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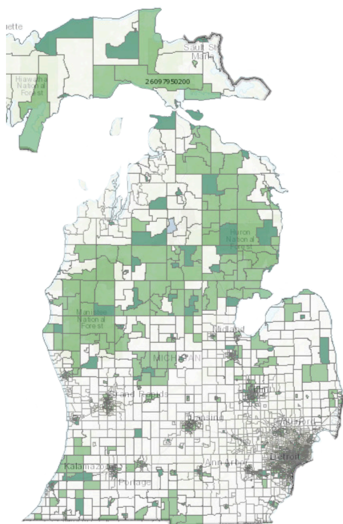
Qualified Opportunity Zone Fund Investments

There has been a lot of talk in recent months about an interesting tax incentive designed to help spur economic investment in distressed areas around the country known as "qualified opportunity zones" ("QOZs"). This incentive, found in Section 1400Z-1 and 1400Z-2 of the Internal Revenue Code (the "Code"), was added as part of the Tax Cuts and Jobs Act, effective December 22, 2017. The new Code section contained many new rules that left tax practitioners with questions about how they and their clients could take advantage of the incentive. Much-anticipated proposed regulations were finally released on October 19, 2018. These proposed regulations give us some insight into how the Treasury Department and IRS will administer the QOZ incentive. The regulations give some clarity on how taxpayers can invest in these QOZs and how taxpayers can make elections to receive tax benefits from QOZs. Notwithstanding this helpful information, the proposed regulations still leave many questions unanswered and sometimes even create new questions. More guidance is expected from the IRS in coming months with respect to QOZs, and these proposed regulations also need to be finalized. In the meantime, this white paper attempts to explain some of the important points of the QOZ incentives based on the guidance currently available.



QOZs are located in every county in Michigan.

What are QOZs?

QOZs are economically distressed areas around the country that have been nominated by each state and approved by the Treasury to participate in this economic incentive. Each state was allowed to designate up to 25 percent of its low-income communities as QOZs. QOZs retain their designation for 10 years. There is an interactive list of locations and interactive map on the [U.S. Department of Treasury's CDFI Fund Website] that can be used to find QOZs.

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What are the tax benefits of investing in a QOZ?

The tax benefits are three-fold:

1) Capital gains deferral: If a taxpayer realizes capital gains and invests in a qualified opportunity zone fund ("QOF") within 180 days, the taxpayer is able to defer the tax on the capital gains until the earlier of the date on which the QOF investment is sold or December 31, 2026. The proposed regulations provide that all of the deferred gains' tax attributes are preserved through the deferral period and are taken into account when the gain is included.

2) Basis step-up: If the taxpayer's investment in the QOF is held for five years, the taxpayer will receive a 10 percent step-up in basis (10 percent of the gain deferred) and an additional 5 percent if the investment is held for seven years (for a total of 15 percent of the gain deferred). These basis increases can be used to offset the deferred capital gains that will be recognized on the earlier of the date on which the QOF investment is sold or December 31, 2026 as stated above.

3) Non-recognition for 10-year investments: If the taxpayer holds the investment in the QOF for at least 10 years, the taxpayer will not pay tax on gains from sale of QOF interest. This benefit applies to gains resulting from appreciation over the invested gains amount and can be taken advantage of through an election to "step-up" basis.

	Combined Example: QOZ Fund
February 1, 2019	Investor sells stock for $2 million with $1 million basis ⟶ $1 million capital gains
July 1, 2019	Investor invests $1 million in QOZ Fund investment (within 180 days)
April 15, 2020	No capital gains tax due
July 1, 2024	Step-up in basis by $100,000 (10 percent step-up after 5 years)
July 1, 2026	Step-up in basis of additional $50,000 (additional 5 percent step-up after 7 years)
December 31, 2026	Investor incurs capital gains tax liability on $850,000 of gain
April 15, 2027	Investor must pay $170,000 in capital gains tax
August 1, 2029	Investor sells QOZ Fund investment for $1.5 million ⟶ no capital gains

Total Benefit

$130,000 in reduced taxes

- $200,000 ⟶ $170,000 due to step-up in basis
- $100,000 ⟶ $0 due to tax-free gains on QOZ Fund investment

$58,185 in value of deferring capital gains tax payment from April 15, 2020 to April 15, 2027 (using 6 percent discount rate)

TOTAL BENEFIT: $188,185

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How does the 180-day deadline for making the QOF investment work?

Any taxpayer who may recognize capital gains for federal income tax purposes is eligible to invest in a QOF and receive deferral of capital gains tax. This includes individuals, C corporations, partnerships, other pass-through entities like trusts, REITs and more. For partnerships or S corporation entities, the entity can elect to defer all or part of its capital gains to the extent that the entity makes an eligible investment in a QOF. If the entity doesn't elect to defer the gains and invest in a QOF, the entity's partners or shareholders can defer to the extent that such person makes an eligible investment in a QOF.

A taxpayer must invest in a QOF during a 180-day period beginning on the date of the sale or exchange giving rise to the gains.

Generally, a taxpayer must invest in a QOF during a 180-day period beginning on the date of the sale or exchange giving rise to the gains. The proposed regulations clarify that in cases of deemed sales or exchanges that give rise to capital gains (think sales of exchange-traded stock or capital gain dividend distributions), the 180-day period starts on the date the gains would be "recognized" for federal income tax purposes, without regard to the QOZ deferral incentive.

The proposed regulations contain some special rules for timing the 180-day investment period for owners of partnerships (and other pass-through entities like S corporations, trusts and estates). They provide that the partner's 180-day period generally begins on the last day of the entity's taxable year. Presumably, this was added to account for the fact that some partners might not be aware of their capital gains until they receive their K-1s. In cases where this later 180-day period might be detrimental to the partner from a holding period perspective, the proposed regulations accommodate: namely, these taxpayers will have the opportunity to elect to start the 180-day clock sooner in cases where the partner knows or receives information regarding both the date of the gains and the entity's decision not to elect deferral.

Is it just capital gains that can be invested in a QOF?

Only capital gains are eligible for tax benefits described above when invested in a QOF. More specifically, only capital gains that would have otherwise been recognized in that particular tax year to the extent they stem from a sale or exchange with an *unrelated* person. Determining who is "related" is a complicated process and should be analyzed whenever the party to the sale or exchange is a member of the person's family; a trust with which the person has a grantor, fiduciary or beneficiary interest; or an entity in which the person has an ownership interest or that has a common owner with the person (generally applying a 20 percent threshold for measuring ownership), among other situations.

If my "investment" in the QOF is in the form of a loan, can I get the benefit of tax deferral?

The investment in the QOF must be an equity interest, including preferred stock or a partnership interest with special allocations but not a debt instrument. Hence, a loan to a QOF that is treated as debt rather than equity for federal income tax purposes will not count as a qualifying investment in a QOF.

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How do I make a capital gains tax deferral election on my tax return?

It is currently anticipated that taxpayers can elect to defer the tax on their capital gains due to a proper investment in a QOF on Form 8949, which will be attached to their federal income tax returns for the taxable year in which the gains would have been recognized if it had not been deferred.

What is a QOF?

A QOF is any domestic entity that is treated as a corporation or partnership for federal income tax purposes, where at least 90 percent of its assets are qualified opportunity zone property ("QOZ Property") and where the entity has self-certified as a QOF using Form 8996.

Based on this definition, it is clear that none of the tax benefits of QOZs are available if a person invests directly in property in the QOZ outside of the QOF entity. The entity can be a pre-existing entity as long as all other requirements are met for it to qualify as a QOF. The entity can be an LLC as long as the LLC is taxed as a corporation or partnership, so consider whether you need to file a "check-the-box" election when forming your QOF.

What is QOZ Property?

Note that if an entity qualifies as a QOZ business, the value of the QOF's entire interest in the entity counts towards the 90 percent asset test.

QOZ Property includes what is referred to as QOZ business property ("QOZ Assets"). QOZ Property also includes stock or a partnership interest in a domestic entity that is acquired by the QOF after December 31, 2017 at its original issue in exchange for cash, and as of the time the QOF acquired the ownership interest the entity was a qualified opportunity zone business ("QOZ Business"), and during substantially all of the QOF's holding period for the ownership interest, the entity qualified as a QOZ Business. Note that if an entity qualifies as a QOZ Business, the value of the QOF's entire interest in the entity counts towards the 90 percent asset test.

The term QOZ Assets refers to tangible property used in the QOF's (or its lower tier entity's) trade or business that was acquired by purchase after December 31, 2017 where substantially all of the property's use during the QOF's holding period is in the QOZ, and where either (1) the original use of the property in the QOZ starts with the QOF (or its lower tier subsidiary), or (2) the QOF (or the lower tier subsidiary) substantially improves the property. The Code also provides that property will not be treated as acquired by "purchase" for purposes of determining whether something is a QOZ Asset if it was acquired from certain related parties. Substantial improvement will occur with respect to a property if the property's basis at least doubles within any 30-month period. In order to facilitate the redevelopment of land in a QOZ, the proposed regulations clarify that "substantial improvement" is measured by the QOF's additions to the adjusted basis of the building in the QOZ but not the land.

A QOZ Business is a trade or business where substantially all of the business's owned or leased tangible property consists of QOZ Assets, and the requirements of Code Section 1397C(b)(2) [at least 50 percent of total gross income must be derived from the active conduct of a qualified business], 1397C(b)(4) [a substantial portion of the

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intangible property must be used in the active conduct of a trade or business], and 1397C(b)(8) [less than 5 percent of the average unadjusted basis of qualified business entity's property can be attributable to nonqualified financial property (and no more)] are satisfied. Also note that a QOZ Business cannot be a business described in Code Section 144(c)(6)(B), which covers commercial golf courses, massage parlors, hot tub facilities, suntan facilities, liquor stores and others. The proposed regulations state that for this purpose, the term "substantially all" means at least 70 percent, such that if at least 70 percent of the business's owned or leased tangible property consists of QOZ Assets, it will be deemed to satisfy the "substantially all" requirement set forth above.

A QOZ Business cannot be a business described in Code Section 144(c)(6)(B), which covers commercial golf courses, massage parlors, hot tub facilities, suntan facilities, liquor stores and others.

Also, the proposed regulations clarify that a QOZ Business can exclude reasonable amounts of cash, cash equivalents and short-term debt instruments with a term of 18 months or less that are held as qualifying "working capital" for purposes of 1397C(b)(2) and 1397C(b)(8). This working capital safe harbor makes it much easier for a QOZ Business with large investments to utilize those funds over time because this rule means that the working capital earnings will count towards meeting the "50 percent of gross income from an active trade or business test" in Code Section 1397C(b)(2) but not count towards the "nonqualified financial property" limit described in Code Section 1397C(b)(8). For purposes of this safe harbor, the amount of working capital will be deemed to be reasonable if there is a written plan designating the amounts for acquisition, construction and/or substantial improvement of tangible property in the QOZ, with a schedule for how the working capital will be spent in the 31 months following receipt by the business of the amounts and the working capital is actually spent in accordance with the schedule.

How does the 90 percent QOZ Property requirement work?

The requirement that a QOF hold at least 90 percent of its assets in QOZ Property is determined by looking at the average of the percentage of QOZ Property held in the fund on the last day of the sixth month of the QOF's tax year and on the last day of the QOF's tax year. The proposed regulations provide an example of how this works for newly-formed QOFs, stating that if a calendar year QOF entity is formed in February but chooses April as its first month as a QOF on Form 8996, the 90 percent asset testing dates for the QOF's first tax year are going to be the end of September and December of that tax year. If a calendar year QOF chooses a month after June as its first month as a QOF, the only testing date for the QOF in that year will be the end of December.

Per the proposed regulations, the 90 percent threshold computation will be based on the value of the QOF's assets as reported on the QOF's applicable financial statements. If no financial statements are available, the QOF needs to use the cost of its assets to make the 90 percent computation.

How much time is there to deploy the invested capital in the QOZ?

If funds are invested directly in a QOF, the funds must be deployed, such that 90 percent of the QOF's Assets consist of QOZ Property by the applicable six-month testing date or it risks not passing the 90 percent test.

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It is likely better to invest in a QOZ through a QOF and lower tier subsidiary than through a QOF directly.

If funds are invested directly in a QOF – which in turn contributes the funds to a lower tier entity - the ownership interests of which qualifies as QOZ Property, the entity has more time to deploy the funds. This is because the entity has the flexibility to treat such funds as “working capital” and put together a plan and schedule for using such funds over the course of the next 31 months from receipt by the business, as long as substantially all of the business’s owned or leased tangible property consists of QOZ Assets and all other requirements are met for the business to qualify as QOZ Property. If a QOF invests in a lower tier subsidiary that uses the working capital safe harbor, the entire entity ownership interest can still qualify as QOZ Property. Hence, the 90 percent test will be met at the QOF level. In this way, there is a difference in the application of the working capital safe harbor between a QOZ Fund and a QOZ Business. Under the proposed regulations, the working capital safe harbor applies only to the assets in a QOZ Business and not to the assets of the QOF itself. Thus, because of this and the 70 percent QOZ Asset threshold that applies to QOZ Businesses, it is likely better to invest in a QOZ through a QOF and lower tier subsidiary than through a QOF directly.

What reporting obligations apply to a QOF?

As previously stated, a QOF can self-certify its status as such for its first tax year on Form 8996, which should be attached to its federal income tax return for that year. Going forward, annual reporting will also be required. The QOF will use the same Form 8996 on its tax return to fulfill this obligation.

The proposed regulations permit taxpayers to make the election to step-up their basis at the end of the 10-year holding period even if a QOZ’s designation as a QOZ will have expired by that time.

What if I invest in a QOF where the QOZ will lose its status as such before my 10-year holding period runs?

The proposed regulations and preamble thereto discuss the fact that the Code currently calls for all QOZs to lose their designation effective on December 31, 2028. The proposed regulations permit taxpayers to make the election to step-up their basis at the end of the 10-year holding period even if a QOZ’s designation as a QOZ will have expired by that time. It is easy to see how this could occur in light of the fact that, basically, the last day to be able to use a QOZ to “defer taxation of capital gains” would be the end of 2026. Therefore, if a capital gains transaction occurred on the last day of 2026, then the 180-day period with respect to that capital gain would end in late June 2027. Hence, a taxpayer deferring such gains would achieve a 10-year holding period in the QOF investment only in late June 2037. The proposed regulations clarify that taxpayers are allowed to make the election to step-up their basis at the end of the 10-year holding period even if an area’s designation as a QOZ will have expired by that time. In addition, the proposed regulations clarify that a taxpayer can take advantage of the 10-year holding period basis step-up until December 31, 2047 (20½ years after the latest date that an eligible taxpayer may properly make an investment that is part of an election to defer gains through a QOF investment). The preamble to the proposed regulations states that this additional 10-year period was added to avoid situations in which, in order to enjoy the 10-year basis step-up benefit of the QOF investment, a taxpayer had to sell their QOF interest shortly after completion of the required 10-year holding period.

Taxpayers are allowed to make the election to step-up their basis at the end of the 10-year holding period even if an area’s designation as a QOZ will have expired by that time.

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Can I make multiple investments in the same QOF?

A taxpayer can make separate investments in the same QOF, and it is possible for a taxpayer to invest in a QOF in part with capital gains for which a deferral election is in place and in part with ordinary gains for which no deferral election is available. The proposed regulations provide guidance on how these multiple fungible investments in the same QOF are tracked and treated for tax purposes.

Can I sell my interest in a QOF and reinvest in another QOF?

If a taxpayer acquires an original interest in a QOF in connection with an election to defer taxes on capital gains and if a later sale or exchange of that QOF interest triggers inclusion of the deferred gains, the proposed regulations provide that the taxpayer is eligible to make a QOZ election to defer inclusion of the previously deferred gains if the taxpayer makes a qualifying new investment in QOF and if the taxpayer has disposed of the entire initial QOF investment. The preamble to the proposed regulations states that this complete disposition is necessary because 1400Z-2(a)(2)(A) expressly prohibits the making of a deferral election with respect to a sale or exchange if an election previously made with respect to the same sale or exchange remains in effect.

There are many issues in the proposed regulations and not all of these issues are covered in this white paper. If you have specific questions on the proposed regulations, please contact us for additional information.

What if a QOF fails to maintain investment standards?

The Code states that the QOF shall pay a penalty for each month in which it fails to meet the 90 percent test, or it may be possible that the QOF could lose its status as a QOF. No penalty will be imposed, however, if it is shown that the failure to meet the 90 percent test was due to reasonable cause. The penalty is computed based on the amount of QOZ Property held by the QOF. This is something to consider when determining whether to invest either through a QOF or a QOF and its lower tier subsidiary.

There are many issues in the proposed regulations and not all of these issues are covered in this white paper. If you have specific questions on the proposed regulations, please contact us for additional information.

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