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Anticipated Proposed Regulations on Qualified Opportunity Zones Released

Last Friday the IRS issued proposed regulations, a revenue ruling and an updated Q&A document providing guidance in applying the Qualified Opportunity Zone (QOZ) rules.

Highlights

The Tax Cuts and Jobs Act created a new rule that allows investors to defer the recognition of capital gain by investing in a Qualified Opportunity Fund (QOF) that invests in Qualified Opportunity Zones (QOZ).

Once invested in a QOF, taxpayers must recognize the deferred gain on the earlier of the sale of its interest in the QOF or December 31, 2026. If the taxpayer holds its interest in the QOF for at least 5 years, then it will be entitled to permanently exclude 10% of its deferred gain. If its interest in the QOF is held for at least 7 years, then it will be entitled to permanently exclude an additional 5% of the deferred gain. Additionally, any future appreciation is permanently excluded if the taxpayer holds its interest in the QOF for at least 10 years.

The proposed regulations provide much needed guidance on how to apply the new QOZ rules and should allow investors to move forward with selling capital assets and rolling over the capital gain into QOFs. Below are some highlights of the more critical aspects of the proposed regulations.

- Only capital gain, either short-term or long-term is eligible for deferral.
- Taxpayers eligible to defer capital gain include individuals, C corporations, REITs, partnerships, S corporations and trust and estates.
- A partnership may choose to defer gain on sale of its property by reinvesting all, or a portion, of the gain in a QOZ property or QOZ business or a QOF. If the partnership does not elect to defer gain, each partner may make its own election to defer gain.
- Taxpayers will be entitled to exclude gain from the sale of QOF interests made before December 31, 2047.
- Partnership debt allocated to partners will not be treated as a separate or disqualifying investment.
- Domestic entities treated as a corporation or a partnership for federal tax purposes may qualify as a QOF. LLCs and REITs will qualify.
- QOF may place funds in a working capital account for as long as 31 months if certain requirements are met.
- Land is treated as qualifying property and not counted when determining whether QOZ property has been substantially improved.

Basic QOZ Rules

1. A taxpayer may defer recognizing capital gain if, within 180 days from the sale or exchange of property to an unrelated party, the taxpayer invests cash equal to such gain into Qualified Opportunity Fund (QOF) and elects the QOZ rules. Taxpayers must recognize the deferred gain on the earlier of the sale of its interest in the QOF or December 31, 2026. If the taxpayer holds its interest in the QOF for at least 5 years, then it will be entitled to permanently exclude 10% of its deferred gain upon sale of its QOF interest. If its interest in the QOF is held for at least 7 years, then it will be entitled to permanently exclude an additional 5% of the deferred gain. Additionally, if the taxpayer holds its interest in the QOF for at least 10 years then it will be entitled to permanently exclude from income any gain from the sale of its investment in the QOF. To maximize deferral, a taxpayer would need to invest deferred gain by the end of 2019.

   For example, if a taxpayer recognizes $1M of capital gain, timely reinvests the gain in a QOF and sells the QOF interest within five years, then 100% of the $1M gain must be recognized in the year of sale. On the other hand, if taxpayer holds the QOF interest for at least five years, then ten percent of the gain ($100K) may be excluded. If the QOF interest is held for an additional two years (for a total of seven years) then an additional five percent of the gain ($50K) is excluded for a total of $150K of gain free from tax. The remaining $850K of deferred gain must be recognized upon the earlier of sale of the QOF interest or at the end of 2026. If the taxpayer holds the QOF interest for at least 10 years, it may eliminate tax on all the appreciation on the QOZ property. Using the above example, if taxpayer sold the QOF interest after ten years for $1.5M, the $500K of appreciation would be free from tax.

   A taxpayer may invest non-gain cash in a QOF, but this investment is not eligible for the ten-year exemption from tax on future appreciation in the QOF. The rollover of the gain cash and additional contribution of non-gain cash are treated as two separate investments in the QOF. For example, if a taxpayer has $1M of cash gain that is contributed to a QOF and contributes $2M of non-gain cash, then only one-third of the future appreciation will be exempt from tax after ten years. As discussed below, a QOF that is a partnership may leverage its investments and the debt will not be treated as a separate investment for these purposes.

   Deferring gain on the sale of property by rolling over the cash gain into a QOF is in lieu of Section 1031 like-kind exchanges. Once the election to roll over the gain into a QOF is made, a subsequent Section 1031 like kind exchange is unavailable and taxpayer must recognize all or part of the gain by the end of 2026.

2. A QOF is a partnership or corporation, organized to invest in “Qualified Opportunity Zone (QOZ) property” which holds at least 90% of its assets in QOZ property (tested at the 6-month mark and on the last day of the year). The law imposes penalties if the QOF fails the 90% test. QOZ property includes (i) QOZ business property and (ii) QOZ partnership interests or corporate stock (QOZ entities). QOZ entities must be engaged in a QOZ business.

3. A QOZ business is a “trade or business” in which
    a. “substantially all” of the tangible property owned or leased by the taxpayer is “QOZ business property”;
    b. at least 50 percent of the total gross income of such entity is derived from the active conduct of such business;
    c. a substantial portion of the intangible property of such entity is used in the active conduct of any such business;
    d. less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property; and
    e. the business is not one of certain listed businesses, such as liquor stores and golf courses.

4. QOZ business property means tangible property used in a trade or business of the QOF if the following requirements are satisfied:
    a. Such property was acquired by the qualified opportunity fund by purchase from an unrelated person after December 31, 2017;
    b. Either
        i. the original use of such property in the QOZ commences with the QOF, or
        ii. The QOF “substantially improves” the property; and
    c. during substantially all of the QOF’s holding period for such property, substantially all of the use of such property was in a QOZ.
    d. Substantial improvement means that the cost of improvement during the 30-month period from the date of purchase exceeds the QOF’s purchase price of the property.
    e. Persons will be treated as related if there is a 20% common ownership.

The Proposed Regulations

The proposed regulations (i) clarify the rules for deferral of gain, (2) allow for self-certification and (3) provide some, but not all, of the requirements allowing a corporation or partnership to qualify as a QOF. Although the regulations are proposed, taxpayers may rely on them until final regulations are issued.

The proposed regulations do not resolve a number issues. The IRS has promised that it will soon provide guidance dealing with these issues as well as requesting advice from taxpayers as to how such questions should be answered.

Deferral of Gain

- A taxpayer eligible to defer gain is any “person” that otherwise may be subject to U.S. tax on such gain. This includes individuals, C corporations, REITs, partnerships, S corporations and trust and estates. Non-U.S. persons subject to U.S. tax also would be eligible to elect deferral.
- Only capital gain, either short-term or long-term is eligible. This can include gains from the sale of stocks as well as real estate including the “unrecaptured Section 1250 gain” which would

otherwise be taxed at the higher 25% rate. The gain must not result from a sale to a related person.

- An open question that the proposed regulations did not address is whether a partnership that owns real estate used in a trade or business may elect to defer the gain on sale. Since this gain is "1231 gain" it is not capital gain at the partnership level; its character as capital gain is determined at the partner level. Additional guidance from the IRS addressing this issue is needed.
- The taxpayer may invest either all, or a portion, of the gain within 180 days from the date upon which the gain was realized, generally the date of sale. For REIT shareholders receiving a capital gain dividend, the triggering date is the day upon which the capital gain dividend was paid. The reinvestment may be made with any funds, whether or not they are the same funds as were generated by the sale. The rules provide flexibility for partnerships and partners. A partnership may choose to defer gain on sale of its property by reinvesting all, or a portion, of the gain in a QOZ property or QOZ business or a QOF. If the partnership does not elect to defer gain, each partner may make its own election to defer gain. In this case, the partner may either (i) reinvest within 180 days of the end of the partnership's taxable year or (ii) the date upon which the partnership recognized the gain. Similar rules are applied to other pass-through entities, such as S corporations, estates and trusts.
- Taxpayers may invest gains realized prior to December 31, 2026 in QOFs. For sales made in December 2026, a taxpayer would have until June 29, 2027 to reinvest the gain. Taxpayers will be entitled to exclude gain on appreciation for sales of QOF interests made before December 31, 2047 (assuming QOF interest has been held for ten years). This means that a taxpayer must sell the QOF interest by the end of 2047.
- QOZ designations end December 31, 2028. However, the fact that the QOZ ends will not impact the taxpayer's ability to take advantage of the QOF rules for sales of QOF interests after that time. The entity must be a QOF when the taxpayer makes its investment.
- The regulations set forth detailed rules governing the way in which gain is recognized, including the tax attributes of the deferred gain and how gain recognized on the sale of a QOF interest may be deferred by reinvesting in a second QOF. There are special rules for Section 1256 contracts and straddles.

Self-Certification

- The regulations adopt a self-certification procedure that will allow a QOF to certify that it qualifies for QOF treatment.
- The election is made on the entity's tax return.

Form of Investment

- A QOF may be a domestic entity treated as a corporation or a partnership for federal tax purposes. REITs will qualify as will LLCs taxed as either a partnership or a corporation.
- Existing entities may be used as QOFs, although this may not be advisable in view of 90% rule. Existing entities may also be used as a subsidiary of the QOF.
- Only equity interests are eligible investments for taxpayers deferring gains. This may include preferred stock and partnership interests with special allocations. Debt does not qualify, but taxpayers may pledge their interests as collateral.
- The rules make it clear that partnership debt allocated to partners will not be treated as a separate or disqualifying investment. Partnerships may leverage their investments. For example, assume a taxpayer has $1M of gain proceeds and invests in a QOF partnership and the QOF also borrows $1M to acquire property and develop it. If taxpayer holds the QOF interest for ten years and sells for $4M, taxpayer will recognize $850K of the original deferred gain. No additional tax on gain of $2M will be due even though part of the acquisition was funded with debt. It is unclear how debt financed distributions will impact the deferral of gain. However, given that the proposed regulations ignore leverage for purposes of calculating gain, debt financed distributions might also be ignored. Future proposed regulations may address this issue.

90% Test – General

- The entity may determine when it intends to become a QOF, which may be the beginning of any month during the taxable year. Investments made before the entity elects to be a QOF are not eligible to be QOZ property.
- The QOF may have 90% of the value of its assets in QOZ property, based on an average of (i) 6-month test and (ii) test at end of taxable year.
- The initial test occurs at the end of 6 months during the first taxable year. If the taxable year is 6 months or less, the test will occur only at the end of the year.
- If the QOF has an "applicable financial statement (AFS)," such as an SEC filed financial statement or a certified audited statement, the test is based on these statements.
- If the QOF does not have an AFS, the test is based on cost.

90% Test – Directly Held Property v. Qualified Stock or Partnership Interest

- If the QOF holds QOZ property directly, the directly held property is subject to the 90% test.
- But if the QOF owns stock or a partnership interest in a qualifying entity, then:

- "substantially all" of the tangible property owned or leased by the entity must be QOZ property---the regulations define "substantially all" as 70%.
- If QOF owns more than one entity, each entity must satisfy the 70% test (see above)

- As a practical matter, if the QOF raises $10M which is used to purchase QOZ property
    - Directly held property - $9M must be QOZ property
    - Property held by underlying entity –
        - QOF must invest $9M in entity, of which 70% (or $6.3M) must be QOZ property
    - Preamble to regulations indicates that IRS is encouraging the use of subsidiaries rather than direct investment
- Determination of whether entity meets 70% test is more complicated
    - If entity has AFS, AFS will govern
    - If entity does not have AFS, but entity has 5% owners, then the entity made use the method adopted by one of the 5% owners that results in the larger percentage of QOZ property. For example, if one 5% owner uses an AFS and the second uses the cost method to determine the value of its QOF interest, the entity may choose either method.

Working Capital Safe Harbor

- QOF may place funds in a working capital account for as long as 31 months if:
    - There is a written plan identifying purpose of the account for the acquisition, construction or improvement of QOZ tangible property.
    - There is a written schedule consistent with ordinary start-up of business operations that shows funds will be used within 31-month period. (The preamble to the regulations provide that the schedule must show the property will be used within the 31-month period, but the language of the regulations is broader, perhaps allowing the funds to be used in the business itself. For example, may be funds be used to leasing expenses?)
    - QOF substantially complies with the schedule.
    - Working capital account means cash, cash equivalents and debt instruments with 18 month or shorter maturity.

  - Income generated by the working capital account will be treated as qualifying active trade or business income.
  - During start-up period, intangible property owned by QOF is deemed to satisfy active business use requirements.
  - The 31-month period is based on the requirement that a QOF has 30 months to make substantial improvements to property discussed below.

Original Use and Substantial Improvement

- QOZ rules require that either (i) the original use of the QOZ property begin with the QOF or (ii) QOF substantially improves property within 30 months by making capital improvements that exceed the cost of the property
  - Regulations reserve definition of original use—it is unclear whether QOF can purchase newly constructed building that is not yet in service; what if property was abandoned?
  - Substantial improvement rules are taxpayer friendly
  - Substantial improvement is measured by cost of building, not including land
  - Example:
    - QOF purchases property for $800, allocating $420 to land and $380 to building
    - QOF spends $400 in next 30 months to improve building
    - Property is treated as substantially improved
    - The regulations do not provide guidance addressing vacant land (or land and building where building is scheduled for demolition and little, if any, of the investment is allocated to the building) and what constitutes substantial improvements. If land is ignored for this purpose can a QOF simply acquire vacant land and not make any improvements? Commentators have pointed out the issue and lack of guidance. We believe the IRS will likely provide further guidance on this issue.
    - We anticipate that in the case of vacant land (or land with little to no basis allocated to the building), the IRS will require some percentage of the purchase price allocated to the land as the base amount that needs to be spent on development to treat the land as substantially improved. There is no indication what that percentage will be based on the proposed regulations.

Unanswered Questions

- Definition of active trade or business, although it appears from the guidance that multi-family rentals will qualify
- Application of penalties and possible decertification of non-qualifying QOFs.

- Definition of “substantially all” for other purposes of QOZ rules, such as the period of time during which an entity’s business must have been a QOZ business and the use of the property in a QOZ by the QOF
- Determination of reasonable time to reinvest proceeds in new QOZ property if QOF sells existing QOZ property and still qualify for QOF treatment.
- Whether the working capital rules should be expanded—in view of the difference between the preamble and the regulations discussed above, the rules should be clarified and expanded.

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