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How to Invest in a QOF

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OVERVIEW

Since coming into effect in January 2018, Subchapter Z of the US Tax Code—also known as the opportunity zone provisions—has enabled investors to pour billions of dollars into a broad array of businesses, from real estate development companies to tech startups. Investments in qualified opportunity funds (QOFs) offer a number of distinct tax benefits, not the least of which is reduced capital gains tax liability. But the rules governing these investments are quirky, perplexing and—in some cases—severely restrictive.

You've decided that the benefits of qualified opportunity funds (QOFs) make this an attractive investment vehicle. But how do you go about identifying and investing in a QOF? In this second of our series of articles on QOFs, we discuss—from an investor's perspective—the requirements for making an eligible investment in a QOF.

IN-DEPTH

Under the opportunity zone provisions contained in Subchapter Z of the US Tax Code, taxpayers may qualify for some or all of the tax benefits discussed previously in this series by investing eligible gains in a qualified opportunity fund (QOF), generally, within 180 days of recognition.

On December 19, 2019, the US Treasury (Treasury) released Final Regulations (the Final Regulations) providing guidance under Subchapter Z. The Final Regulations clarify what is meant by Subchapter Z's instruction that a taxpayer must invest "eligible gains" in order to benefit from investing in a QOF. Generally, the Final Regulations consider eligible gains to include those treated as capital gains for US federal income tax purposes. These include gains from the disposition of capital assets, gains from the disposition of Section 1231(b) property, and other forms of income treated as capital gain under the Internal Revenue Code. Both long-term and short-term capital gain are eligible gains. Thus, gains from the disposition of real property, stock, cryptocurrency, artwork, and many other types of assets may be invested into a QOF. The Final Regulations clarify that eligible gain does not include recapture gain that is treated as ordinary income under Section 1245(a) or Section 1231(c).

In what was a favorable decision for many taxpayers, Treasury also noted that capital gain can be invested even if the taxpayer has offset capital losses. This has a major impact on Section 1231 gains, which, ordinarily, would only be determined at year-end when Section 1231 gains are netted against Section 1231 losses. Instead, the Final Regulations clarify that Section 1231 gains are immediately available upon recognition as eligible gains to invest in a QOF and are not offset by Section 1231 losses for purposes of amounts contributed into a QOF. Thus, the 180-day period to invest in a QOF generally begins on the date of the sale or exchange that gives rise to the eligible Section 1231 gain. Moreover, because the invested Section 1231 gains are not netted against Section 1231 losses, there is a greater possibility that taxpayers could find themselves in a Section 1231 loss position, which may be treated as an ordinary loss to the taxpayer.

The Final Regulations generally provide that eligible gains only include those that are otherwise subject to US federal income tax. This position has significant consequences for tax-exempt and foreign investors who in certain circumstances may not be subject to US federal income tax. However, other foreign or tax-exempt investors will be able to benefit from the QOZ provisions to the extent such an investor generates capital gain that is subject to a federal income tax liability. For example, a tax-exempt entity that has capital gains attributable to unrelated business taxable income under Section 511 can generate eligible gains and benefit from investment in a QOF. Similarly, a foreign investor with capital gains that are effectively connected to a US trade or business could treat those gains as eligible gains.

The Final Regulations further provide that the QOZ provisions are not considered nonrecognition provisions for purposes of withholding under the Foreign Investment in Real Property Tax Act (FIRPTA). Therefore, a foreign investor who plans to reinvest gains subject to FIRPTA into a QOF will still be subject to the 15% withholding at the time they dispose of an interest in US real property. The Final Regulations also are silent as to whether the amount of withholding may be reduced under 1446(f) for a sale by a foreign investor of a US partnership interest. It is debatable whether these provisions will further the underlying goal—to encourage investment in low-income communities—of the QOZ provisions. Foreign investment constitutes a large portion of investment in US real estate, and many foreign investors have limited US federal tax liabilities. Therefore, the Final Regulations appear to limit their incentive to invest in a QOZ rather than in a more economically advantaged census tract.

In order to benefit from the QOZ provisions, taxpayers are required to invest their eligible gains within 180 days of the date that the taxpayer would recognize the gain. The Final Regulations provide generally helpful clarifications for calculating this 180-day investment window for RIC/REIT capital gain dividends, installment sale gains, and gains from pass-through investments. In the case of RIC/REIT capital gain dividends, the 180-day period begins at the end of the shareholder’s taxable year in which the gain would be recognized or, if the taxpayer elects, from the date the capital gain dividend is actually paid. Similarly, the 180-day period for installment sale gains may be calculated from either the date payment is received or the last day of the taxable year when the eligible gain would otherwise be recognized. Importantly, installment sale gains recognized in 2018 or later from a sale transaction that occurred prior to 2018 are eligible gains that may be invested into a QOF.

The Final Regulations also clarify the beginning of the 180-day period for gains derived from the pass-through investment. The taxpayer may elect to begin the 180-day period on the date of the transaction of the entity giving rise to the gain, on the last day of the pass-through entity’s taxable year or on the due date of the entity’s tax return. This allows partners to determine with full information whether pass-through entity gains are eligible gains.

Eligible gain can only arise from a taxable transaction with an unrelated party. In response to public

comments, the Preamble to the Final Regulations warns that a transaction whereby a taxpayer ostensibly recognizes gain from selling property to an unrelated QOF as part of a plan that involves reinvestment of the gain in the QOF may be recharacterized as a contribution of the property under circular cash flow or step transaction doctrine principles. For example, a scenario where a taxpayer sells land to an unrelated QOF with which they develop a working relationship and, seeking to defer recognition of gain on the sale, invests the capital gain in the same QOF may be subject to recharacterization depending on the specific facts. Similar rules apply where a taxpayer enters a transaction with a qualified opportunity zone business (QOZB) and seeks to reinvest gain in a related QOF. If correct, the position put forth by the Treasury in the Preamble would effectively eliminate from the statute the term “unrelated” from Section 1400Z-2(a)(1) and much of the 20% threshold in Section 1400Z-2(e)(2), and ignore the existence of Section 707(a). If recharacterized as a contribution in the manner described in the Preamble, there would be significant repercussions to the remaining members of the QOF. For example, the deemed contributed property would not be qualifying QOZ property and could, thus, cause the entire QOZB to not meet its statutory requirements.

In the year that a taxpayer invests eligible gain into a QOF, the taxpayer must report the investment on Form 8997. The taxpayer must continue to report annually, on Form 8997, its cumulative investments in QOFs and dispositions until all investments of eligible gain are disposed of.

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