Qualified Opportunity Zones

January 25, 2019

As part of the 2017 Tax Cuts and Jobs Act ("**Act**"), Congress introduced new tax incentives for investments in low-income communities designated as "Qualified Opportunity Zones" ("**QOZs**"). Under sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code, investors can now defer and/or reduce certain taxable gains reinvested into "Qualified Opportunity Funds" ("**QOFs**") that invest in QOZs.

The IRS released its first set of proposed regulations regarding QOFs on October 19, 2018 for public notice and comment ("**Proposed Regulations**").[1] The Proposed Regulations provide fund managers and investors with much needed guidance regarding QOFs, and we expect to gradually see increased demand for QOFs in 2019 as a result. The 60-day notice and comment period has ended, and the public now awaits the IRS's review of all comments and issuance of a final rule. Below is a general overview of QOFs and the potential tax benefits of investing in them.

Establishing QOZs

State governors can nominate economically-distressed census tracts within their respective states as "low-income communities" for IRS approval. Once the IRS approves a tract, it becomes eligible for favorable tax treatment as a QOZ. A "low-income community" is defined as any population census tract (i) where the poverty rate is at least 20%; (ii) if located in a non-metropolitan area, where the median income is below 80% of the statewide median family income; or (iii) if located in a metropolitan area, where the median income is below 80% of either the statewide median family income or the metropolitan area itself, whichever is greater.

The total number of approved QOZs must not exceed 25% of the number of low-income communities in each state. If there are fewer than 100 low-income communities in a state, a state can contain up to 25 QOZs. The IRS' website provides a list and a map[2] of more than 8,000 approved QOZs.[3]

QOF Eligibility

A QOF is an investment vehicle (i) treated as a U.S. corporation or partnership for tax purposes; (ii) organized for the purpose of investing in QOZs; and (iii) that holds at least 90% of its assets in "Qualified Opportunity Zone Property" ("**QOZ Property**"). QOZ Property includes stock or partnership interests in a "Qualified Opportunity Zone Business" ("**QOZ Business**") and direct investments in tangible property (such as real estate) located in a QOZ.

Direct investments in tangible property by a QOF (i) must be purchased after December 31, 2017; (ii) must be used in that QOF's trade or business; and (iii) either the original use of such property must commence with the QOF or the QOF must make improvements to the property that double the original basis in the property within a 30-month period, excluding the basis in land.

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1 The Proposed Regulations are available on the Federal Register website.
2 Approved state and U.S. territory QOZs are indicated on the map here.
3 U.S. Department of the Treasury provides additional information regarding designated QOZs.

A QOZ Business is a business in which at least 70% of the tangible property owned or leased by such business was acquired after December 31, 2017 and is located in a QOZ for "substantially all" of the business's holding period of that property. Further, a QOZ Business must (i) derive at least 50% of its total gross income from the business; (ii) use a substantial portion of its intangible property in the business; and (iii) hold non-qualified financial property (e.g. debt, stock, partnership interests, futures, etc.) that constitutes less than 5% of its total assets. Certain businesses—such as golf courses, country clubs, massage parlors, gambling facilities and liquor stores—are prohibited from qualifying as QOZ Businesses.

Tax Benefits of Investing in QOFs

Taxpayers can receive the following tax benefits by reinvesting capital gains into QOFs within 180 days of recognizing such gains ("**Rollover Gains**"):

a. **Deferral.** Investors can defer current capital gains tax by reinvesting their Rollover Gains in a QOF—whether short-term or long-term—until the earlier of December 31, 2026 or the disposition of the QOZ Property. At realization, the Rollover Gains will be taxed at the capital gains rate at the time the gains were deferred.

b. **Reduction.** If investors hold their QOF interests for at least 5 years, only 90% of the Rollover Gains will be recognized. Further, if the QOF interests are held for at least 7 years, only 85% of the Rollover Gains will be recognized.[4]

c. **Exclusion.** Finally, investors that hold their QOF interests for at least 10 years will recognize no additional gain from appreciation over the Rollover Gains amount. Note that this exclusion does not apply to realized gains attributable to investments of new capital.

Below is an example of how the tax incentives work:

Following the sale of an asset, if a taxpayer reinvests $100,000 of Rollover Gains by acquiring a limited partnership interest in a QOF ("**QOF Interest**"), the capital gains tax on that $100,000 can be deferred until the earlier of December 31, 2026 or the disposition of the QOF Interest. If the taxpayer holds the QOF Interest for 5 years, 10% of the Rollover Gains (i.e. $10,000) can be added to the taxpayer's basis in the QOF Interest. Assuming a basis of $0, the adjusted basis would be $10,000; upon disposition of the QOF interest, the taxpayer would only pay capital gains tax on $90,000 (i.e. 90% of the Rollover Gains). If held for 7 years, the adjusted basis would increase to $15,000, and the taxpayer would only pay capital gains tax on $85,000 (i.e. 85% of the Rollover Gains). If held for 10 years, and the taxpayer realizes a gain of 20% on the reinvested capital (i.e. the Rollover Gains reinvested in the QOF Interest appreciate to $120,000), the $20,000 of additional gains will not be recognized.

A QOF must submit Form 8996 to certify that it is organized to invest in QOZ Property and that 90% of the QOF's assets are held in QOZ Property. This form must be resubmitted annually. Taxpayers do not need to obtain prior approval from the IRS to qualify for QOF tax benefits, and they can self-certify by submitting Form 8949 with their federal income tax returns.

4 However, because the latest date in which Rollover Gains can be deferred is December 31, 2026, investors must invest in a QOF by December 31, 2019 to qualify for the 15% capital gains tax reduction. To qualify for the 10% reduction, investors must invest in a QOF by December 31, 2021.

Next Steps and Remaining Questions

The IRS public hearing regarding QOFs was originally scheduled for January 10, 2019, but it was postponed to February 14, 2019 due to the temporary government shutdown. We will be closely monitoring the public hearing for further guidance regarding the use of QOFs. Although we believe the Act and the Proposed Regulations currently provide enough guidance for fund managers and investors to begin taking advantage of QOFs, we would like to see additional guidance regarding the following open questions: (i) what penalties will be applied if a QOF or a QOZ Business fails to adhere to each of their qualification requirements, even if only temporary; (ii) whether QOFs are limited to only one investment opportunity and, if not, how the sale of one of multiple underlying investments will affect the applicability of the 10-year exclusion incentive; (iii) how these proposed incentives coincide with other tax incentives such as the Low Income Housing Tax Credit; and (iv) what "substantially all" means with regard to the amount of time during the holding period that a partnership interest must be in a QOZ Business and whether it could fall under the 70% test.

If you have any questions regarding this alert or QOFs in general, please contact Kevin Cott at kcott@colefrieman.com or by phone at 770.674.8481.

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