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Latest Regulations on Qualified Opportunity Zones and What They Clarify for Investors

By Trey Webb[*]

INTRODUCTION

When President Trump signed the Tax Cuts and Jobs Act into law on December 22, 2017, taxpayers initially paid little attention to the new §1400Z-1 and §1400Z-2, which introduced qualified opportunity zones and detailed rules for the capital gains invested in them.[1] As tax professionals and taxpayers have learned more, they have become excited about using Qualified Opportunity Funds (QOFs) as vehicles for investment in qualified opportunity zone businesses. However, many questions have surfaced about how these funds should operate and how taxpayers can take advantage of the benefits provided in the law.

The Internal Revenue Service has issued two rounds of proposed regulations addressing many of these questions. This article discusses some of the provisions in the second round of regulations issued in April 2019 that will help investors wanting to invest in a QOF.[2] It assumes the reader has some understanding of the basic rules and guidance provided in the original proposed regulations issued in October 2018.[3]

CLARIFICATIONS FROM NEW REGULATIONS

As the law was written, an investor in a QOF can elect to step up the basis of the investment to its fair market value when it is sold if the investor has held the fund for at least 10 years. This election allows investors to exclude gain from the sale of a fund investment. However, the law does not state that investors who hold a fund investment for at least 10 years can exclude the gain if the fund sells the underlying property instead. Many were concerned that limiting the step up in basis to when an investor sold his or her interest could impact the ability of a fund to hold more than one property. A bulk sale of multiple properties would limit the number of buyers and could lead to discounts on the sale price. The proposed regulations address this problem by allowing more flexibility to exclude gain when a fund sells qualified opportunity zone property.[4]

Making an investment in a single property with a 10-year holding period can be a risky investment, while a fund holding a diversified group of properties is a safer investment for a taxpayer looking to defer capital gain income recognition. The proposed regulations allow taxpayers to elect to exclude gain from a QOF that is taxed as a partnership or an S corporation. The QOF investor must have held the qualifying investment for at least 10 years to make this election.

The election applies to capital gains from a QOF partnership or QOF S corporation reported on Schedule K-1 to the investor when the QOF disposes of qualified opportunity zone property. If the property disposed of generates §1231 capital gain, the election only applies to the capital gain net income from §1231 property. While this provides important relief to multi-asset funds, a challenge still exists for tiered partnership funds. As written, the regulations only ap-

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[1] All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

[2] REG-120186-18, 84 Fed. Reg. 18,652 (May 1, 2019).

[3] REG-115420-18, 83 Fed. Reg. 54,279 (Oct. 29, 2018).

[4] *See* Prop. Reg. §1.1400Z2(c)-1(b)(2)(ii).

ply when a QOF sells qualified opportunity zone property. If a QOF owns an interest in a partnership that sells the property, the election does not appear to be available.

In addition to the relief provided to QOFs taxed as partnerships and S corporations, the regulations provide relief to QOFs taxed as real estate investment trusts (REITs). If a shareholder of a QOF REIT receives a capital gain dividend and the QOF REIT meets the date identification requirements, the shareholder can apply a 0% tax rate to that capital gain dividend as long as the shareholder has held a qualifying investment in the QOF REIT for at least 10 years.

For a business to be a qualified opportunity zone business, at least 50% of the gross income must come from an active trade or business. A constant challenge for tax advisors is determining when an activity rises to the level of trade or business. To facilitate investment in qualified opportunity zones, the proposed regulations provide that the ownership and operation (including leasing) of real property used in a trade or business will be treated as the active conduct of a trade or business for purposes of §1400Z-2(d)(3). However, a mere triple net lease will not be considered an active trade or business. This will provide some assurances to taxpayers investing in QOFs holding rental real estate that their investment will not be challenged based on being an active trade or business.

PROPERTY CONTRIBUTIONS AS AN ELIGIBLE INVESTMENT IN A QOF

One interesting development in the April proposed regulations is that investors can contribute property to a QOF as an eligible investment.[5] This provision gives investors more options regarding how to fund a QOF when deferring gain. If an investor contributes property, the qualifying investment is the lesser of the taxpayer's net basis in the contributed property or the net value of the property. If the net value of the property is greater than the qualifying investment, the excess amount gives rise to a mixed funds investment (a mixed funds investment is one where a portion of the investment qualifies for the QOZ benefits and a portion does not). However, a property contribution may cause problems for the fund.

First, the statute states that in tiered situations, the QOF must acquire its interest in qualified opportunity zone stock ''solely in exchange for cash.'' The proposed regulations allowing property contributions to a QOF do not indicate that the fund can then use the contributed property to capitalize the corporation or partnership. Second, if the QOF were to retain the property, it is not certain how the property is treated when calculating the 90% test. Qualified opportunity zone property is acquired by purchase or lease. Contributed property may cause a QOF to fail to hold 90% of its assets in qualifying property. Therefore, QOFs may be reluctant to accept property contributions from investors.

WHAT GAINS ARE ELIGIBLE FOR INVESTMENT IN A QOF

Another challenge for prospective investors has been determining what gains are eligible for exclusion. In the first round of proposed regulations, the IRS clarified that only gain treated as capital gain for federal income tax purposes is potentially eligible for investment in a QOF. This left open the question of eligibility of §1231 gain for gain deferral.

Section 1231 covers gains and losses on the sale of depreciable property and real property. Technically, §1231 property is not a capital asset as defined in §1221, but net §1231 gain is taxed at capital gains rates. In the recently proposed regulations, the capital gain net income from the sale of §1231 property is eligible for deferral if an investment is made in a QOF. This provision allows taxpayers more opportunities to defer gain recognition. However, there was a caveat to deferring gain on §1231 property. Per the proposed regulations, the net capital gain income is computed by ''taking into account the capital gains and losses for a taxable year on all of the taxpayer's section 1231 property.'' While §1231 gain income is taxed at capital gains rate, §1231 losses are deductible as an ordinary loss. The IRS is concerned that taxpayers could defer §1231 capital gains and recognize §1231 ordinary losses if netting at the end of the year is not required. The 180-day investment window does not begin until the last day of the taxable year. Taxpayers may miss out on certain investment opportunities if they must wait until December31 to make a qualifying investment in a QOF.

MAXIMIZING THE BENEFITS OF QOF INVESTMENTS

To maximize the tax benefits of investing in a QOF, a taxpayer will need to hold onto an investment for at least 10 years, as the return on an investment can change significantly in a decade. Sometimes it may be in the best interest of QOF investors to dispose of qualified opportunity zone business property, qualified opportunity zone stock, or qualified opportunity zone partnership interests. However, advisors had concerns whether a QOF would fail the 90% test requirement if a fund disposed of property shortly before a testing

[5] *See* Prop. Reg. §1.1400Z2(a)-1(b)(10)(i)(B).

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date. Congress authorized the IRS to prescribe regulations to "ensure a qualified opportunity fund has a reasonable period of time to reinvest the return of capital from investments. . ."

In the 2019 proposed regulations, QOFs will have 12 months from the date of distribution, sale, or disposition of qualified opportunity zone property to reinvest the proceeds in other qualifying property without failing the 90% test due to holding the proceeds from the sale.[6] However, the fund must hold the proceeds in cash, cash equivalents, or debt instruments with a term of 18 months or less. The fund can have additional time to reinvest the proceeds if there is a delay waiting for governmental action on a completed application. Additionally, the IRS has requested comments on whether a similar rule for QOF subsidiaries to reinvest proceeds from the disposition of QOZ property would be beneficial. Commenters on the proposed regulations had requested that the IRS exempt QOFs and their investors from gain when a fund sells QOZ property, but the IRS declined to do so, feeling that it did not have authority to exclude the gain from income.

In one bit of surprising news, the IRS allows taxpayers to make an investment in a QOF by acquiring an eligible interest in a fund from another person rather than only from the fund itself. This will give taxpayers more investment opportunities because the timing of their investment periods do not have to match up with the time a fund is open for investments. Per at least one treasury official, taxpayers can even purchase non-qualifying interests in funds and still be eligible for the tax benefits under §1400Z-2.[7] This provision can allow developers to close funds with other money to start a project and then sell those interests at a later period to taxpayers looking to defer tax on capital gains. A taxpayer's investment for these acquisitions is equal to the amount of cash or the fair market value of other property that the taxpayer exchanged for the eligible interest.

Generally, the deferred gain from an investment in a QOF is included in a taxpayer's income on the earlier of the date that an investment is sold or exchanged or December 31, 2026. The proposed regulations provide extensive rules for when certain transactions called "inclusion events" will trigger the deferred gain from a QOF investment. The proposed regulations also provide guidance on the amount of gain recognized, the holding period for qualifying investments, basis adjustments to the property, and special rules for partnerships and S corporations. The list of inclusion events is non-exclusive, so other transactions could trigger gain, but these rules will provide taxpayers making QOF investments much needed guidance on the types of actions they or the fund should not take to ensure that the initial gain is deferred until December 31, 2026.

CONCLUSION

Taxpayers have shown a lot of interest in qualified opportunity zone fund investments. The issuance of guidance in the form of proposed regulations will help them feel more comfortable making investments. Hopefully, the IRS will maintain its mostly taxpayer friendly posture as they finalize the proposed regulations and also provide additional guidance on remaining issues for QOFs and their investors.

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[6] *See* Prop. Reg. §1.1400Z2(f)-1(b).

[7] Cumings, Stephanie, *Treasury Official Clarifies O-Zone Rule on Secondary Purchases*, Tax Notes Today (June 20, 2019).

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