

Qualified Opportunity Zone Funds : A Tax Investment Worth Considering

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The 2017 Tax Act created a new investment vehicle called the Qualified Opportunity Zone (QOZ) Fund, for the purpose of spurring investment in thousands of economically distressed areas across the country. IRC §§ 1400Z-1, 2. To stimulate investment in QOZ funds, investors who have recognized capital gain from the sale of *any* asset can defer taxation of such gain by investing in a QOZ fund within 180 days of the sale. Additionally, they can be eligible for other tax benefits if they hold their investment in the fund for a specified time. Id. § 1400Z-2(a)(1), (b).

In 2018, the IRS published proposed regulations and a related revenue ruling, which have shed light on both how an investor can achieve tax benefits by investing in a QOZ fund and how a QOZ fund can be created. Prop. Reg. §§ 1.1400Z-2(a)-1 through 1.1400Z-2(e)(1); Rev. Rul. 2018-29. Although there are still several issues that await further guidance, the IRS's actions have created both a workable blueprint to create a QOZ fund and guidance for the investors who want to take advantage of this new investment vehicle.

The tax benefits of investing in QOZ funds are available to any taxpayer recognizing a capital gain, which includes both individuals and fully taxable corporations, referred to as C Corporations. Capital gains recognized by a partnership, an S Corporation, a trust, an estate, a real estate investment trust (REIT), or a mutual fund classified as a regulated investment company are also eligible for these benefits. Prop. Reg. § 1.1400Z-2(a)-1(b)(1). The tax benefits apply only if the taxpayer acquires an equity interest in the fund, which can include a partnership interest with special allocations or a preferred equity interest in the fund. No benefits apply if the taxpayer makes a loan to the fund. Prop. Reg. § 1.1400Z-2(a)-1(b)(3).

Tax Benefits for Investors

Investment in a QOZ fund offers the following three tax benefits, which will stimulate investment in QOZ funds.

First, the investor can elect to defer recognition of any capital gain until the earlier of the date the taxpayer sells its interest in the QOZ fund or the year 2026. IRC § 1400Z-2(b)(1). Deferral applies to both long term capital gain (LTCG) from the sale of an asset held for more than one year, which is subject to a maximum 20 percent tax rate for individuals, as well as short-term capital gain (STCG) that otherwise is subject to tax at regular tax rates. Prop. Reg. § 1.1400Z-2(a)-1(b)(2). Investment of STCG can thus be especially advantageous given the high rate of tax that may otherwise apply.

Like kind exchanges (LKEs) have been a popular technique to eliminate recognition of gain on the sale of business or rental real estate and other assets (IRC § 1031), but QOZ investment may be a better option. Unlike a tax-free LKE, there is no requirement to invest the entire sale price in the QOZ Fund to get tax deferral; the taxpayer only has to invest cash equal to the capital gain to get tax deferral. While tax free treatment under a LKE requires the use of a qualified intermediary to hold the cash from a sale of property before it is used to acquire replacement property, there is no similar limitation when investing in a QOZ fund. The taxpayer can receive the cash proceeds from a sale, freely use the cash for any purpose, and later invest cash equal to the capital gain in a QOZ fund to get a tax deferral. Finally, 2017 Tax Act legislation narrowed the use of tax-free LKEs to apply only to the sale of business or rental real estate, so the use of LKEs for other sales is no longer an option. IRC § 1031(a)(1). By contrast, any capital gain can be rolled into a QOZ fund.

A taxpayer that has timely invested in a QOZ fund must elect to defer gain recognition in a manner specified by the IRS. Prop. Reg. § 1.1400Z-2(a)-1(d). The election is made when a tax return is filed for the year of sale. The taxpayer reports the QOZ investment on Form 8949, the form used to report sales of capital assets that is attached to the taxpayer's income tax return. This form has been modified to include specific instructions for reporting the QOZ investment. See Instructions to Form 8949 at 10 (How to Report an Election to Defer Tax on Eligible Gain Invested in a QO Fund).

Second, there is a permanent reduction in taxation of part of the deferred capital gain from the original investment if the investment in the QOZ fund is held for at least five years before a sale. IRC § 1400Z-2(b)(2)(B). If the fund investment is held for five or more years, then the deferred gain will be reduced by 10 percent. If the QOZ fund is held for seven or more years, the deferred gain is reduced by 15 percent. Thus, the investor will only pay tax on 85 percent of the gain if the investor maintains the fund investment for seven years or longer. Also, whenever the deferred gain is recognized, the tax basis of the fund is increased by the gain that is then recognized, which lowers tax on a later sale of an investment in the fund.

Third, if the investor has patience and can delay the sale of its interest in the QOZ fund until it has held the investment for ten years or more, then the tax basis of the investment is increased to the fair market value of the investment on the date of sale. IRC § 1400Z-2(c). This step-up in tax basis effectively eliminates any federal income tax on the sale. The only restriction is that the investment in the fund must be sold before the year 2048. Prop. Reg. § 1.1400Z-2(c)-1(b). This deadline is far in the future and gives investors plenty of time to dispose of their investment.

There is one caveat to note with any exit strategy. If the QOZ fund sells its property to a buyer after ten years, there is no step-up in tax basis for the assets being sold by the fund. Full taxation would result to the fund, which gain will be allocated to the partners of the fund if the fund is structured as a partnership.

As an alternative exit planning technique, the partners of the QOZ fund should sell their interest in the fund to the buyer, which would be eligible for tax exemption if sold after ten years. Buyers usually want to get a tax basis for the underlying fund assets based on the purchase price they are paying. A basis step-up would be allowed if the buyer buys 100 percent of the fund because it is then treated for tax purposes as if it purchased the assets. Rev. Rul. 99-6. If the buyer buys less than 100 percent of the QOZ fund, the buyer can also get a step up in tax basis for its allocable share of fund assets if an IRC § 754 election is made by the fund, which can be easily done and causes no harm to the sellers or the fund. As a result, a properly structured exit strategy can be beneficial to both the QOZ investors and the buyer.

Scope of Capital Gain Eligible for Tax Deferral

Deferral is available for a sale of any capital asset (such as stock) held for more than one year, which generates LTCG. However, the Code includes other cases where a sale of an asset that is not a capital asset may get LTCG treatment or income may be specially treated as taxable as LTCG.

Rental real estate and real estate otherwise used in a business are generally treated as IRC § 1231 property, which gets special tax treatment that may complicate the determination of how much to invest in a QOZ fund. Sales of § 1231 property are aggregated in a year. The excess of the taxpayer's gains from the sale of § 1231 property minus the taxpayer's losses from the sale of § 1231 property is the net § 1231 gain, which is treated as LTCG that should be eligible for tax deferral by investing in a QOZ fund. By contrast, if a taxpayer's losses from the sale of § 1231 property exceed the taxpayer's gains from the sale of § 1231 property, the taxpayer has a net § 1231 gain, which is treated as an ordinary loss. A taxpayer will not know until the end of the year if it has a net § 1231 gain.

To illustrate the practical concern with sales of § 1231 property, on January 1, a taxpayer recognizes a \$500,000 gain from the sale of a § 1231 property, and the 180-day investment period expires at the end of June. On December 1, the taxpayer has a \$400,000 loss from the sale of another § 1231 property, which will reduce the net § 1231 gain for the year to \$100,000. In this case, only \$100,000 can be deferred by investing in a QOZ Fund. A taxpayer's net § 1231 gain also takes into account sales of § 1231 property by partnerships and other pass-through entities (such as S corporations), which further complicates the determination of whether the taxpayer may have a net § 1231 gain for the year because the taxpayer may not even be aware of those sales until after year-end. Unless the IRS gives relief in later guidance, a taxpayer must invest within 180 days of the sale date even though the taxpayer may not know for certain if the sale will generate capital gain until past that deadline.

For individuals, the taxation of gain from the sale of depreciable real estate is affected by the depreciation recapture rules, which will tax the lesser of the gain on sale or prior real estate depreciation deductions taken, at a 25 percent rate rather than the regular 20 percent LTCG rate. The real estate depreciation recapture rules should not affect the gain that can be deferred. Capital gain eligible for

deferral should also include qualified dividend income that a taxpayer receives (e.g., dividends from most US companies and certain foreign companies), which is taxed as LTCG, as well as REIT dividends that get LTCG treatment.

180-Day Election Period

IRS guidance addresses how to deal with a capital gain recognized by a partnership to obtain tax deferral under the QOZ fund rules. Prop. Reg. §§ 1.1400Z-2(a)(1)(c)(1), (2). The partnership has 180 days from the date of the sale generating the capital gain to invest the capital gain in a QOZ fund. If the partnership makes that investment within 180 days of the sale, then tax deferral and related tax benefits apply for all partners.

If the partnership does not invest in a QOZ fund within the 180-day period, then each partner can choose to reinvest their share of the capital gain into a QOZ fund and get tax deferral and the tax benefits described above. That partner must make that investment within 180 days of the end of the partnership's taxable year and not the actual date of the partnership's sale. This approach gives partners in a partnership a second bite at the apple to invest the capital gain in a QOZ fund and gives them added time to make that decision well after the tax year is over. Also, a partner could make this investment earlier if the partnership has recognized a capital gain and the partnership indicates it will not reinvest the sales proceeds in a QOZ fund. In that case, the partner can elect to start the 180-day period on the date the partnership sold the asset that generated the capital gain. A partnership may decide that giving each partner the option to invest in a QOZ fund may be preferable because it gives each partner more flexibility in choosing what fund to invest in, if any, and when to sell it.

Similar treatment applies to S corporations and their shareholders, as well as trusts and estates. Prop. Reg. §§ 1.1400Z-2(a)(1)(c)(3). As a result, each S corporation shareholder may have the opportunity to invest directly in a fund if the S corporation recognized a capital gain and chose to not invest directly into a QOZ fund.

What is a QOZ?

QOZs exist in every state, the District of Columbia, Puerto Rico, and several US possessions (e.g., the US Virgin Islands). QOZs are economically distressed areas, which can include select parts of cities and townships. IRC § 1400Z-1. Nonetheless, many QOZs are on the edge of developed and developing areas, which were already on the verge of development without this new tax incentive. The Department of the Treasury's CDPI Fund Opportunity Zone Resources web page has a map showing certified QOZs on the internet, available at https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml. Around 8,000 areas have been designated as QOZs. More than 500 exist in New York State, more than 800 in California, and even Wyoming, the smallest state by population, has more than 20.

What is a QOZ Fund?

A QOZ fund is a partnership or corporation if 90 percent or more of its assets consist of QOZ property, as described below. IRC § 1400Z-2(d)(1); Prop. Reg. § 1.1400Z-2(d)-1. The partnership form will be most often used because a partnership is not a taxpayer—all of its income and loss flow through to its

partners, who then include such amounts on their own tax return. The partnership must have two or more partners; a single member LLC cannot be a QOZ fund because the tax law treats it as a disregarded entity.

Unlike prior tax programs that were targeted to specified activities (e.g., low income housing tax credits), the QOZ fund can invest in QOZ commercial real estate or nearly any active trade or business located in the QOZ. As a result, the funds are very flexible. The only restriction is the fund cannot be engaged in what is commonly referred to as a “sin business,” which includes running a golf course, a country club, a massage parlor, a hot tub or tanning facility, a racetrack, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. Prop. Reg. § 1.1400Z-2(d)-1(d)(6).

QOZ property that must be owned by a fund includes QOZ business property, QOZ partnership interests, or QOZ stock. IRC § 1400Z-2(d)(2)(A); Prop. Reg. § 1.1400Z-2(d)-1(c)(1). QOZ business property is tangible property located and used in the QOZ that was acquired from unrelated persons by purchase after December 31, 2017, if either the original use of the property starts with the fund or the fund substantially improves the property. IRC § 1400Z-2(d)(2)(D); Prop. Reg. § 1.1400Z-2(d)-1(c)(4).

The prohibition on purchases from related parties is very broad because a related person includes anyone who owns a 20 percent or greater interest in the fund. IRC §§ 1400Z-2(d)(2)(D)(iii), (e)(2). Constructive ownership rules apply that prevent the related party rules from applying by having a family member or related companies own the interest in the fund. For this purpose, a family member only includes a spouse, ancestors (e.g., parents), and lineal descendants (e.g., children) but does not include brothers and sisters and other family relationships. IRC § 179(d)(2)(A). These constructive ownership rules need to be reviewed to determine if they may apply.

The requirement to substantially improve the property is met if, within 30 months of the purchase of the property, the fund invests money into building improvements to the property, the cost of which exceed the cost of the property. IRC § 1400Z-2(d)(2)(D)(ii); Prop. Reg. § 1.1400Z-2(d)-1(c)(8)(i). In applying this test, the IRS offers helpful guidance, providing that if a fund buys a building and land, as will most often occur, the fund need only invest money in excess of the cost to acquire the building and not the underlying land. Prop. Reg. § 1.1400Z-2(d)-1(c)(8)(ii); Rev. Rul. 2018-29. For example, if a fund buys property in the zone for \$1 million, and \$800,000 of the purchase price is allocable to the building and \$200,000 is allocable to the land then the fund need only spend more than \$800,000 in building improvements on the property. It is important that documentation to purchase the property include an allocation of the purchase price between building and land. Alternatively, an appraisal can be obtained to allocate the purchase price between building and land, so the fund knows how much it must spend to meet the substantial improvement requirement. The IRS has not yet addressed how this substantial improvement requirement applies when the fund purchases land or enters into a ground lease and the fund will then construct a building on the land.

What Is a QOZ Partnership Interest or QOZ Stock?

A QOZ partnership interest is an equity interest in a domestic partnership, which is acquired by the fund for cash directly from the partnership, and the partnership is a QOZ business at the time of the acquisition and remains so for substantially all of the fund's holding period for the investment. IRC §§ 1400Z-2(d)(2)(C); Prop. Reg. §§ 1.1400Z-2(d)-(c)(3). QOZ stock is an equity interest in a domestic corporation, which is acquired by the fund for cash directly from the corporation, and the corporation is a QOZ business at the time of the acquisition and remains so for substantially all of the fund's holding period for the investment. IRC §§ 1400Z-2(d)(2)(B); Prop. Reg. §§ 1.1400Z-2(d)-1(c)(2).

A QOZ business requires that (1) "substantially all" of the tangible property of the entity (i.e., partnership or corporation) is QOZ business property, (2) at least 50 percent of the entity's income is derived from the active conduct of a trade or business, (3) a substantial portion of the intangible property of the entity is used in the "active conduct of a trade or business," and (4) less than five percent of the entity's average tax basis in its property is attributable to certain financial assets including debt, stock, partnership interests, and certain financial instruments, but not including reasonable amounts of working capital held in cash or cash equivalents and certain short term debt instruments (i.e., terms of 18 months or less). IRC § 1400Z-2(d)(3); IRC § 1397C(b)(2), (4), (8); Prop. Reg. § 1.1400Z-2(d)-1(d)(1).

IRS guidance interprets the requirement that "substantially all" of the tangible property be tangible property used in the zone as requiring only 70 percent of the business's tangible assets to be invested in the zone. Prop. Reg. § 1.1400Z-2(d)-1(d)(3). As a result, although a QOZ fund must have 90 percent or more of its assets invested in QOZ property, a QOZ partnership or corporation in which the fund invests must only have 70 percent or more of its tangible assets invested in the zone to be engaged in a QOZ business. This lower 70 percent threshold may make it more beneficial for a QOZ fund to invest in a partnership or corporation, which conducts business in the zone, rather than the QOZ fund itself directly owning and operating the business.

The "active trade or business requirement" may be met if the business employs full-time employees who operate its business or leases property to multiple tenants. If the business has no employees or only triple net leases its property to a single tenant, then the active trade or business test may not be met. The scope of what constitutes an active trade or business has been reserved by the IRS and awaits needed IRS clarification. Prop. Reg. § 1.1400Z-2(d)-1(d)(5).

Impact of Retaining Cash as Working Capital

Cash is not normally an eligible asset in applying the 90 percent/10 percent tests applicable to the QOZ fund or the 70 percent/30 percent test applicable to a QOZ business conducted by a QOZ partnership or QOZ corporation in which the fund invests. As construction of improvements will often be made by the fund, the fund may have to retain contributed cash to pay for such construction. If a QOZ fund retains too much cash, it may result in a failure to meet the qualification rules. To address this concern, the IRS adopted a reasonable working capital safe harbor exception. Prop. Reg. § 1.1400Z-2(d)-1(d)(5)(iv).

The working capital safe harbor cannot be used by the QOZ fund itself, but it can be used by a QOZ partnership or a QOZ corporation in which the fund invests. As a result, a two-tiered structure often must be used to take advantage of this safe harbor unless the IRS relaxes its rules in later guidance. The investors will invest cash in a QOZ fund and then the fund will invest the cash in a QOZ partnership; the QOZ partnership must have two or more partners, but the fund can own 99 percent of the QOZ partnership.

To take advantage of this safe harbor, there must be a written schedule providing for the working capital (cash) to be spent within 31 months, and the working capital must be used in a manner that is substantially consistent with the schedule. The 31-month period does not match up with the 30-month period required to complete the substantial improvements to fund property. The added month was given to allow the fund the opportunity to obtain the cash before purchasing property to be used in the zone.

Mechanics for Obtaining and Maintaining QOZ Fund Status

A fund does not have to obtain advance approval of the IRS for its status as a QOZ fund. Prop. Reg. § 1.1400Z-2(d)-1(a)(1). A QOZ fund self-certifies its compliance with applicable requirements on Form 8996. Despite the absence of IRS approval, a fund needs to maintain records to show compliance with all requirements, which may be requested by the IRS upon an audit. Also, an investor in a QOZ fund needs to be confident that the fund qualifies as a QOZ fund. A previously existing entity can elect to be treated as a QOZ fund. Prop. Reg. § 1.1400Z-2(d)-1(a)(3). However, assets acquired before January 1, 2018 are not eligible assets required to be owned by a QOZ fund. Care must be taken in using any preexisting entity.

The IRS has given a fund flexibility to specify the first year in which it elects QOZ fund status and then identify the first month in that year in which it wants QOZ Fund status to commence. Prop. Reg. §§ 1.1400Z-2(d)-1(a)(1)(ii), (iii). The choice of an effective date is important because a fund must be a QOZ fund on the first date an investor contributes capital gain to the fund in order for the investor to get the tax benefits. This flexibility can also be helpful to ensure the fund can properly comply with all requirements, which must be met only on two testing dates during each year of the fund's existence. IRC § 1400Z-2(d)(1).

If the fund was formed in the last half of the year, there will only be one testing date for the first year, December 31. If the fund is formed in the first half of the year, the first testing date will be six months after the effective date for starting fund status, and the second testing date will be December 31. The testing dates will be June 30 and December 31 in all later years. For example, if a fund is formed on June 1, its first testing period ends on November 30 and its second testing period ends on December 31.

Starting a fund late in a year may be disadvantageous because the fund must meet the requirements on December 31, which may give it very little time to ensure compliance. For example, if a fund starts on December 1, the fund must comply with all fund requirements on December 31. Delaying the effective date to the start of the following year may be helpful, assuming the investors have adequate time to make their contributions to the fund within 180 days.

On each testing date, a QOZ fund is required to have 90 percent or more of its assets in QOZ property, which includes investment by the fund itself in a QOZ business or investment in a QOZ partnership or QOZ stock. The IRC is silent as to whether this test is applied based on fair market value (FMV), original cost, tax basis of assets, or some other measure of value. If the fund has applicable financial statements, which are statements filed with the SEC or any federal agency or audited financial statements prepared in accordance with GAAP, then the fund can use the values shown on the financial statements in applying this 90 percent/10 percent test. If the fund does not have applicable financial statements, then the fund can use the original cost of the assets. Prop. Reg. § 1.1400Z-2(d)-1(b).

Debt Financing

Current IRS guidance generally acknowledges that a fund can borrow money to help acquire property or construct improvements without jeopardizing QOZ tax benefits. Prop. Reg. § 1.1400Z-2(e)-1. However, the IRS is still reviewing the impact of use of debt, so there is some uneasiness about what later guidance may provide. Partnerships owning real estate often refinance debt when property values have grown and then distribute the refinancing proceeds to their partners. Partnership tax rules generally allow distribution of refinancing proceeds to be made tax-free to the partners. However, the IRS is reviewing whether such general rules should be changed if the partnership making the distribution is a QOZ fund. Further IRS guidance is needed.

Single v. Multiple Property Funds

QOZ fund status may be easier to maintain for a partnership that will invest in and develop only a single property. Many investment funds, however, are created to invest in more than one property and may require multiple investor contributions to fund purchase or development of property on different dates.

An investor in a QOZ fund must invest only capital gain to get the related tax benefits. Although an investor may know it has capital gain to invest when the QOZ fund is first formed, that same investor may not be sure it will have additional capital gain to invest if the fund requires it to make a later capital contribution. If that investor is required to make a second capital contribution but has no capital gain to then invest, then that second investment will dilute the QOZ benefits.

To illustrate the concern, a fund requires each investor to contribute \$100,000 up-front in exchange for a specified percentage interest in the fund. An investor can then decide whether to invest if it has at least \$100,000 capital gain. However, if the fund also requires that investor to contribute another \$100,000 one year later to buy and develop a second zone property, the investor may not know when it initially chooses to invest in the fund if it will have another \$100,000 of capital gain available to invest a year later. If the investor makes the second \$100,000 capital contribution, but it then has no capital gain to invest, then the future opportunity to sell the interest in the fund after ten years without incurring tax is lost. Only 50 percent of the gain on a later sale of the investment in the fund is eligible for tax exemption because only 50 percent of the investor's \$200,000 contributions to the fund came from capital gain.

As a planning matter, an investor must be careful if it is asked to make more than one capital contribution to the fund. Unless the investor has a high certainty that it will have future capital gains to invest, the investor needs to consider dilution of future tax benefits that may occur when a later capital contribution is required.

Conclusion

The bottom line is that investing in a QOZ fund has major tax advantages deserving of consideration. Also, unlike other tax programs targeted at low income areas (such as the low income housing tax credit), this tax incentive is not restricted to only aiding low income people. Rather, the QOZ fund can invest in real estate or certain operating businesses that may have significant profit potential. As a result, the QOZ fund can offer both tax benefits and economic benefits. Investors and those forming funds need, however, to make sure the QOZ fund is properly managed and compliant with all tax rules to better assure these benefits may materialize. That process is made more difficult by the lack of IRS guidance as to many areas that still remains more than one year after these new funds were first allowed to be formed. n