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Qualified Opportunity Zones: The Newest Method of Tax Deferral

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Qualified Opportunity Zones:
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Qualified Opportunity Zones

- Section 13823 of the TCJA amended the Internal Revenue Code to add IRC §§ 1400Z-1 and 1400Z-2. These provisions are intended to encourage economic growth and long-term investment in designated distressed communities ("qualified opportunity zones" or "QOZs") by providing significant federal income tax benefits to taxpayers who invest in businesses located within a QOZ.
- Goal of unlocking private investment potential of over $6 trillion in captive capital gain.

Qualified Opportunity Zones

Roadmap

- IRC § 1400Z-1 provides the procedural rules applicable to the designation of QOZs and related definitions.
- IRC § 1400Z-2 allows taxpayers to elect to defer certain capital gains to the extent that the gain is timely invested in a qualified opportunity fund (a "QOF").
- The Treasury Department initially issued two sets of proposed regulations to implement IRC §§ 1400Z-1 and 1400Z-2. Proposed Regulation 115420-18 was issued on October 29, 2018 ("First Set"), and Proposed Regulation 120186-18 was issued on April 17, 2019 ("Second Set").
- Contemporaneously with the issuance of the First Set of Proposed Regulations, the IRS issued Rev. Rul. 2018-29, which deals with the original use and substantial improvement requirements with respect to land.
- The Treasury Department issued Final Regulations to implement IRC §§ 1400Z-1 and 1400Z-2 on December 19, 2019. The Final Regulations will be effective 60 days after publication in the Federal Register (approximately February 17, 2020).
- The Final Regulations contain transition rules for taxable years beginning before the issuance of the Final Regulations.

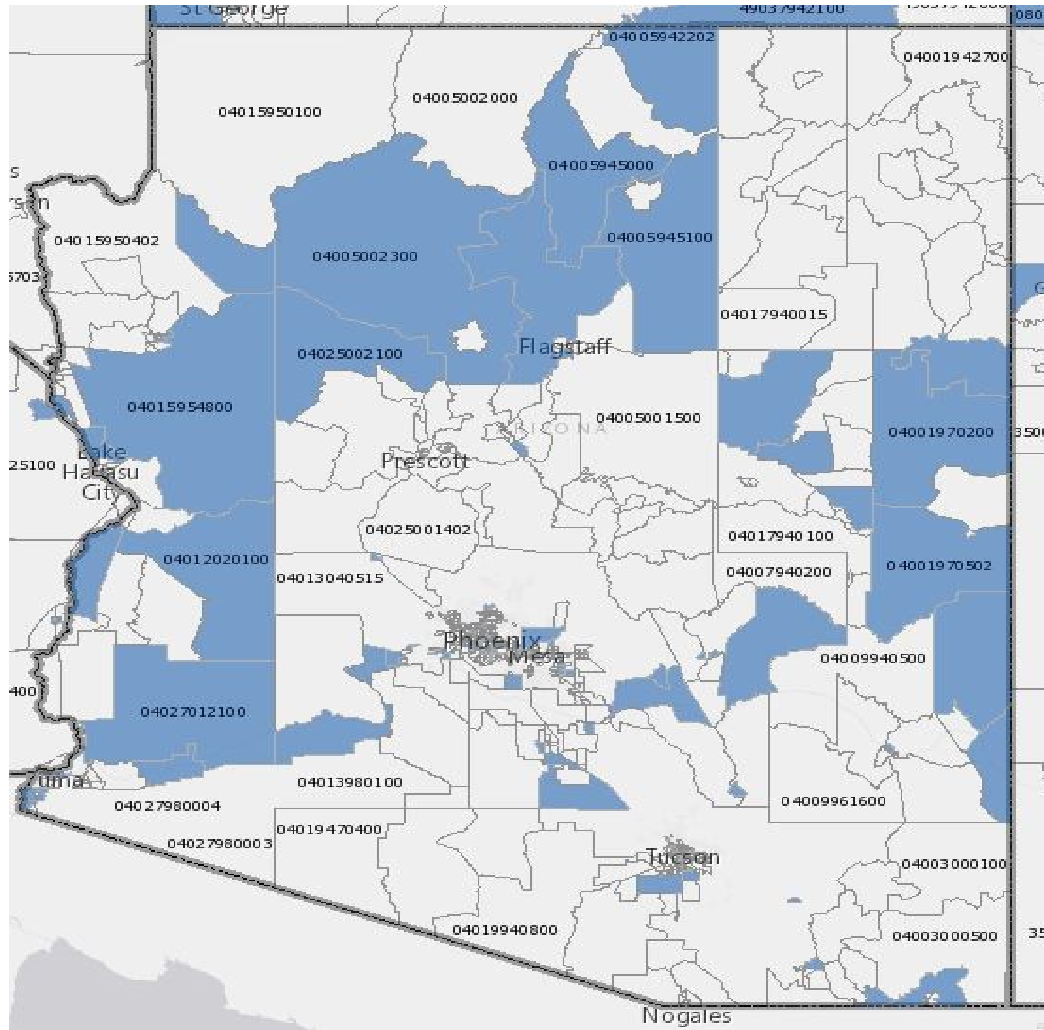
QOZ Designations

- A QOZ is a population census tract that is a low income community designated as a QOZ by the CEO of each State and certified and designated as a QOZ by the Department of the Treasury.
- All QOZs were required to have been designated by the States as of March 21, 2018 for certification and designation by the Department of the Treasury.
- QOZs will retain their QOZ designations for a period of 10 years.

Designated QOZs in Arizona

- On April 9, 2018, the Department of the Treasury designated the QOZs in the State of Arizona based on submissions made by Governor Ducey. Arizona was one of the first states to submit its proposed QOZ designations. These QOZs will retain their QOZ designations for a period of 10 years or until April 9, 2028.
- In total,168 tracts were nominated and approved across every county in Arizona, all (according to the ACA) believed to be suited for a variety of development including manufacturing, warehousing, distribution, and technology.
- In the Phoenix area notable opportunity zones include most of downtown Phoenix, the light rail route and anticipated extension, as well as areas around Grand Canyon University, Christown and Paradise Valley malls, and Phoenix Sky Harbor, Deer Valley, Mesa Gateway, and Falcon Field airports.
- The State of Arizona also conformed to the federal TCJA/QOZ legislation (i.e., the benefits are also available for state/local income tax purposes).

Arizona Qualified Opportunity Zones



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QOZ Key Tax Incentives

- IRC § 1400Z-2 provides three key tax incentives to encourage long-term investment in QOZs:
  - Deferral: It permits the deferral of capital gain (short-term or long-term) to the extent the gain is reinvested in a "qualified opportunity fund" (a "QOF") in exchange for stock or a partnership interest in the QOF before December 31, 2026.
  - Reduction: For QOF investments made prior to December 31, 2019, it provides for a reduction of up to 15% of the amount of the deferred gain over time. For QOF investments made after December 31, 2019, it provides for a reduction of up to 10% of the amount of the deferred gain over time.
  - Permanent Exclusion: Taxpayers may elect to exclude from gross income any post-acquisition gain on investments in a QOF that are held for at least 10 years.

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The Key Tax Incentives in Detail

Deferral	Reduction	Exclusion
Temporary deferral of capital gain for capital gain invested in a QOF. Any deferred gain is recognized on the earlier of: (i) the date on which the interest in the QOF is disposed of (by sale, exchange, gift, contribution, etc., unless timely reinvested (i.e., 180 days) in another QOF); or (ii) December 31, 2026. On the earlier of disposition or December 31, 2026, the gain included is the lesser of the originally excluded gain or the FMV of the QOF investment, less the taxpayer's basis. All of the deferred gain's tax attributes are preserved through the deferral period and taken into account when the gain is included. (However, the applicable tax rate in the year of disposition or 2026 is the rate that applies). ***No 100% permanent deferral on original inside deferred capital gain***.	The initial basis in an investment in a QOF is deemed to be $0. A step-up in basis for the capital gain invested in a QOF of 10% is provided if the taxpayer holds the QOF interest for at least 5 years. An additional step-up in basis of 5% (for a total step-up of 15%) is provided if the taxpayer holds the QOF interest for at least 7 years. ***Potential to exclude up to 15% of the original capital gain permanently for pre-December 31, 2019 investments. Potential to exclude up to 10% of the original capital gain permanently for post-December 31, 2019 investments.***	A permanent exclusion for gain on the sale or exchange of the taxpayer's interest in the QOF, or the QOF's direct or indirect sale of assets, if the QOF investment is held for at least 10 years. This permanent exclusion only applies to gains accrued after the QOF investment. The exclusion must be elected. If an exclusion election is made, it is deemed to occur immediately prior to sale. Can only make the election with respect to funds that qualified for deferral (i.e., can't elect for after-tax funds also invested in a QOF as part of a mixed-funds investment). ***Permanent exclusion of outside gains after 10 years***. Can make the election even after the QOZ designation expires for the applicable zone – but only through December 31, 2047.

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Only Capital Gains Can Be Deferred

- The Final Regulations confirm that only "capital gain" (as defined for federal income tax purposes) is eligible for deferral. This includes long-term and short-term capital gain, capital gain from actual or deemed sales or exchanges, and any other gain that is required to be included in a taxpayer's computation of capital gain. IRC § 1231 gains are eligible for deferral.
- The Final Regulations also clarified that the full amount of capital gain, unreduced by any losses, is eligible for deferral (i.e., taxpayers do not need to first net capital gains against capital losses to determined the amount that qualifies for deferral.)
- Two caveats:
  - The gain to be deferred must be gain that would be recognized, absent the application of IRC § 1400Z-2, no later than December 31, 2026.
  - The gain must arise from a transaction with an **unrelated** person (as determined by using 20% as opposed to 50%). This also means that taxpayers cannot sell property to a QOF and then defer the resulting capital gain by making an investment into that QOF.

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Time Period to Invest in a QOF

- Deferral under IRC § 1400Z-2 must be elected. In order to elect deferral, a taxpayer generally must invest in a QOF during the 180-day period beginning on the date of the sale or exchange giving rise to the capital gain.
- However, if the capital gain is recognized as a result of a deemed transaction, the first day to make an election to defer the gain is the date on which the gain would be recognized for federal income tax purposes absent IRC § 1400Z-2 (typically, December 31st for calendar year taxpayers).
- Under the Proposed Regulations, only net IRC § 1231 gain qualified for deferral and the 180-day investment period was deemed to commence on the date the gain would have been recognized for federal income tax purposes absent IRC § 1400Z-2 (i.e., December 31st).
- Under the Final Regulations, gross IRC § 1231 gain qualifies for deferral and the 180-day investment period commences on the date of the sale or exchange giving rise to the gross IRC § 1231 gain. Transition rules apply for taxpayers who relied on the Proposed Regulations.

Time Period to Invest in a QOF – Pass-through Entities

- Taxpayers who are owners of an interest in a pass-through entity (partnerships, LLCs taxed as partnerships, S corporations, and beneficiaries of decedent's estates and non-grantor trusts) have various options for purposes of determining the applicable 180-day investment period.
- First, the pass-through entity may elect deferral of the eligible gain during the 180-day period beginning on the date of the applicable sale or exchange.
- Second, if the pass-through entity does not elect deferral with respect to all of the eligible gain, the owners (i.e., the partners, members, shareholders, or beneficiaries) may elect to use the pass-through entity's 180-day period OR the owners may elect to treat the 180-day period as beginning on the last day of the pass-through entity's taxable year in which the owner's share of the eligible gain is taken into account (typically, December 31st).

Time Period to Invest in a QOF – Installment Sales

- If the eligible capital gain is gain recognized in an installment sale pursuant to the installment method under IRC § 453, the Final Regulations provide two options for purposes of determining the applicable 180-day investment period.
- First, a taxpayer may elect to start the 180-day period on the date a payment under the installment sale is received during the taxable year. This method could result in multiple 180-day periods over multiple years, depending on how many installment payments are to be made.
- Second, a taxpayer may elect to start the 180-day period on the last day of the taxable year the eligible gain would be recognized but for deferral under IRC § 1400Z-2 (i.e., generally December 31st). This method would result in a single 180-day period for all of the gain at the end of the taxable year.

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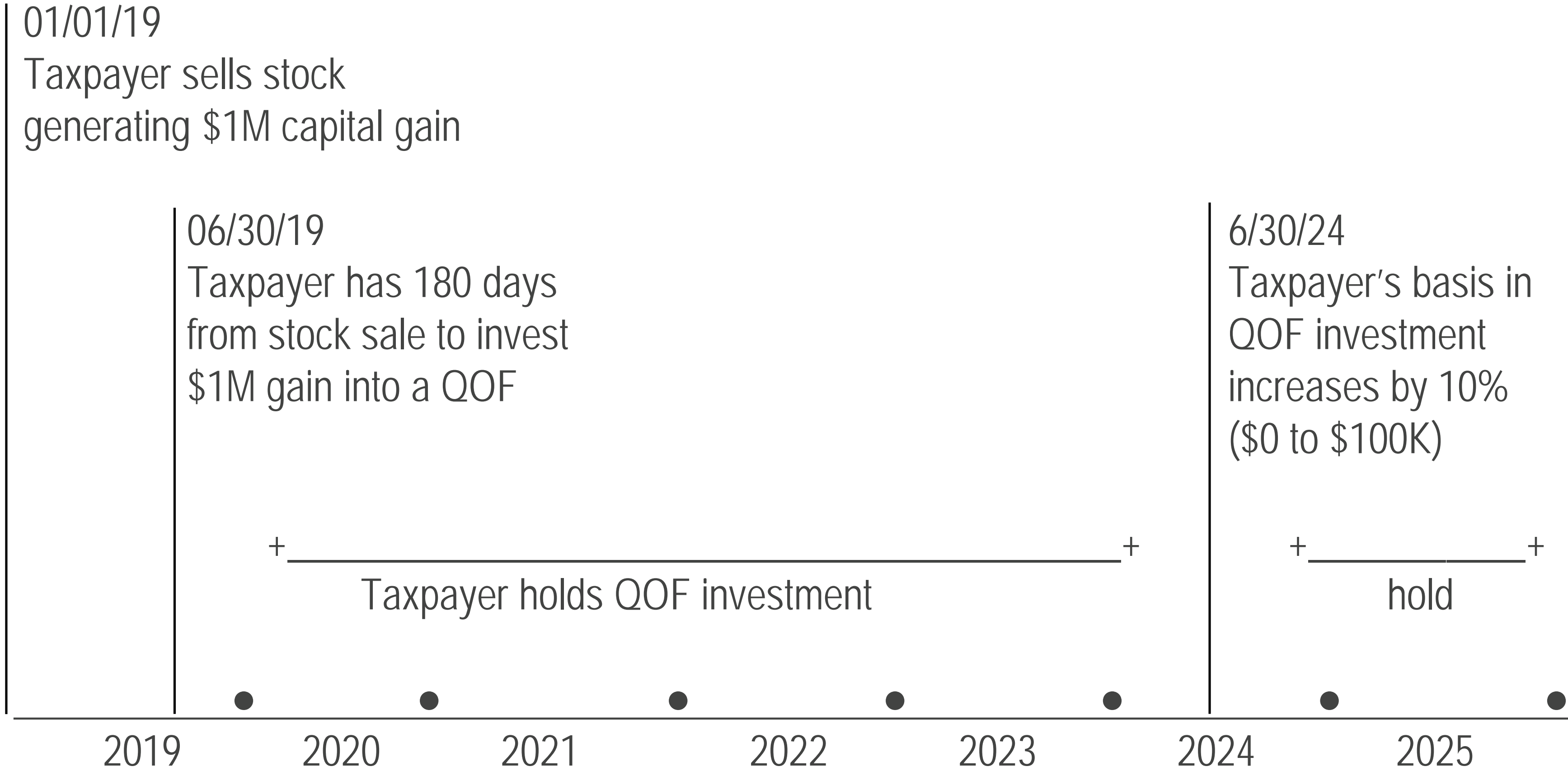
Sample Investment Timeline
1 of 2



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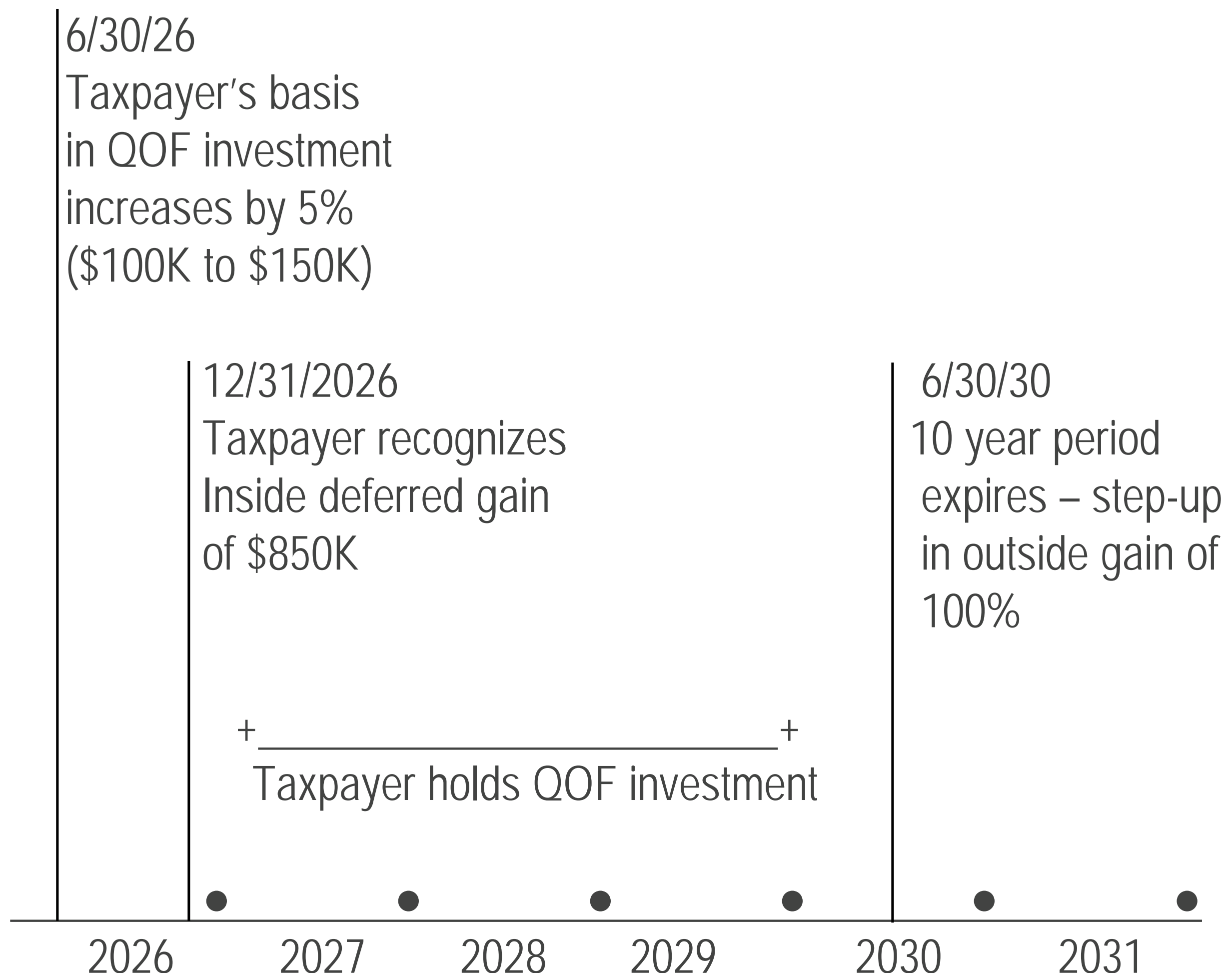
Sample Investment Timeline
2 of 2



What is a Qualified Opportunity Fund or QOF?

- A QOF is an investment vehicle organized as a domestic corporation or domestic partnership for tax purposes (i.e., LLCs are included).
- The purpose of the QOF must be to invest in QOZ property.
- 90% of the assets of a QOF must consist of QOZ property (tested at 6 months and at the end of the taxable year of the QOF). Penalties apply to the violation of the 90% asset test. Test is subject to a working capital safe-harbor in tiered partnership structures only. Value based on values reported in the QOF's applicable financial statements or, if none, by using cost basis.
- QOF must be certified. QOFs self-certify by filing IRS Form 8996, Qualified Opportunity Fund. No limit on the number of QOFs that can be created and certified. Must select a certification date prior to any qualifying investments. Pre-existing entities can qualify and self-certify if all of the QOF requirements are satisfied.

IRS Form 8996

Form **8996**
(December 2018)
Department of the Treasury
Internal Revenue Service

Qualified Opportunity Fund
▶ Go to *www.irs.gov/Form8996* for the latest information.
▶ Attach to your tax return. See instructions.

OMB No. 1545-0123
Attachment Sequence No. **996**

Name | **Employer identification number**

Part I General Information and Certification

1 Type of taxpayer: ☐ Corporation ☐ Partnership

2 Is the taxpayer organized for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund)?
☐ **No. STOP.** Do not file this form with your tax return.
☐ **Yes.** Go to line 3.

3 Is this the first period the taxpayer is a Qualified Opportunity Fund?
☐ **Yes.** By checking this box, you certify that by the end of the taxpayer's first qualified opportunity fund year, the taxpayer's organizing documents include a statement of the entity's purpose of investing in qualified opportunity zone property and the description of the qualified opportunity zone business. See instructions.
☐ **No.** Go to Part II.

4 If "Yes" on line 3, list the first month in which the fund chooses to be a Qualified Opportunity Fund.

Part II Investment Standard Calculation

5 Total qualified opportunity zone property held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes" 5
6 Total assets held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes" 6
7 Divide line 5 by line 6 7
8 Total qualified opportunity zone property held by the taxpayer on the last day of the taxpaye's tax year 8
9 Total assets held by the taxpayer on the last day of the taxpayer's tax year 9
10 Divide line 8 by line 9 10

Part III Qualified Opportunity Fund Average and Penalty

11 Add lines 7 and 10 11
12 Divide line 11 by 2.0. See instructions if Part I, line 3 is "Yes" 12
13 Is line 12 equal to or more than .90?
☐ **Yes.** Enter -0- on this line and file this form with your tax return.
☐ **No.** The fund has failed to maintain the investment standard. Complete Part IV to figure the penalty. Enter the penalty from line 8 of Part IV on this line, and file this form with your tax return 13

Cat. No. 37820G Form **8996** (12-2018)

Form 8996 (12-2018) Page **2**

Part IV Line 13 Penalty

If you checked "No" in Part III, line 13 complete Part IV to figure the penalty. Enter the number from line 8 below on Part III, line 13. See instructions if Part I, line 3 is "Yes."

	(a) Month 1	(b) Month 2	(c) Month 3	(d) Month 4	(e) Month 5
1 Total assets on the last day of the month . .					
2 Multiply line 1 by .90					
3 Total Qualified Opportunity Zone Property on the last day of the month					
4 Subtract line 3 from line 2. If less than zero, enter -0-					
5 Underpayment rate					
6 Multiply line 4 by line 5					
7 Divide line 6 by 12.0. Round up to two decimal places. See instructions if Part I, line 3 is "Yes"					

	(f) Month 6	(g) Month 7	(h) Month 8	(i) Month 9	(j) Month 10	(k) Month 11	(l) Month 12
1							
2							
3							
4							
5							
6							
7							

8 **Penalty.** Add columns (a) through (l) of line 7. Enter the total here and on Part III, line 13 . . . . $

Form **8996** (12-2018)

90% Test Working Capital Safe Harbor

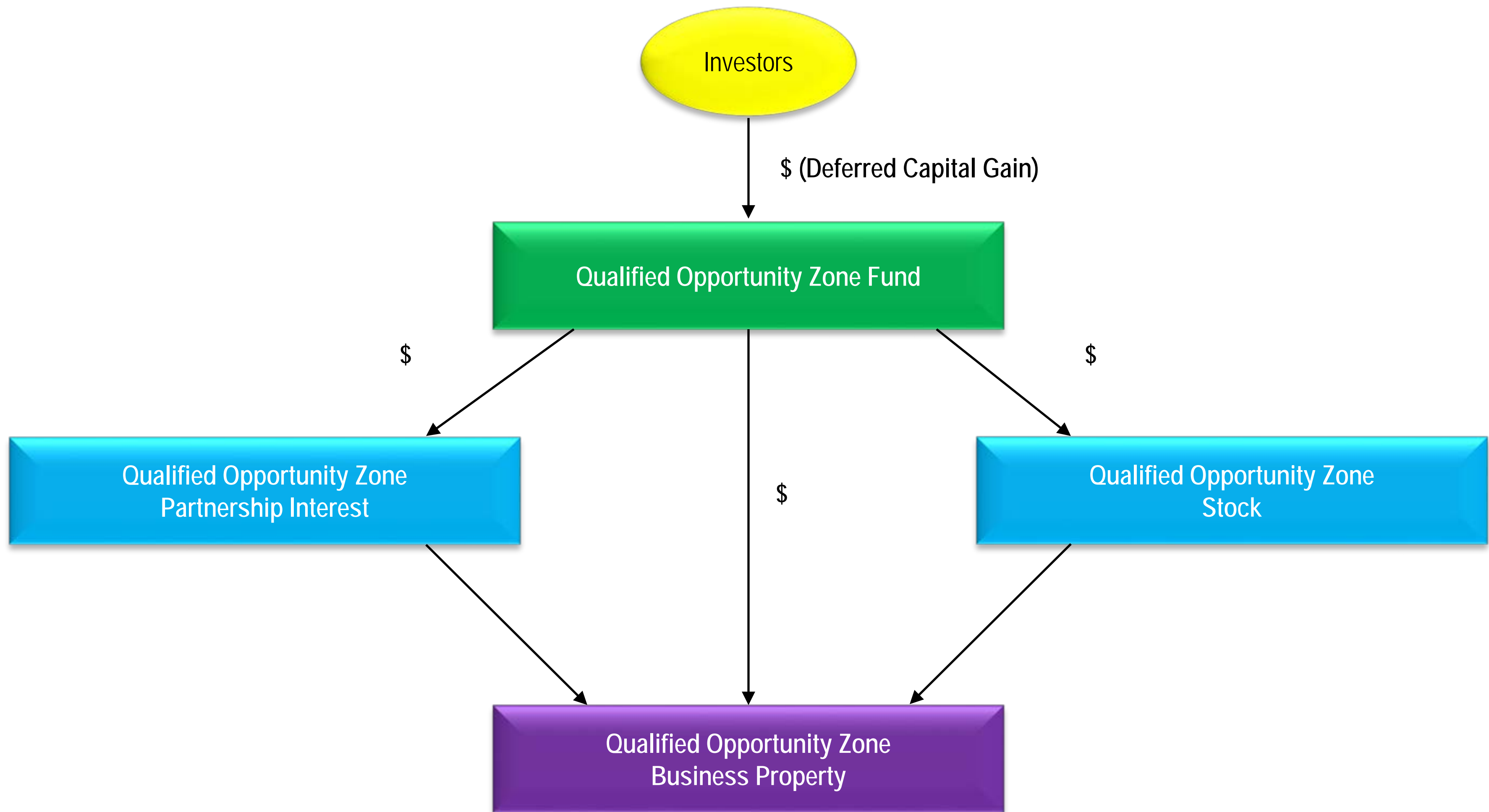
- In a one-tier entity structure, 90% of the assets of the QOF must consist of QOZ property. The 90% test does not permit holding cash assets of more than 10%.
- However, in a two-tier entity structure, the lower tier entity has a 70% test for its tangible assets and, as a result, may hold a greater amount of working capital in the form of cash, cash equivalents, or short term debt.
- In a two-tier entity structure, the Proposed and Final Regulations also provide a working capital safe-harbor for cash amounts that will be spent to acquire, construct, or rehabilitate tangible business property (including real property) over a 31-month period. The safe-harbor requires a written plan and written schedule to develop a QOZ business or to acquire, construct, or substantially improve tangible property in a QOZ. Under the Final Regulations, a QOZ business can apply subsequent 31 month working capital safe-harbors up to a maximum of 62 months, provided that each 31-month period meets the requirements and each safe-harbor plan is part of an integral plan.
- Delays caused by slow government action do not count against the 31-month period.

What is QOZ Property?

QOZ property means:

- QOZ Stock
  - Stock in a domestic corporation created or organized in one of the 50 states, D.C. or a U.S. possession and acquired by the QOF after 12/31/2017 at original issuance from the corporation solely in exchange for cash.
  - Corporation is engaged in a "QOZ business" or, in the case of a new corporation, was formed to engage in a "QOZ business".
  - During substantially all (i.e., 70% under the Final Regulations) of the QOF's holding period for the stock, the corporation qualified as a QOZ business.
- QOZ Partnership Interest
  - Capital or profits interest in a domestic partnership (including an LLC) created or organized in one of the 50 states, D.C. or a U.S. possession and acquired by the QOF after 12/31/2017 from the partnership solely in exchange for cash.
  - Partnership is engaged in a "QOZ business" or, in the case of a new partnership, was formed to engage in a "QOZ business".
  - During substantially all (i.e., 70% under the Final Regulations) of the QOF's holding period for the interest, the partnership qualified as a QOZ business.
- QOZ Business Property
- Tribal entities

Investment in Qualified Opportunity Zone Property



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What is QOZ Business Property?

- QOZ business property is tangible property used in a trade or business of the QOF if:
  - The tangible property was acquired by the QOF by purchase (or lease) from an unrelated party after December 31, 2017;
  - The "original use" of such property in the QOZ commences with the QOF or the QOF "substantially improves" the tangible property; and
  - During substantially all of the QOF's holding period for the property (90% per the Final Regulations), substantially all of the use of such property (70% per Final Regulations) was in a QOZ.
- Note, these rules do not allow the contribution of QOZ business property into a QOF structure. The property must be acquired by purchase or lease.
- Leased property qualifies (intended to help aid investment in Tribal lands but applies broadly) if lease is entered into after December 31, 2017 and substantially all of the use of the leased tangible property is in a QOZ during substantially all of the period in which the business leases the property. Lessor and lessee can also be related (with some restrictions) as long as the lease is a "market rate lease."

Original Use and Substantial Improvement

Original Use Requirement (Original Use of Property in QOZ Commences with QOF):

- The "original use" of tangible property acquired by purchase commences on the date when the purchaser *or a prior person* first places the property in service (for purposes of depreciation or amortization) in the QOZ.
- Thus, tangible property located in a QOZ that is depreciated or amortized by someone other than the QOF will not satisfy the original use requirement.
- The original use requirement does not apply to land.
- Otherwise must satisfy the substantial improvement requirement.

Original Use and Substantial Improvement

- How to satisfy the original use requirement:
  - Acquire vacant land and construct all of the improvements.
  - Acquire land with a building before building is first placed in service for purposes of depreciation. QOF could finish construction, place building in service, and be considered the original user.
  - Acquire land with a building that has been vacant for 1 or more years prior to QOZ designation and purchase and the QOF will be treated as the original user when the building is again placed in service. If the building was not vacant at the time of QOZ designation, it must be vacant for 3 years after designation and be vacant at purchase in order for this exception to apply.
  - Acquire land with a building located in a Brownfield site.
  - Purchase land and a building from a local government if the local government owns the property as the result of an involuntary transfer (abandonment, bankruptcy, foreclosure).
  - Land does not need to satisfy the original use requirement (facilitates repurposing of vacant or otherwise unutilized land).
  - No original use requirements for leased property, but improvements by a lessee to leased property would satisfy the original use requirement.

Original Use and Substantial Improvement

Substantial Improvement Requirement:

- Property is treated as "substantially improved" if, during any 30-month period beginning after the acquisition of the property, additions to basis of the property exceed an amount equal to the adjusted basis of the property at the beginning of such period.
- The Final Regulations permit an aggregate approach to the substantial improvement requirement, as opposed to an asset-by-asset approach, in certain limited situations.
- For purposes of the substantial improvement requirement, the basis attributable to land is disregarded (i.e., land does not need to be substantially improved).
- Can also lease tangible property without being required to satisfy the original use or substantial improvement requirements.

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Original Use and Substantial Improvement

The Final Regulations permit asset aggregation for purposes of determining whether the substantial improvement requirement has been satisfied in two cases.

- First, improvements to buildings on contiguous parcels, or a single parcel transferred by a single deed, may be aggregated as if they were a single property if: (a) all of the buildings are operated exclusively by the QOF or QOZ business; (b) the buildings share facilities or significant centralized business elements, such as personnel, legal, manufacturing, purchasing, human resources, or IT resources; and (c) the buildings are operated in coordination with, or reliance upon, one or more common or interdependent trades or businesses.
- Second, the cost of purchased original use assets can apply towards the substantial improvement requirement with respect to an existing asset, like a building. Under this rule, the cost of purchased original use assets can be aggregated with the cost of the improvements to an existing asset, if the purchased assets: (a) are used in the same trade or business in the QOZ (or a contiguous QOZ) in which the existing asset is used; and (b) improve the functionality of the existing asset.

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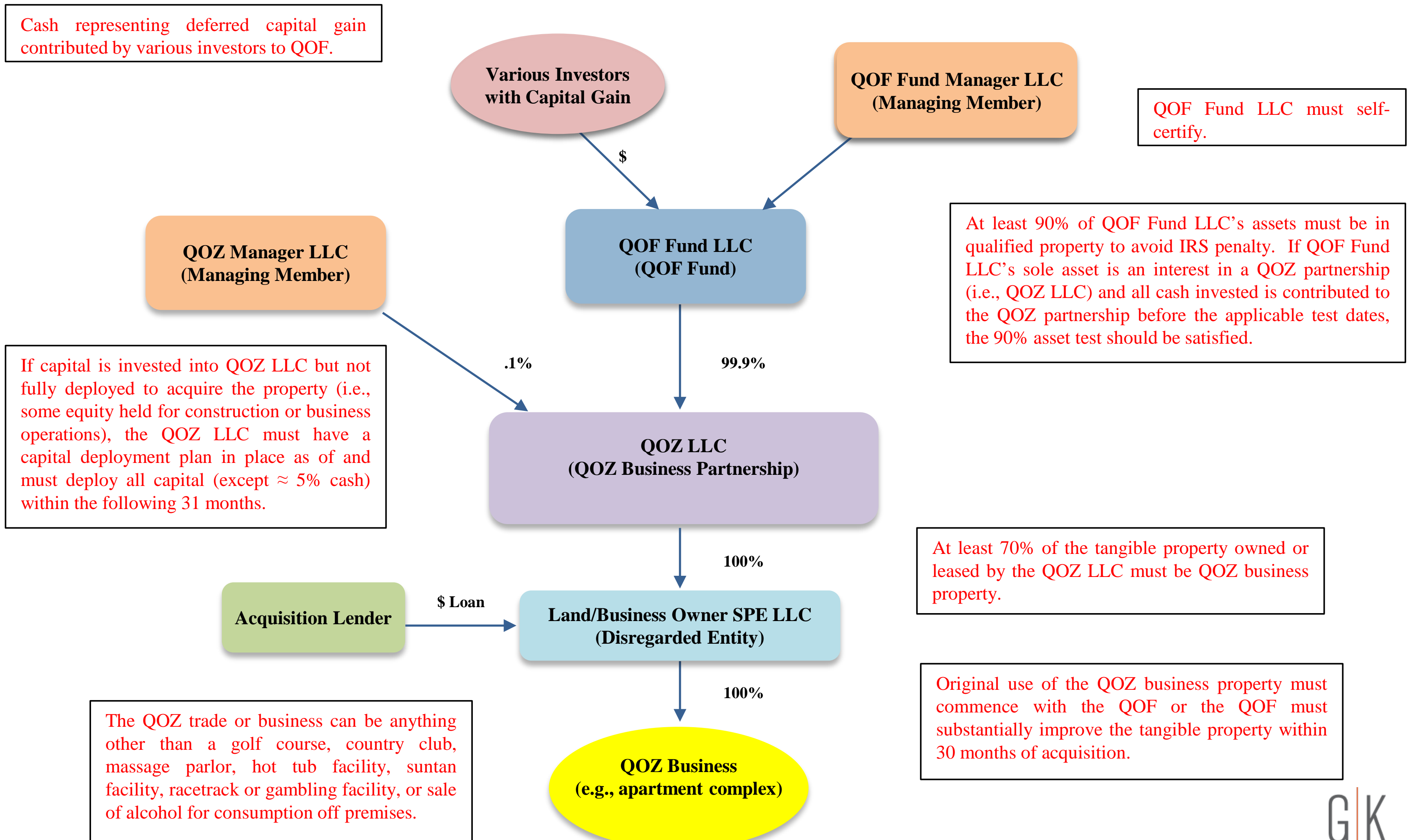
What is a QOZ Business?

- A QOZ business is a trade or business (within the meaning of IRC § 162) –
  - In which substantially all (at least 70%) of the tangible property (whether owned or leased) is QOZ business property.
  - At least 50% of the total gross business income comes from the active conduct of the trade or business in the QOZ. (Final Regulations provided three safe-harbors for the 50% test). Trade or business includes ownership, operation, and leasing of real property (except merely entering into a triple-net lease). Land banking is not a trade or business.
  - A substantial portion (40%) of the business' intangible property is used in the active conduct of the trade or business in the QOZ.
  - Less than 5% of the average unadjusted basis of the business assets consists of non-qualified financial property.
  - The trade or business is not a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or any store the principal business of which is the sale of alcoholic beverages for consumption off-premises.

Sample QOZ Acquisition Structure



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Tax Consequences of Sales After 10 Years

- If a taxpayer holds its investment in a QOF for 10 or more years, the taxpayer may elect to exclude any gain recognized as a result of any the following events from gross income:
  - The sale or other disposition of the taxpayer's interest in the QOF.
  - The sale of any property owned directly by the QOF.
  - The sale of an interest in any partnership, corporation, or LLC owned directly by the QOF.
  - The sale of any property owned by a QOZ business partnership, corporation, or LLC in which the QOF invested.
- The exclusion election applies to gain from the sale of any assets owned by the QOF or the QOZ business, even if the asset was not qualified QOZ property, and applies to all gains, including items like depreciation recapture.
- However, any sale by the taxpayer or the QOF during the 10 year period is taxable.

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