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TAX ALERT

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Opportunity zones come a-knocking

Knock knock: How can a taxpayer take $1 million of pre-tax capital gain proceeds, invest it for 10 years, sell the investment for $2 million and only pay tax on $850,000 at a much later point in time?

Who's there: An investor in a Qualified Opportunity Fund (QOF) which holds at least 90 percent of its assets in qualified opportunity zone property as further explained below.

On Oct. 19, 2018, the Treasury Department and IRS issued guidance on investments in qualified opportunity zones (QOZs). Enacted as part of the 2017 U.S. tax reform, the QOZ program was developed to spur investment in low-income communities by providing tax deferral, tax reduction and avoidance of gain. Communities in all 50 states, the District of Columbia and five U.S. territories were nominated for designation as QOZs and would retain the designation for 10 years. The legislation will benefit QOF investors and QOZ landowners and developers.

The guidance includes proposed treasury regulations, Revenue Ruling 2018-29 and Draft IRS Form 8996. These publications describe how the program will operate and how an entity can self-certify as a QOF. Certain issues are reserved for future guidance.

What type of gains qualify to be invested in QOFs?

The proposed regulations clarify that almost all types of capital gains qualify for deferral. Investors must invest capital gains within 180 days of when they would be recognized for federal income tax purposes. This should include capital gains generated by Internal Revenue Code (IRC) §1231. In the case of a capital gain realized by a partnership, the rules allow either a partnership or its partners to elect deferral. Similar rules apply to other pass-through entities, such as an S corporation and its shareholders, and estates and trusts, and subsequent beneficiaries. Ordinary depreciation recapture and other ordinary income do not qualify for deferral.

Practice note: Partnerships can defer at the partnership or partner level. If the partnership does not elect to defer, the partner may elect to defer either at the time the gain was recognized by the partnership or six months after the partnership tax year end (the general rule).

How long do I have to keep my QOF investment to obtain the tax benefits?

A taxpayer starts with a zero basis in the QOF. After a taxpayer holds its investment five years, it increases its basis by 10 percent of the investment and then another five percent after seven years. If a taxpayer holds its investment 10 years, it can step up its qualifying investment basis to its fair market value. However, as currently drafted, the statute requires a taxpayer to recognize 85 percent of the original deferred gain on Dec. 31, 2026.

For example, if a taxpayer invested a $1 million capital gain in a QOF on Jan.1, 2019, that was worth $2 million on Jan. 1, 2029, it could increase its zero basis by $100,000 in 2024, by $50,000 in 2026 and to $2 million on Jan. 1, 2029. It could then sell its investment for $2 million in 2029 and recognize no gain at that time (with the caveat that $850,000 of gain would be deemed recognized as of Dec. 31, 2026). Overall, the taxpayer would avoid paying tax on $1,150,000 in this example.

What types of entities qualify as QOFs?

To qualify for deferral, the amount of a capital gain to be deferred must be invested in a QOF, which must be an entity treated as a partnership or corporation for federal tax purposes and organized in any of the 50 states, the District of Columbia or five U.S. territories fo¬¬r the purpose of investing in a QOZ property.

The proposed regulations define a QOF as a corporation or tax partnership organized for the purpose of investing at least 90 percent of its assets in a QOZ business or QOZ business property, measured as of the last day of the first six-month period of the taxable year of the QOF and, the last day of the taxable year of the QOF. There is a monthly penalty for failure to meet the 90 percent test.

Practice note: Initially there was concern that limited liability companies (LLC) would not qualify as QOFs but the proposed regulations make relatively clear that they do qualify, so long as they are taxed as partnership.

What is Qualified Opportunity Zone Property?

QOZ property includes a QOZ business (QOZ stock or partnership interest) (indirect ownership by the QOF) and QOZ business property (direct ownership by the QOF).

QOZ stock or partnership interests must be acquired after Dec. 31, 2017, for cash in a corporation or partnership that is a QOZ business at the time the QOF acquires the stock or partnership interest and throughout substantially all of the QOF's holding period thereafter.

A QOZ business is a trade or business where:

- Substantially all of the tangible property is QOZ business property
- At least 50 percent of income is derived from the active conduct of the trade or business
- A substantial portion of the intangible property is used in the trade or business
- Less than five percent of the assets by aggregate basis are attributable to nonqualified financial property
- Is not a "sin business" like a golf course, country club, massage parlor, liquor store, etc.

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Practice Note:

One advantage to a QOZ business (indirect ownership) has to do with the 'substantially all' test. If at least 70 percent of tangible business property owned or leased by a trade or business is QOZ business property, the requirement that substantially all of such tangible business property is a QOZ business property can be satisfied if other requirements are met. Therefore, theoretically, a QOZ business could satisfy the 90 percent substantially all test by investing 63 percent of its assets in QOZ businesses that pass the 70 percent substantially all test, versus having to meet the 90 percent direct ownership requirement.

- QOZ business property (direct ownership) is tangible property used in a trade or business of a QOF that is:
- acquired by purchase after Dec. 31, 2017 from an unrelated party
- the original use or substantial improvement of which begins with a QOF, and
- substantially all of the use of which is in a QOZ

Am I going to have to knock myself out to become a QOF?

The good news is that the process to become a QOF is quite easy. Eligible entities will self-certify as a QOF by filing Form 8996 along with its income tax return for the relevant year. An eligible entity can designate the taxable year in which it becomes a QOF and the first month in that year for the designation to apply. If no month is specified, the first month of the taxable year is treated as the first month that the eligible entity is a QOF.

The month designation is significant for purposes of the 90 percent test for QOFs outlined above. For example, if a calendar-year entity formed in February designates April as its first month as a QOF, the two 90 percent testing dates would be the end of September (six months after the designation) and the end of December (the end of the taxable year). If the same taxpayer selected a month after June as its first month as a QOF, then the end of its taxable year in December would be the only testing date.

With respect to calculating the 90 percent test, the value of a QOF's assets is as reported on the QOF's financial statements that are:

- Filed with the SEC, certified and audited in accordance with GAAP, or filed with another federal agency other than the IRS and significantly used in the management of the QOF's business. If no such financial statements are available, the QOF must use the cost of its assets for the 90 percent test.

Practice note: If a calendar year QOF designates a month after June to be a QOF, it must meet the 90 percent test by Dec. 31 of the same year, and apparently does not get six months to meet the test.

How much cash can be kept as working capital?

The statutory QOZ business test precludes a QOZ business from having five percent or more of the basis of its assets attributable to nonqualified financial property. However, the proposed regulations furnish a safe harbor permitting QOZ businesses that acquire, construct or rehabilitate tangible, real or personal property to treat cash, cash equivalents or debt instruments with a term of 18 months or less as reasonable working capital for up to 31 months if certain requirements are met, including:

- There is a written plan that identifies such assets as property held for the acquisition, construction or substantial improvement of tangible property in a QOZ
- There is a written schedule consistent with the ordinary business operations of the QOZ business showing that the assets will be used within 31 months
- The QOZ business substantially complies with such schedule

How does real estate qualify – do I have to count the value of land?

The revenue ruling clarifies that you do not need to improve the unencumbered portion of the land and that the value of the land does not count toward the substantial improvement test.

The revenue ruling noted above specifies the applicability of QOZ rules related to original use and substantial improvement to an existing building located within a QOZ. Generally, to qualify, the original use of property must commence with a QOF or a QOZ business. Therefore, a newly constructed building will qualify, but an existing building would not qualify unless it is substantially improved.

Substantial improvement of a building occurs if, during the 30-month period beginning with its acquisition, a QOF's basis increases in the building by an amount exceeding the taxpayer's adjusted basis at the time of acquisition. For example, a building with an adjusted basis of $500,000, not including land, must have improvements worth at least another $500,000.

Knocking it out of the park

Example:

In 2019, Taxpayer H realized $10 million of capital gains and within the 180-day period invested $10 million in QOF T, a qualified opportunity fund which has self-certified. QOF T immediately acquired from partnership P, a partnership interest in P, solely in exchange for $10 million cash.

P immediately placed the $10 million into working capital assets, which remained in working capital assets until used. P had written plans to acquire land in a QOZ on which it planned to construct a commercial building. Of the $10 million, $1 million was dedicated to the land purchase, $8 million to the construction of the building and $1 million to ancillary but necessary expenditures for the project. The written plans provided for purchase of the land within a month of receipt of the cash from QOF T and for the remaining $8 and $1 million to be spent within the next 30 months on construction of the building and ancillary expenditures.

All expenditures were made on schedule, consuming the $10 million. During the taxable years that overlap with the first 31-month period, P had no gross income other than that derived from the amounts held in those working capital assets. Prior to completion of the building, P's only assets were the land it purchased, the unspent working capital assets and P's work in process as the building was constructed.

P met the three requirements of the working capital safe harbor:

1. P had a written plan to spend the $10 million received from QOF T for the acquisition, construction and/or substantial improvement of tangible property in a QOZ.

2. P had a written schedule consistent with the ordinary start-up for a business for the expenditure of the working capital assets.

3. And, finally, P's working capital assets were actually used in a manner that was substantially consistent with its written plan and the ordinary start-up of a business.

Therefore, the $1 million, the $8 million and the $1 million are treated as reasonable in amount.

Practice Note:

These conclusions would also apply if P's plans had been to buy and substantially improve a pre-existing commercial building. In addition, the fact that P's basis in the building has not yet doubled does not cause the building to fail to satisfy the QOZ provisions.

Because P had no other gross income during the 31 months at issue, 100 percent of P's gross income during that time is treated as derived from an active trade or business in the QOZ for purposes of satisfying the 50 percent income test noted above.

For purposes of satisfying the requirement of the IRC, during the period of land acquisition and building construction, a substantial portion of P's intangible property is treated as being used in the active conduct of a trade or business in the QOZ.

All of the facts described are consistent with QOF T's interest in P being a QOZ partnership interest for purposes of satisfying the 90 percent substantially all test.

For more information please contact David Tumen, Mark Snider or any member of Porter Wright's Tax Practice Group.