QUALIFIED OPPORTUNITY ZONES

KEY TERMS

QOZ – Qualified Opportunity Zone
QOF – Qualified Opportunity Fund
QOZP – Qualified Opportunity Zone Property
QOZB – Qualified Opportunity Zone Business
QOZBP – Qualified Opportunity Zone Business Property
STCG – Short-Term Capital Gain
LTCG – Long-Term Capital Gain

SIMPLE FLOWCHART SHOWING HOW THIS WORKS

Step 1 – Taxpayer recognizes capital gain from the sale of assets
Step 2 – Within 180 days, taxpayer invests some or all of that gain in a QOF
Step 3 – QOF then must reinvest more than 90% of its assets in QOZP located within a QOZ either by:

1. Operating a QOZB directly by holding QOZBP (more than 90% of the assets of the QOF must be QOZBP), or
2. Investing in a corporation or partnership that operates a QOZB (this corporation or partnership must invest more than 70% of its assets in QOZBP).

WHY INVEST/CREATE A QOF?

- Only the gain recognized needs to be invested in the QOF, not all of the cash received. For example, if an asset is sold for $2 million and its basis is $1 million, only $1 million needs to be invested. Any gain not invested is taxable so partial investments are also allowed. Taxpayers can also invest more than capital gains recognized, but only the capital gain portion is eligible for the deferral.
- Differs from like-kind exchanges in that it doesn't have to be just an exchange of real estate for real estate. Gain from the sale of any type of property that produces a capital gain can be deferred if the gain is invested in a QOF that meets the requirements set forth below. A taxpayer could sell Amazon stock and invest the gain to purchase real estate.
- Tax benefits – see Tax Savings below

ORIGINAL GAIN ELIGIBLE FOR DEFERRAL

- Individuals, C corporations, S corporations, partnerships, trusts, estates, and real estate investment trusts (REITS) are eligible to defer gains using the opportunity zone incentive.
- Only capital gains are eligible for the deferral (STCG, LTCG, and Sec. 1231 gains)
- The capital gain has to happen from a sale occurring after 12/22/17 and before 1/1/27; however tax savings start to slip away for sales occurring after 2019.
- Capital gain must be the result of a sale to an unrelated party; cannot be a spouse, parent, child/grandchildren, or members of a controlled business group.

180 DAY REINVESTMENT WINDOW

- The 180 days starts on the date on which the gain would be recognized for federal income tax purposes (date of sale) and ends exactly 180 days after that date (even if the 180th day falls on a week-end or holiday).
- In order to defer the gain, an election will need to be made on Form 8949.
- If a pass-through entity (partnership, S corporation, estate, or trust) chooses to defer the gain and invest those amounts at the entity level, then the entity has 180 days to do so.

If the entity chooses not to defer, then it would pass out the gain to the investors on their K-1s, but in that case the 180-day clock does not start until the last day of the entity's tax year.

180 DAY REINVESTMENT WINDOW, CONTINUED

    - If the investor knew about the sale, they could elect to start the 180-day clock on the date of the sale so they could make their investment sooner.

WHAT IS A QOF?

- Any partnership or C corporation (no S corporations) organized for the purpose of investing in a QOZP.
- It can be an existing entity, but it must be designated as a QOF before investing in order for investments to qualify for the deferral.
- QOF self-certifies on Form 8996 attached to its tax return that states year and month it will be a QOF.
- QOF will need to prove that at least 90% of its assets are QOZP twice per year; once at the halfway point and again on last day of the year, unless it was created in second half of the year and then only the last day of the year will be the test date.
- The investment into the QOF must be a cash equity investment and it cannot be a loan.

QOZP

- QOZ map: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx
- A QOF will be treated as operating with an opportunity zone if at least 90% of its assets are QOZP and a QOF can invest in QOZP in one of three ways:
    1. Directly conducting a QOZB by investing at least 90% of its assets in QOZBP, or
    2. Acquiring stock in a corporate subsidiary that operates a QOZB, which invests "substantially all" of its assets in QOZBP, or
    3. Acquiring an interest in a partnership that operates a QOZB, which invests "substantially all" of its assets in QOZBP

    "Substantially all" – 70% of the assets owned by the corporation or partnership is QOZBP.
- To be a QOF the business must invest in QOZP, and to invest in QOZP, you must either directly or indirectly own QOZBP.

QOZBP

- Tangible property acquired via purchase after 12/31/17
- Original use of the property within the opportunity zone must begin with the business (example: business can purchase used machinery as long as that machinery was only used outside of an opportunity zone).
- A business can buy existing used property in a QOZ if it "substantially improves" the property which means within 30 months, the business must spend more to improve it than it did to buy it. For real property, land doesn't have to be doubled, but rather just the building portion.

CORPORATION STOCK OR PARTNERSHIP INTEREST WHEREBY THOSE ENTITIES OPERATE A QOZB

- Stock or partnership interest must be acquired by the QOF after 12/31/17.
- Must be purchased directly from the entity itself and not from an existing shareholder or partner.
- At least 50% of the gross income from the business must be from the active conduct of a trade or business.
- A "substantial portion" of intangible property must be used in the active conduct of the trade or business (currently undetermined as to what this means).
- Less than 5% of the property of the business can be nonqualified financial property.

CORPORATION STOCK OR PARTNERSHIP INTEREST WHEREBY THOSE ENTITIES OPERATE A QOZB, CONTINUED

- Business cannot be a “sin business” – golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling, or liquor store.
- When the QOF acquires the stock or partnership interest:
    1. The corporation or partnership must be a QOZB (more than 70% of the assets of the corporation or partnership are QOZBP, business isn’t a sin business, and other above tests are met), or
    2. If the corporation or partnership is brand new, it must be organized for the purpose of becoming a QOZB.

SUBSTANTIALLY IMPROVED RENOVATIONS NEEDED

- Issue is this – QOF must invest 90% of its assets in QOZBP which can be accomplished via a direct investment in property, or investing in a corporation or partnership that invests in property. If investors put cash into the QOF and in turn the QOF rehabs a building in the QOZ, that rehab can take years and if the QOF only has cash on its balance sheet for too long, the 90% standard will not be met.
- Having this cash on hand will not be an issue if:
    - Cash is designated in writing as being for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ,
    - There is a written schedule showing the cash will be spent within 30 months, and
    - Business substantially complies with its written schedule.
    - Assuming these three rules are met:
        - Any income generated from holding the cash counts towards the 50% active conduct trade or business test.
        - Cash counts towards the “substantial portion” of intangible property test.

QOF OPERATES BUSINESS DIRECTLY BY OWNING QOZBP

- More than 90% of the assets (substantially all) of the QOF must be QOZBP which is property purchased after 12/31/17 that is new to the QOZ or used but substantially improved within 30 months.

TAX SAVINGS

- Four different waves of tax savings:
    1. Deferral of original gain
    2. Exclusion of 10% of original gain
    3. Exclusion of another 5% of the original gain
    4. Exclusion of 100% of the gain realized on the disposition of the QOF
- Example: sell stock held for a few years for $3 million with a tax basis of $1 million on 10/26/18 and on 12/31/18 invest $2 million in a corporation or partnership that is a QOF.
    - $2 million gain deferral (or less) is not permanent – it has to be recognized on the earlier of:
        - The date the QOF interest is sold, or
        - 12/31/26
    - Savings #2 - on 12/31/23, $200,000 (10% of the gain being deferred) will become permanently excluded since the QOF investment was held for five years.
    - Savings #3 – on 12/31/25, $100,000 (5% of the gain being deferred) will become permanently excluded since the QOF investment was held for seven years.
    - If hold QOF investment until 12/31/26, 85% of the gain ($1.7 million) will be recognized on that date.

TAX SAVINGS, CONTINUED

- What if sell before 12/31/26?
    - If QOF investment is sold on 12/31/24 for $3 million (more than the original investment), since beyond the 5 years, only $2.8 million of the gain is recognized
    - If QOF investment is sold on 12/31/24 for $1.5 million (less than the original investment), since beyond the 5 years, only $1.3 million of the gain is recognized (don't recognize $500,000 loss on difference between $2 million invested and $1.5 million proceeds)
- Savings #4 – if hold investment for ten years, then when the QOF investment is sold, none of the appreciation above and beyond the deferred gain is recognized
    - Using the example above, if you sell the QOF investment on 12/31/32 for $8 million, no gain is recognized on the sale. On a total $8 million gain only $1.7 million is recognized.
    - To get the 100% exclusion taxpayers must sell before 12/31/47.

- Character of the gain when eventually recognized stays the same as it would have been had it not been deferred.
- If sell part of the QOF investment, the rules aren't exactly clear, but assuming pro rata approach.
- If multiple investments are made at multiple times into a QOF, and then only part of the QOF investment is sold, then a first-in, first-out method will be used to determine the recognized gain.

RECAP

- To defer/exclude capital gain, within 180 days the gain must be invested into a QOF.
- The QOF has to conduct a QOZB, either directly (more than 90% of the assets of the QOF must be QOZBP), or indirectly (more than 90% of the assets of the QOF must be stock in a corporation or an interest in a partnership that in turn conducts a QOZB).
- If the QOF conducts a QOZB through a corporate or partnership subsidiary, more than 70% of the assets of the corporation or partnership must be QOZP.
- QOZBP = property acquired after 2017, that has never been used in a QOZ, or that has been used in a QOZ but will be substantially improved within 30 months.
- If all that is done:
    - The original capital gain does not need to be recognized immediately.
    - This deferred gain will be recognized on the earlier of:
        - The date the interest in the QOF is sold, or
        - 12/31/26
    - If the QOF interest is held for five years before one of those two events occur, then 10% of the deferred gain goes away forever.
    - If the QOF interest is held for seven years before one of those two events occur, then another 5% of the deferred gain goes away forever.
    - If the QOF interest is held for ten years any gain on the sale of the QOF interest is excluded forever as long as the sale takes place before 12/31/47.

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