Qualified Opportunity Zones: What the Proposed Regulations Reveal

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The 2017 Tax Cuts and Jobs Act introduced the Qualified Opportunity Zone program, designed to provide a tax incentive for private, long-term investment in economically distressed communities. In June 2018, approximately 8,700 Opportunity Zones, with map boundaries, were certified in locations nationwide for taxpayers to invest and defer their recently triggered capital gains. We released basic information about the program in the Qualified Opportunity Zones: What Investors Should Know planning update in August 2018.

After extensive review of the tax law, questions and uncertainties arose regarding specifics of how the program would work and how taxpayers might use it. Officials from the U.S. Treasury let the public know that regulations for Opportunity Zones were a priority and, in October, the Treasury released proposed regulations answering many questions and providing investors a relatively clear roadmap to investing in a Qualified Opportunity Zone (QOZ).[1]

This planning update includes an abbreviated summary of the basics, but the focus here is on understanding proposed regulations and providing additional context on how the program will operate.

Revisiting the Basics

To defer of recognition of all or some of the gains from the sale of a capital asset, the taxpayer may make an investment of the capital gain portion of the proceeds, within 180 days of being recognized, into a Qualified Opportunity Fund (QOF).[2] A QOF is defined as an entity which is organized as a corporation or partnership (but not a disregarded entity) and which subsequently makes investments in QOZ property, which is defined as:[3]

1. **QOZ Stock or QOZ Partnership Interests**: Stock in a corporation, or a capital or profits interest in a partnership, which must operate or invest in other QOZ businesses located within a QOZ.[4]
2. **QOZ Business Property:** Property acquired by purchase after December 31, 2017, with its original use in the QOZ or, if the property is already in the QOZ, then the property is substantially improved upon by the QOF. Substantially improved means investing an amount equal to the acquisition cost of the property over a 30-month period.[5]
3. **Meeting the 90% Rule:** A QOF must hold at least 90% of its assets as qualified QOZ Stock, QOZ Partnerships, or QOZ Business Property.[6]

A related term which gets used often in discussing this subject is a QOZ Business. This is simply a trade or business in which substantially all of the tangible property owned or leased by the business is QOZ Business Property, as discussed above.[7]

Taxpayers are incentivized to invest capital gains in QOZ property or businesses in the following three ways:

1. **Tax Deferral Through 2026:** A taxpayer may elect to defer tax on any capital gain invested in a QOF within 180 days of realizing the gain.[8] The capital gain is not recognized (i.e., subject to tax) until the earlier of the QOF sale/liquidation date or December 31, 2026 (with

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any tax due with the filing of the 2026 return in 2027).[9]

2. **Up to 15% Exclusion of Deferred Gain:** The taxpayer receives a 10% step-up in tax basis after holding the QOF investment for five years and an additional 5% step-up after a total of seven years. In other words, when the deferred capital gain is recognized in 2026, the taxpayer may be subject to tax on as little as 85% of the deferred gain depending on when the investment in the QOF was made and how long the investment was held.[10]

3. **No Tax on Future Appreciation:** The taxpayer is subject to tax on the deferred capital gain in 2026 (subject to the reduction described above), but any appreciation on the QOF investment held for 10 years or more is not taxable.[11]

While the basics seem clear enough, until the proposed regulations were revealed in October, many questions remained. The proposed regulations provide clarification on a number of these questions, but a few still remain unanswered.

What do the "Proposed" Treasury Regulations Mean?

As the name suggests, these regulations are proposed, not final; the rules may change. The Treasury specifically requests comments and suggestions from the public on certain parts of the law and has allocated a 60-day comment period (expiring mid-December).[12]

Though not final, a taxpayer may rely on the proposed regulations so long as the taxpayer "applies the rules in their entirety and in a consistent manner."[13] This is important because QOZ investments are extremely time sensitive.[14] By issuing proposed regulations and permitting taxpayers to rely on them, the Treasury is giving us its first interpretation of the QOZ legislation and providing taxpayers with a potential roadmap to take advantage of this program.

What Gains are Eligible?

A simple question, but the answer was unclear in the original statute. The QOZ statute used both terms "gain" and "capital gain."[15] The proposed regulations clarify that all capital gains, but only capital gains, realized prior to January 1, 2027 are eligible for deferral.[16] This means both short term and long term capital gains are available for deferral. The deferred gains retain the same character over the life of the investment in the QOF (i.e., until the earlier of 2026 or the sale date), so short term capital gains cannot become long term capital gains by deferral in a QOF.[17]

It's also important to note that the gain cannot arise from a sale or exchange with a related person (meaning typical family members), and would also exclude transactions between a trust and its grantor, a trust and a beneficiary, and related corporations or transactions between an entity and a significant shareholder/owner (applying a 20% ownership test).[18]

Who is an Eligible Taxpayer?

Any taxpayer that recognizes a capital gain is eligible. For instance, individuals, C corporations, partnerships, real estate investment trusts (REITs), S corporations, and trusts and estates are all eligible to participate in a QOZ.[19]

When Must the Gain Be Invested in the QOF?

The taxpayer has 180 days from realizing a capital gain to invest in the QOF.[20] For most taxpayers, the capital gain is realized on the date the capital asset is sold. However, the proposed regulations clarify that the owner of a pass-through entity does not realize the gain until the end of the entity's taxable year.[21] This means that if any capital gain is not deferred by the entity within 180 days from the sale event, then an owner of the pass-through entity will have 180 days from the last day of the entity's taxable year to defer the capital gain. The entity and the individual may elect to defer all or a portion of the gain within the respective time frames. This is a major clarification because an owner of a pass-through business may have as late as 180 days from December 31 regardless of when the entity realized the gain earlier that year.[22]

How Long Can an Investor Hold the QOF Investment?

The QOZ statute did not require a termination date. Absent guidance, many taxpayers thought they could hold the investment for 30, 40, 50 years or more and all appreciation would avoid tax. The proposed regulations clarify that the tax-free appreciation of a QOF investment terminates in 2047.[23] This still gives an investor several decades for the QOF investment with potential to appreciate tax free so long as they meet the 10-year holding period.[24] The QOZ program is designed to encourage long-term investment, so we feel that this sets a reasonable time frame for an investor to realize the full benefits of the program. What we don't know is how this

termination date works. The Treasury is asking for comments on whether: 1) the investment must be sold in 2047, or 2) the investor should simply receive an income tax basis equal to the fair market value (presumably a "step-up" in basis), but can continue to hold the investment.[25]

Do Existing Entities Qualify for the QOZ Program?

It's possible for existing entities to qualify for the QOZ program, but only in unique circumstances.[26] Taxpayers with a business entity in a QOZ may utilize this business for their QOF or as a QOZ Business so long as the business entity itself satisfies the QOZ requirements. One requirement, however, is that the business property must have been *acquired* by the entity *after* December 31, 2017. In other words, existing assets in an entity acquired prior to 2018 will apparently not qualify for QOZ treatment unless the entity can qualify as a QOF or QOZ Business with newly acquired property and application of the 90% rule, discussed below.

Does 90% investment, really mean 90%?

A QOF must hold 90% of its assets in QOZ stock, partnership interests, or business property.[27] We see that as a high threshold, especially when running a business or developing property. If a QOF were going to renovate or construct real estate within a QOZ, it could take many months, even years, to get permits, finalize plans, obtain zoning changes, etc. During that time, cash held by the QOF to start the project or meet the "substantial improvement" requirements would likely cause the QOF to fail the 90% test. The proposed regulations address these concerns in a few different ways.

1. **Working Capital Written Plan Safe Harbor:[28]** A QOZ Business meets the 90% test if it holds cash as working capital and meets the following three requirements:

    a. The QOZ Business has a written working capital plan for the acquisition, construction, and/or substantial improvement of tangible property within a QOZ over no more than a 31-month period.

    b. The plan must be reasonable and consistent with the ordinary start-up of a trade or business.

    c. The working capital assets must actually be used in a manner substantially consistent with the written plan.

    It is worth noting that there's currently no requirement to present or otherwise certify the plan on an ongoing basis. It appears that the written plan must simply exist and may need to be produced if, for example, requested by the IRS.

2. **The 90% Rule…Unless it's the 70% Rule:[29]** Do you remember the "substantially all" requirement?[30] This is the requirement that a QOZ Business must have "substantially all" of its tangible property invested in a QOZ. Well, the regulations clarify that "substantially all" means 70%. The result is that a QOF has a 90% QOZ business property investment requirement, but could simply meet this requirement by investing in a QOZ business that only has a 70% QOZ business property investment requirement. The regulations themselves admit this rule opens the door for some gamesmanship, but seem to be ok with it.[31] Although, guidance is requested on whether 70% is too much, too little, or just right for operating the QOZ.

3. **The Substantial Improvement Requirement:** Whether the QOF invests in a QOZ Business or directly in QOZ business property, the "substantial improvement" requirement comes into play where property is already being used in a QOZ. This property qualifies for the 90% test (or 70% test), so long as it is substantially improved over a 30-month period. It appears the new working capital test is being coordinated with the substantial improvement requirement as requiring a written plan over the 31-month period.[32] However, it is not clear that the written plan is required or even satisfies the substantial improvement requirement, so additional clarity is needed.

How Does Real Estate Fit into All This?

Investors looking to develop real estate in opportunity zones were likely the primary target of this new program. New businesses, jobs, and growth in these communities seem to start with real estate. However, a plain reading of the new law begged the questions: 1) Does land even qualify? and 2) If I'm not tearing the building down and rebuilding, can I really meet the substantial improvement requirement?

These points were so important and unclear that they could not be addressed in the proposed regulations alone. The IRS issued a Revenue Ruling (Rev. Rul. 2018-29) to clarify its position on the issue.[33]

The short answers are: 1) land qualifies for a QOF, and 2) only the value of the improvements at purchase are subject to the substantial improvement requirement.[34]

This means that a taxpayer could potentially purchase a property and allocate the purchase price between the land and improvements. For example, a $1 million investment might be allocated 50% ($500,000) to the land and 50% ($500,000) for the improvements. The taxpayer must "substantially improve" the improvements by investing an additional $500,001 over the next 30 months, but is not required to invest another $1 million as additional capital.

In addition to this clarification, the Treasury is asking for comment on whether property already in a QOZ may at some point be deemed "not in use," so a taxpayer could avoid the substantial improvement requirement altogether. For instance, imagine a run-down apartment complex that has been vacant for years. Its value may be high relative to what it needs in improvements to get it up and running. If it's not being used now, shouldn't any improvement and use count? We'll keep an eye on this issue.

Leveraging the QOF Investment

Loans play a major role in any investment opportunity and QOZ investors sought clarity on how loans will impact the QOZ investment. The proposed regulations address loans in two different ways:

1. Collateralizing a QOF Interest: Investors may use their QOF interest as a collateral for a loan without disqualification.[35]
2. Borrowing by the QOF or QOZ Business:[36] Investors may borrow to acquire a QOZ Business or QOZ Business Property in the QOF and the amount borrowed is not treated as a separate non-qualifying investment. This is a major win for investors because they can use leverage to acquire a more favorable and valuable investment, thus ultimately increasing the non-taxable appreciation
business with $1 million of qualifying gain investment could use that as 20% down on a $5 million investment for QOZ Business Property or a QOZ Business.

Re-Investing a Previously Deferred Gain

The regulations confirmed that a taxpayer can sell a QOF investment and re-invest within 180 days without recognizing the gain.[i] This allows an investor to exit one QOF and invest in another.

Also, if you do not reinvest the full QOF amount, then the portion of the proceeds withdrawn are taxable. This is an area where the proposed regulations get very detailed and examples are provided to help determine how much gain and what type of gain should be recognized.[ii]

Don't Forget State Taxes

Lastly, let's not forget state taxes. This is a federal program and not all states conform to federal tax law. Though this could be a great opportunity to defer federal taxes, you may have to pay your state income taxes in the meantime. Be sure to check with your tax advisor to understand whether your state conforms to this new program.

Questions Remain for Qualified Opportunity Zones

With significant capital gains, exploring the advantages and disadvantages of an Opportunity Zone investment may be worthwhile. On the other hand, since the regulatory guidelines are not final, taxpayers should know that some important questions remain. A few of the considerations include:

- What measures will be put in place for operating Qualified Opportunity Zone Funds to ensure they continue to qualify while providing investment opportunities to unrelated parties with significant capital gains?
- What will the impact of the Opportunity Zone Fund legislation be? Who will benefit?

We are committed to keeping you up to date on Opportunity Zones and future clarity on these investments. Watch for future planning updates as regulations and clarifications move forward.

[i] Proposed Treasury Regulation §1.1400Z-2(a)-1(b)(4), example 4
[ii] Proposed Treasury Regulation §1.1400Z-2(a)-1(b)(6), (7), and (8) with accompanying examples.

[1] Reg. 115420-18; also at: https://www.irs.gov/newsroom/treasury-irs-issue-proposed-regulations-on-new-opportunity-zone-tax-incentive
[2] Internal Revenue Code (IRC) §1400Z-2(a)(1)(A)
[3] IRC §1400Z-2(d)(2)(A)
[4] IRC §1400Z-2(d)(2)(B) and (C)
[5] IRC §1400Z-2(d)(2)(D)
[6] IRC §1400Z-2(d)(1)
[7] IRC §1400Z-2(d)(3)
[8] IRC §1400Z-2(a)(1)(A)
[9] IRC §1400Z-2(b)(1)
[10] IRC §1400Z-2(b)(2)(B)
[11] IRC §1400Z-2(c)
[12] Reg. 115420-18; also at: https://www.irs.gov/newsroom/treasury-irs-issue-proposed-regulations-on-new-opportunity-zone-tax-incentive
[13] Reg. 115420-18; and https://www.irs.gov/newsroom/treasury-irs-issue-proposed-regulations-on-new-opportunity-zone-tax-incentive (pages 29-30)
[14] As related to the 180-day investment period following a taxpayer's triggering of a capital gain, see IRC §1400Z-2(a)(1)(A); and for the deadline for a Qualified Opportunity Fund to have 90 percent of its assets invested in qualified Opportunity Zone Property on the last day of the first 6-month period of the taxable year of the fund and on the last day of the taxable year of the fund, see §1400Z-2(d).
[15] Compare the title of the statute §1400Z-2: "Special Rules for Capital Gains Invested in Opportunity Zones" and the use of only the term "gain" omitting the word "capital" in the remainder of §1400Z-2.
[16] Proposed Treasury Regulation §1.1400Z-2(a)-1(b)(2)
[17] Proposed Treasury Regulation §1.1400Z-2(a)-1(b)(5)
[18] Proposed Treasury Regulation §1.1400Z-2(a)-1(b)(2)(C)
[19] Proposed Treasury Regulation §1.1400Z-2(a)-1(b)(1)
[20] IRC §1400Z-2(d)(2)(A)
[21] Proposed Treasury Regulation §1.1400Z-2(a)-1(c)(2)
[22] Proposed Treasury Regulation §1.1400Z-2(a)-1(b)(3)(ii)
[23] Proposed Treasury Regulation §1.1400Z-2(c)-1(b)
[24] IRC §1400Z-2(c)
[25] Proposed Treasury Regulation, Commentary Section C, 2, d (Clarity regarding electing post-10-year gain exclusion if zone designation expires (pages 35-38))
[26] Proposed Treasury Regulation §1.1400Z-2(d)-1(a)(3)
[27] IRC §1400Z-2(d)(1)
[28] Proposed Treasury Regulation §1.1400Z-2(d)-1(d)(5)(iv)
[29] Proposed Treasury Regulation §1.1400Z-2(d)-1(d)(3)
[30] IRC §1400Z-2(d)(2)(D)(i)(III)
[31] Proposed Treasury Regulation, Commentary Section C, 2, f (Definition of substantially all) (pages 41-42))
[32] Proposed Treasury Regulation §1.1400Z-2(d)-1(d)(5)(iv)
[33] Revenue Ruling 2018-29, also at: https://www.irs.gov/pub/irs-drop/rr-18-29.pdf
[34] Revenue Ruling 2018-29
[35] Proposed Treasury Regulation §1.1400Z-2(a)-1(c)(2)(ii)
[36] Proposed Treasury Regulation §1.1400Z-2(e)-1(a)(2)

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