Qualified Opportunity Zone Investments: Overview

A Practice Note discussing the Qualified Opportunity Zone program created under the Tax Cuts and Jobs Act of 2017. This Note provides an overview of the tax benefits provided by the program and the requirements for structuring and investing capital gains in qualified opportunity funds.

Under the Tax Cuts and Jobs Act (Pub. L. No. 115-97 (2017)), changes were made to the Internal Revenue Code (Code) that provide tax benefits to investors in Qualified Opportunity Zones (QOZs) (26 U.S.C. §§ 1400Z-1 and 1400Z-2). Investments in QOZs may allow investors to:

- Temporarily defer recognition of capital gains that are reinvested in a Qualified Opportunity Fund (QOF).
- Reduce the amount of recognized deferred capital gains by an increase in basis.
- Exempt from taxation any appreciation in their QOF investment if they meet certain requirements.

This Note outlines:

- The criteria for structuring and investing in QOFs.
- The tax benefits provided if the Code requirements are properly met.

Initial proposed Treasury Regulations (Proposed Regulations) clarifying some of the QOZ program requirements were issued in October 2018 (Prop. Treas. Reg. §§ 1.1400Z-2(a)-1 to 1.1400Z-2(e)-1, 2018 WL 5312325). The Treasury and the IRS also provided guidance to taxpayers in Revenue Ruling 2018-29. Investors are permitted to rely on the Revenue Ruling and the Proposed Regulations even though the Proposed Regulations are not finalized. Additional regulations are expected to be issued that will further clarify certain requirements of the program (see Box, Unanswered Questions).

The Proposed Regulations include special rules for Section 1256 contracts, offsetting-positions transactions, and straddles, which are beyond the scope of this Note.

For a graphic illustration of the QOZ investment structure and tax benefits, see Qualified Opportunity Zone Investments Flowchart and Timeline (w-019-2441).

QUALIFIED OPPORTUNITY ZONES

Code Section 1400Z-1 authorizes the designation of QOZs, which are low-income communities that are:

- Identified and proposed by the chief executive officers of states and other US possessions (District of Columbia and US territories).
- Designated by the Secretary of the Treasury (Secretary).

The purpose of designating a QOZ is to spur economic development and job creation by encouraging new long-term investment in these low-income communities.

QUALIFIED OPPORTUNITY FUNDS

To qualify for the tax benefits provided by the QOZ program, an investor must invest capital gains in a QOF. A QOF is an investment vehicle that is:

- Formed in a US state, the District of Columbia, or a US possession.
- A QOF that is formed in a US possession must only invest in that possession.
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- Taxed either as a corporation or a partnership for federal income tax purposes.
- Organized for the purpose of investing in Qualified Opportunity Zone Property (QOZ Property) (see Qualified Opportunity Zone Property).

(I.R.C. § 1400Z-2(d)(1).)

While limited liability companies taxed as partnerships are eligible for the program, single-member limited liability companies are not eligible because they are disregarded entities for federal income tax purposes.

The investment in a QOF must be an equity investment, which includes preferred stock or a partnership interest with special allocations. The investment cannot be a debt instrument or a deemed contribution of money under Section 752(a) of the Code (an increase in a partner’s share of or assumption of partnership liabilities by a partner). However, the Proposed Regulations clarify that a taxpayer may use its equity investment in a QOF as collateral for a loan. (Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(3)(i), (ii), 2018 WL 5312325.)

90% Asset Test

A QOF must also hold at least 90% of its assets in QOZ Property (see Qualified Opportunity Zone Property). The QOF’s property holdings are determined by the average of the percentage of QOZ Property held by the QOF, as measured on the last day of both:

- The first six-month period of the taxable year of the fund.
- The taxable year of the fund.

(I.R.C. § 1400Z-2(d)(1).)

The Proposed Regulations provide a special rule that allows a QOF to choose to become a QOF in a month other than the first month of the taxable year (Prop. Treas. Reg. § 1.1400Z2(d)-1(a)(1)(iii), 2018 WL 5312325). However, regardless of when an entity becomes a QOF, the last day of the taxable year is a testing date. Therefore, if an entity becomes a QOF in the seventh or later month of a 12-month taxable year, the 90% test is applied on the QOF’s assets on only the last day of the taxable year (Prop. Treas. Reg. § 1.1400Z2(d)-1(a)(2), 2018 WL 5312325).

The IRS also notes that additional guidance is forthcoming in to-be-released regulations on:

- The 90% asset test.
- The reinvestment of the return of capital from investments in QOF stock and partnership interests.

Valuation Method for 90% Asset Test

For purposes of the 90% asset test, the Proposed Regulations require the QOF to use the asset values reported on the QOF’s applicable financial statement for the taxable year. If the QOF does not have an applicable financial statement, the QOF must use the QOF’s cost basis. (Prop. Treas. Reg. § 1.1400Z2(d)-1(b), 2018 WL 5312325.) A taxpayer’s applicable financial statement is generally a financial statement prepared under US generally accepted accounting principles (GAAP) that either:

- Is required to be filed with the SEC.
- Is required to be provided to the federal government or any of its agencies (other than the IRS).

The Proposed Regulations also clarify that a pre-existing entity may self-certify as a QOF if:

- The QOF requirements under Section 1400Z-2(d) are met.
- Its QOZ Property is acquired after December 31, 2017.


The Proposed Regulations allow a QOF to both:

- Identify the taxable year in which the entity becomes a QOF.
- Choose the first month in that year to be treated as a QOF.


A gain deferral election is not effective for an investment that is made before an eligible entity certifies as a QOF.

Qualified Opportunity Zone Property

For QOF investors to receive the intended tax benefits, a QOF must be organized to invest in QOZ Property. QOZ Property includes the following three types of property:

- QOZ Stock (see QOZ Stock).
- QOZ Partnership Interests (see QOZ Partnership Interests).
- QOZ Business Property (see QOZ Business Property).

(I.R.C. § 1400Z-2(d)(2)(A).)

QOZ Stock

If an entity is classified as a corporation for federal income tax purposes, then an equity interest (stock) in the entity qualifies as QOZ stock (QOZ Stock) if:

- The stock is acquired by a QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash.
- As of the time the stock is issued, the corporation is a QOZ Business (or, in the case of a new corporation, is being organized for purposes of being a QOZ Business) (see QOZ Business). During substantially all the QOF’s holding period for the stock, the corporation is a QOZ Business.

(I.R.C. § 1400Z-2(d)(2)(B).)

QOZ Partnership Interests

If an entity is classified as a partnership for federal income tax purposes, then an equity interest in the entity qualifies as a QOZ partnership interest (QOZ Partnership Interest) if:
The partnership interest is acquired by a QOF after December 31, 2017 from the entity solely in exchange for cash.

As of the time the interest is issued, the entity is a QOZ Business (or, in the case of a new entity, is being organized for purposes of being a QOZ Business) (see QOZ Business).

During substantially all the QOF’s holding period for the interest, the entity is a QOZ Business. (I.R.C. § 1400Z-2(d)(2)(C).

**QOZ BUSINESS PROPERTY**

Tangible property used in a trade or business of a QOF qualifies as QOZ business property (QOZ Business Property) if:

- The tangible property was acquired by the QOF by purchase from an unrelated party after December 31, 2017 (unrelated parties means having no more than 20% common ownership).
- During substantially all the QOF’s holding period for the tangible property, substantially all the use of the tangible property was in a QOZ and either:
  - the original use of the tangible property in the QOZ commences with the QOF (see Original Use Requirement); or
  - the QOF substantially improves the tangible property (see Substantial Improvement Requirement).

(I.R.C. § 1400Z-2(d)(2)(D).)

**Original Use Requirement**

The Revenue Ruling addresses the original use requirement for two types of tangible property, land and existing buildings. The rules are as follows:

- **Land.** The Revenue Ruling states that, given the permanence of land, its original use can never commence with a QOF, so the original use requirement does not apply to the land on which a building is located.

- **Buildings.** The original use of an existing building located on land also does not commence with the QOF. The QOF instead must substantially improve the building for the building to qualify as QOZ Property. For purposes of determining whether or not the building is substantially improved:
  - the land’s adjusted basis is not included in a building’s adjusted basis; and
  - the land on which a substantially improved building is located does not itself need to be separately substantially improved for the building to qualify as QOZ Property.

(Rev. Rul. 2018-29.)

**Substantial Improvement Requirement**

Tangible property is treated as substantially improved by the QOF only if, during any 30-month period beginning after the acquisition date of the property, the QOF adds to the basis of the property an amount equal to more than the adjusted basis of the property at the beginning of the 30-month period. The Proposed Regulations provide a special rule for buildings located on land wholly within a QOZ that only requires the substantial improvement to the building and does not require the QOF to separately substantially improve the land on which the building is located. (Prop. Treas. Reg. §§ 1.1400Z2(d)-1(c)(8)(ii)(A) and 1.1400Z2(d)-1(d)(4)(ii)(A), 2018 WL 5312325.)

**QOZ BUSINESS**

An entity that issues stock or partnership interests to a QOF must qualify as a QOZ Business for investors to receive the intended tax benefits. A trade or business is a QOZ Business if:

- Substantially all the tangible property owned or leased by the trade or business is QOZ Business Property (see QOZ Business Property).
- For each taxable year, at least 50% of its gross income is derived from the active conduct of a trade or business in the QOZ.
- A substantial portion of its intangible property is used in the active conduct of a trade or business in the QOZ.
- In each taxable year, less than 5% of the average aggregate unadjusted bases of its property is attributable to nonqualified financial property, subject to a working capital safe harbor (see Working Capital Safe Harbor).

(I.R.C. § 1400Z-2(d)(3).)

**Working Capital Safe Harbor**

The Proposed Regulations allow QOZ Businesses to hold reasonable amounts of working capital in:

- Cash.
- Cash equivalents.
- Debt instruments with a term of 18 months or less.
The working capital may be held for a period of up to 31 months if:

- There is a written plan that designates these amounts for the acquisition, construction, and/or substantial improvement of tangible property in the QOF.
- There is a written schedule consistent with the ordinary start-up of a trade or business requiring the working capital assets to be spent within 31 months.
- The business substantially complies with the plan and schedule.

(Prop. Treas. Reg. § 1.1400Z2(d)-1(d)(5)(iii), (iv), 2018 WL 5312325.)

Any gross income earned from this working capital is counted toward the satisfaction of the 50% gross income test above. The “use of intangible property” requirement for a QOZ Business is also treated as satisfied during any period in which the business is proceeding in a manner consistent with the plan and schedule described above.

**QOZ PROGRAM TAX BENEFITS**

There are three tax incentives to encourage investment in QOFs:

- **Temporary capital gains tax deferral.** An investor may defer income tax on gains from the sale or exchange of capital assets by reinvesting the amount of gain into a QOF within 180 days of the sale or exchange, with special rules for pass-through entities (see 180 Day Rule). Taxes are deferred until the earlier of:
  - the date the QOF investment is disposed of; and
  - December 31, 2026.
  (I.R.C. §§ 1400Z-2(a), (b)(1),)

- **Step-up in basis/capital gains reduction.** If the investment in the QOF is held for five years, the investor receives an increase in basis equal to 10% of the deferred gain invested in the fund. If the investment is held for another two years, up to December 31, 2026, the investor receives an additional increase in basis equal to 5% of the deferred gain invested in the fund (for a total of 15%). (I.R.C. § 1400Z-2(b)(2).)

- **Tax exemption.** If the investment in the QOF is held for ten or more years, the investor may elect to increase its basis in the QOF investment to the fair market value of the interest on the date sold or exchanged. The investor is not taxed on any capital gains resulting from the appreciation of the investment in the QOF. This option is available until December 31, 2047. (I.R.C. § 1400Z-2(c), Prop. Treas. Reg. § 1.1400Z2(c)-1(b), 2018 WL 5312325.)

To illustrate, if an investor realizes a gain of $100,000 from the sale or exchange of a capital asset and reinvests that money into a QOF within 180 days, the tax on that $100,000 is deferred until the earlier of:

- December 31, 2026.
- The date the investor disposes of its interest.

The investor’s initial basis in its QOF investment is zero.

If the investor holds the investment for five years, the investor receives a $10,000 increase in basis, which is excluded from income tax when the investor recognizes the deferred gain. If the investor leaves the investment in place for an additional two years, the investor receives an additional $5,000 increase in basis, amounting to a total of $15,000 excluded from income tax. The investor must pay taxes on the $85,000 balance of the deferred gain as of December 31, 2026 and its basis is increased to $100,000 at that time.

If the investor holds the investment for a minimum of ten years, the investor has the option to avoid capital gains tax on any appreciation in the $100,000 QOF investment in addition to the $15,000 increase in basis. Therefore, after ten years, the investor may only pay tax on $85,000 of gain.

For a graphic illustration of the tax benefits, see Qualified Opportunity Zone Investments Flowchart and Timeline (W-019-2441).

**TAXPAYERS ELIGIBLE FOR GAIN DEFERRAL**

All taxpayers that recognize capital gain for federal income tax purposes are eligible to elect deferral, including:

- Individuals.
- C corporations.
- Regulated investment companies (RICs).
- Real estate investment trusts (REITs).
- Partnerships.
- Other pass-through entities (including certain common trust funds, qualified settlement funds, and disputed ownership funds).

(Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(1), 2018 WL 5312325.)

**Rules for Partnerships**

Either a partnership or a partner may elect deferral of capital gains.

If a partnership elects to defer all or part of a capital gain by making an investment in a QOF, then:

- No part of the deferred gain is included in the distributive share of the partners.
- The gain is not included in the partners’ basis.

If the partnership does not elect to defer the gain, then:

- The gain is included in the partners’ distributive shares and basis.
- Each individual partner may elect its own deferral regarding the gain.

(Prop. Treas. Reg. §§ 1.1400Z2(a)-1(c)(1), (c)(2), 2018 WL 5312325.)

**GAIN ELIGIBLE FOR DEFERRAL**

Although the statute refers to gains from the sale of property, the Proposed Regulations clarify that only capital gains are eligible for deferral (Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(i)(A), 2018 WL 5312325). Any type of capital gains are eligible. The Proposed Regulations also address two additional requirements for the deferral of gain. The gain must:

- Be gain that would be recognized by no later than December 31, 2026, if the opportunity zone provisions did not apply to defer recognition of the gain deferral (Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(i)(B), 2018 WL 5312325).
- Arise from a sale or exchange with an unrelated person (Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(2)(i)(C), 2018 WL 5312325). To be unrelated persons, the two parties generally must have no more than 20 percent common ownership.

An investor may invest more than the capital gain amount, but only the capital gain amount receives tax deferral. In this case, the QOF investment is treated as two separate interests: one that qualifies for tax benefits and one that does not.

An investor may also:
- Not invest the entire capital gain amount. Any capital gain not reinvested is subject to payment of tax.
- Split its capital gains for investment in multiple QOFs.

### 180 DAY RULE

To be eligible for QOZ tax benefits, the Proposed Regulations require an investor to invest its capital gains in a QOF within a 180-day period. The 180-day period begins on the day the gain would be recognized for federal income tax purposes if the taxpayer did not elect to defer recognition of the gain under Code Section 1400Z-2. (Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(4)(i), 2018 WL 5312325.)

However, there is an exception regarding the start of the 180-day period for partners in a partnership or other pass-through entity. A partner’s 180-day period generally begins on the last day of the partnership’s taxable year, which is the day on which the partner would otherwise recognize the gain if the gain was not deferred. If a partner knows the date of the partnership gain and that the partnership is not electing to defer the gain, the partner may instead choose to start the 180-day period on the same date as the beginning of the partnership’s 180-day period. (Prop. Treas. Reg. § 1.1400Z2(a)-1(c)(2)(iii), 2018 WL 5312325.)

### RULES FOR MULTIPLE QOF INVESTMENTS

The Proposed Regulations address the treatment of multiple investments in a QOF by a single investor as follows:

- **First-in, first-out (FIFO) method.** This method must be used to identify the interest that was sold if a taxpayer:
  - holds investments with identical rights in a QOF that were acquired on different days; and
  - on a single day, disposes of less than all its interest.

- **Pro-rata method.** If after the application of the FIFO method, a taxpayer is treated as having disposed of less than all the investments that the taxpayer acquired on one day, and if the interests acquired on that day have different tax attributes, then a pro-rata allocation must be made to determine which interests were disposed of.

(Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(6), 2018 WL 5312325.)

### ROLLOVER OF QOF INVESTMENT

An investor may elect to defer gain from the disposition of all its QOF interest by reinvesting the gain in another QOF within 180 days from the sale, provided the rollover investment is made before December 31, 2026 (Prop. Treas. Reg. § 1.1400Z2(a)-1(b)(4)(ii)(D), Example 4, 2018 WL 5312325). If the new QOF investment is held for at least ten years and disposed of before 2048, any future appreciation should be eligible for tax exemption.

### STATE INCOME TAX

Whether the federal income tax benefits of investing in a QOF also apply for state income tax purposes depends on whether the state:
- Conforms with the Code and as of when it does so.
- Imposes a tax on capital gains.

### ADVANTAGES AND DISADVANTAGES OF ALTERNATE INVESTMENT STRUCTURES

#### DIRECT VERSUS INDIRECT INVESTMENT

There are advantages and disadvantages of a QOF investing in a QOZ through a subsidiary (by acquiring QOZ Stock or QOZ Partnership Interests in a QOZ Business), versus investing directly in QOZ Business Property.

For example, when investing in a QOZ Business only 70% of the tangible assets must consist of QOZ Business Property. On the other hand, up to 90% may be required if investing directly in QOZ Business Property. An investment in a QOZ Business can also take advantage of the working capital safe harbor and thus hold more working capital assets.

However, a QOZ Business is subject to additional restrictions including the 50% active gross income test, restrictions on conducting sin businesses, and limits on holding nonqualified financial assets (see QOZ Business). Investors and sponsors should carefully consider these factors and their business needs when structuring their investment.

#### SINGLE ASSET VERSUS MULTIPLE ASSET QOFS

Another structuring consideration for investors and sponsors is whether to structure QOFs to invest in individual assets or a portfolio of assets. Traditional private equity funds are formed to invest in portfolios of assets, which diversifies risk. However, the term “fund” in the QOZ context is somewhat of a misnomer. A QOF can be formed by two partners forming a limited liability company to acquire a single property and self-certifying as a QOF. A QOF can also invest in projects of varying sizes and types, allowing for investment by smaller investors.

Without further clarity in future Regulations, one drawback of a multi-asset QOF is the recognition of gain on the sale of an asset by the QOF. Although a QOF investor can avoid capital gains tax on the sale of its interest in the QOF (see QOZ Program Tax Benefits and Rollover of QOF Investment), the same benefit does not extend to the sale of assets by the QOF. The investors are allocated their pro-rata share of the gain and must roll over that gain into another QOF to defer capital gains tax.

With single asset QOFs, there is the option of selling the equity interests in the QOF to a purchaser as an exit strategy to avoid additional gains tax. The exit strategy for multi-asset QOFs may be less clear. Finding a purchaser for 100% of the ownership interests in a QOF to take advantage of the fair market value basis increase is likely to be more difficult than selling the properties individually.
UNANSWERED QUESTIONS

The Proposed Regulations answer many questions that have arisen since the QOZ program was enacted, but many questions remain. In fact, the current set of Proposed Regulations note that the Department of the Treasury (Treasury) and the IRS are working on additional proposed Regulations that are expected to be released in the near future. Those Regulations are expected to address issues that are not already addressed, including:

- The meaning of “substantially all” in each of the various places where it appears in Code Section 1400Z-2.
- Transactions that may trigger inclusion of the deferred gain.
- The “reasonable period” for a QOF to reinvest proceeds from the sale of qualifying assets without penalty.
- Administrative rules applicable when a QOF fails to maintain compliance with the 90 percent asset test.
- The meaning of “active conduct of a trade or business” for satisfying the gross income test of a QOZ Business.
- If there is a time limit on deferring commencement of substantial improvement of tangible property.
- How allocations of depreciation, liabilities, and loss are to be handled when investors are given a zero basis at the inception of their QOF investment.
- Information reporting requirements.

The Treasury and the IRS are also soliciting comments on:

- The Proposed Regulations.
- All aspects of the definitions of “original use” and “substantial improvement.”
- Any other issues that should be addressed in future proposed Regulations or guidance.

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