain, or (2) the now fair market value of the initial capital gain investment, over the taxpayer's basis. The taxpayer's basis in the initial capital gain is zero but, if the taxpayer holds the QOF investment for at least five years at the time of the deferral conclusion, the taxpayer's basis is increased by 10 percent of the initial capital gain. If the taxpayer had held the QOF investment for at least seven years at the time of the deferral conclusion, the basis is increased by an additional 5 percent of the initial capital gain. Any appreciation in the QOF investment is eliminated provided the investment is held for 10 years. As a note, because the deferred gain will be taxed by December 31, 2026 (at latest) and because the deferred gain must be held at least seven years in order to obtain the maximum 15 percent step-up in basis, investment in a QOF should be made on or before December 31, 2019, to achieve the maximum benefit.

To receive these benefits, the QOF must be a corporation or partnership organized for the purpose of investing in "qualified opportunity zone property" (QOZP) and at least 90 percent of the assets of which are such property. The Proposed Regulations provide clarity on two important rules as to when cash can be treated as QOZP. Specifically, the Proposed Regulations provide that cash held as working capital will be counted as QOZP and that cash from the proceeds of selling QOZP will qualify so long as such cash is reinvested within a reasonable period of time in other QOZP. To determine whether a QOF holds 90 percent of its assets as QOZP, the assets are valued based on valuations used in audited financial statements and if the company does not utilize audited financials the value of property is equal to its initial cost basis. An investment in a qualified opportunity zone stock and qualified opportunity zone partnership interest is treated in its entirety as an investment in QOZP. A QOF failing to meet the 90 percent asset percentage test will be required to pay a penalty for each month it fails the test.

A QOZP is defined as property that is "qualified opportunity zone stock," a "qualified opportunity zone partnership interest," or "qualified opportunity zone business property."

"Qualified opportunity zone stock" and "qualified opportunity zone partnership interest" is stock or an interest in a US corporation or partnership, respectively. The stock or interest must be acquired by the QOF after December 31, 2017, at original issue and solely in exchange for cash. At the time the stock or interest is issued, the entity must be a "qualified opportunity zone business" (QOZB) (or, in the case of a new entity, organized for purposes of being a QOZB). The entity must remain a QOZB for substantially all of the time the QOF holds the stock or interest.

A "qualified opportunity zone business" (QOZB) is a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is "qualified opportunity zone business property" (QOZBP). The Proposed Regulations provide a safe harbor clarifying that if 70 percent or more of the tangible property is QOZBP, the entity will own an adequate amount of tangible property to meet this requirement. At least 50 percent of the total QOZB's gross income must be derived from the active conduct of such business, a "substantial portion" of the intangible property of the QOF must be used in the QOZB, and the average of the aggregate unadjusted bases of the QOZBP attributable to "nonqualified financial property" must be less than 5 percent.

A QOZBP owned by a QOZB may not be used to provide, including the provisioning of land, for any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off the premises.

A QOZBP means tangible property used in a trade or business of the QOF if (1) the property was purchased by the QOF after December 31, 2017, (2) the original use of the property in a "qualified opportunity zone" starts with the QOF, or the QOF substantially improves the property, and (3) substantially all of the use of the property was in a "qualified opportunity zone" during substantially all of the time the QOF holds the property. Future regulations will be issued to clarify what "substantially all" of the use of the property and "substantially all" of the time holding the property means. "Qualified opportunity zone business property" will be treated as substantially improved by a QOF only if during any 30-month period beginning after the date of the property's acquisition its basis is increased by an amount exceeding its initial cost basis. In the case of real property, the Proposed Regulations and Rev. Rul. 2018-29 make an important clarification. Even though land can never be put to first use by a taxpayer, the guidance from Treasury clarifies that the price paid for land is excluded for purposes of determining whether substantial improvement occurs. For example, if a QOF acquires a parcel of real estate, which includes land with a value of $60,000 and a building with a value of $40,000, to substantially improve this property would require that the QOF incur $40,000 of improvement to the building.

Under IRC § 1400Z-1 a "qualified opportunity zone" (QOZ) is a low-income community that is designated as a qualified opportunity zone by the state in which it is located and certified by the US Treasury.

In sum, a QOF can invest its funds in a QOZBP through a QOZB that is a corporation or partnership, or it can invest directly in to a QOZBP. One advantage of investing directly in to a QOZBP is the ability to engage in the business listed above (*e.g.*, golf course, country club, massage parlor, hot tub facility, suntan facility, etc.) as opposed to investing in a QOZBP owned by QOZB and which is not permitted to engage in these businesses. Other advantages of a QOF investing directly in QOZBP include the QOF's ability to hold up to 10 percent of the QOF's assets in cash (versus the 5 percent—plus working capital—threshold for QOZB investments) and the absence of a minimum percentage of gross income that the QOF must derive from the QOZBP (versus the requirement that a minimum of 50 percent of a QOF's gross income be derived from QOZB investments).

On the other hand, the advantages of a QOF investing in QOZB include the absence of a minimum percentage of QOF assets that must be invested in tangible property (versus the minimum 90 percent requirement for QOZBP investments). Thus, a QOZB can be comprised entirely of intellectual property. For example, a tech startup company located in a qualified opportunity zone could issue qualified opportunity zone stock even if the majority of its assets is comprised of intellectual property. Moreover, to the extent the QOZB owns tangible property only 70 percent of such property need be QOZBP. This flexibility on asset composition puts the QOZB investment at an advantage in many cases. The non-taxation of gain provisions under the Opportunity Zone Provisions differ from general IRC non-taxation of gain provisions (*e.g.*, IRC § 1031) in that, generally, under the other IRC provisions deferral of gain is only permitted if the taxpayer reinvests the entirety of the sales proceeds in the new property—which includes both the portion representing basis and the portion representing gain. Taxpayers may choose to defer all or a portion of a capital gain. In contrast, the Opportunity Zone Provisions require only that the taxpayer invest the gain from a sale to receive the deferral treatment. Second, as noted above, IRC § 1400Z does not only defer the initial capital gain from tax and potentially reduce the amount of such tax, but also enables the QOF investment appreciation to never be taxed—assuming that the investment is held for 10 years. The Proposed Regulations allow an investor to pledge his or her interest in a QOF as collateral on a loan. Thus, the investor can receive a significant amount of cash from the capital gain event, while still otherwise receiving the benefits of the Opportunity Zone Provisions. Moreover, an investor can continue to defer the capital gain even if he or she were to sell the interest in the QOF within the seven year period, so long as the initial investment is entirely disposed of by the investor and is reinvested within 180 days in a replacement QOF.

How It Works – by the Numbers

As an example, assume an investor invests $1,000,000 of capital gain in a QOF in 2018 (QOF Investment). The deferred gain will be taxed at the earlier of (1) the date on which the taxpayer sells the QOF Investment, or (2) December 31, 2026. The amount taxed will be $1,000,000, reduced by the investor's basis in the QOF Investment. If on the date that the QOF Investment is sold the QOF Investment is worth less than $1,000,000, then the QOF Investment is taxed at its fair market value on the date on which it is sold, reduced by the investor's basis in the QOF Investment.

The investor's basis in the QOF Investment is initially zero, but if the investor holds the QOF Investment for at least five years (*e.g*., until 2023), the investor's basis in the QOF Investment becomes $100,000 (10 percent of $1,000,000); if the investor holds the QOF Investment for at least seven years (*e.g*., until 2025), the investor's basis in the QOF Investment becomes $150,000 (15 percent of $1,000,000). After the $1,000,000 is taxed, the taxpayer's new basis in the QOF Investment becomes $1,000,000. Therefore, if the investor holds the QOF Investment for nine years (*e.g*., until 2027), the amount taxed will be any appreciation in the investment over the $1,000,000 of new basis. If the investor holds the QOF Investment for at least 10 years (*e.g.,* until 2028), the investor's basis in the QOF Investment is increased to the fair market value of the QSF Investment on the date on which it is sold, resulting in none of the investment appreciation being taxed (*i.e*. any increase in the investment over $1,000,000 is never taxed).

The benefits to the investor in this example are (1) tax deferral of the $1,000,000 of initial capital gain invested in the QOF until the earlier of the date that the QSF investment is sold, or December 31, 2026; (2) decrease of the $1,000,000 of initial capital gain ultimately taxed to $900,000 (90 percent) or $850,000 (85 percent), depending on whether the investment is held for five or seven years, and most noteworthy (3) tax avoidance on any appreciation that the $1,000,000 of initial capital gain invested in the QOF generates, if the QOF Investment is held for 10 years.

Conclusion

The Opportunity Zone Provisions provide rare tax benefits for many investors. While the recently released Proposed Regulations answer many questions, additional regulations and guidance from the IRS and the US Treasury is expected before year-end.

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