

Larry's Tax Law

Opportunity Zone Funds – Part III: Lots of Questions But Few Answers

By Larry Brant and Peter Evalds on 3.14.19 | Posted in Legislation, Tax Laws, Tax Planning, Tax Procedure

There has been a lot of “buzz” in the media about Qualified Opportunity Zones (“QOZs”). Some of the media accounts have been accurate and helpful to taxpayers. Other accounts, however, have been less than fully accurate, and in some cases have served to misinform or mislead taxpayers. Let’s face it, the new law is quite complex. Guidance to date from Treasury is insufficient to answer many of the real life questions facing taxpayers considering embarking upon a QOZ investment.

In this installment of our series on QOZs, we will try to address some of the questions that are plaguing taxpayers relative to investing in or forming Qualified Opportunity Funds (“QOFs”). Please keep in mind before you attempt to read this blog post that we readily admit that we do not have all of the answers. We do, however, recognize the many questions being posed by taxpayers.

QUESTIONS AND SOME ANSWERS

1. Definition of QOZs and How to Locate Them

Many taxpayers are asking two of the most basic questions, namely: what constitutes a QOZ; and how can I locate a QOZ.

Code Section 1400Z-1(a) defines a QOZ. There are three requirements to be a QOZ: (a) It must be “a population census tract that is a low-income community;” (b) It must be nominated by the governor of a state as a QOZ; and (c) It must be designated by the Secretary of the Treasury as a QOZ. The period for nomination and designation has passed, so no further QOZs may be added at this time.

In all, there are currently 8,700 QOZs. A full list of QOZs is contained in [IRS Notice 2018-48](#).

Additionally, a map of the current QOZs across the country can be found [here](#) (*Adobe Flash Player version 11.1.0 or greater may be needed to view the map*). Note that the map shows QOZs in blue and New Market Tax Credit zones in green. The two sometimes overlap, but are not always the same.

A map of Oregon QOZs can be found at [this Oregon Opportunity Zones website](#). In addition to areas undeniably low income communities, Oregon's Governor Kate Brown controversially nominated all of downtown Portland which is east of 12th Avenue, and much of the highly acclaimed Pearl District (the SoHo of Portland) as a QOZ.

2. The Necessity to Make Improvements

Many taxpayers and their advisers are asking whether they are required to improve property in a QOZ in order to obtain the tax deferral benefits. As discussed in [our first blog post](#) in this series, 90% of a QOF's assets must be Qualified Opportunity Zone Property ("QOZP"). QOZP is defined as: (1) stock or partnership interests in a Qualified Opportunity Zone Business ("QOZB"), 70% of the assets of which must be Qualified Opportunity Zone Business Property ("QOZBP"); or (2) a direct investment in QOZBP. In order for property to be considered QOZBP, its "original use" must be in a QOZ or the QOF must substantially improve it (by doubling its basis).

According to Revenue Ruling 2018-29, the original use of land can never be in a QOZ. Thus, an investor who desires QOZ deferral treatment cannot not simply buy raw land and hold it without improving it. As we discuss directly below, however, there may be a narrow exception to the improvement requirement.

3. Purchasing a New Building in a QOZ

Many taxpayers and advisers are posing the question whether a taxpayer can buy a newly constructed building in a QOZ **without** substantially improving it and still qualify for the deferral benefits. The law is not totally clear, but if logic prevails, the answer may be "yes" in a limited circumstance.

The limited circumstance we are envisioning is where a newly constructed building located in a QOZ is purchased by the taxpayer prior to the building being placed into service. The newly constructed building's "original use" should logically be considered to be in a QOZ if it had not been placed in service prior to the taxpayer's purchase. The proposed regulations and Revenue Ruling 2018-29 do not foreclose this possibility. If so, no further improvements to the building would need to be made. Again, the law is not totally clear.

However, as stated above, since the original use of land cannot begin in a QOF, any land not substantially improved by the taxpayer would not count toward the required QOZ property ownership thresholds. 90% of a QOF's assets must be QOZBP if it owns the assets directly, or 70% if the assets are owned by a corporation or partnership. Thus, as long as the newly constructed building represents at least 70% of the value of the property held by a partnership or corporation, or 90% of the property directly owned by a QOF, it could potentially qualify as a QOF.

Note that a provision regarding original use is “reserved” in the proposed regulations, and the IRS and Treasury requested comments on the definition and contours of original use. Stay tuned as we expect Treasury will directly address this issue.

4. Tracing Proceeds from Sales of Capital Gain Property Not Required

Many taxpayers and advisers are puzzled by the issue of tracing. The precise question posed is whether the taxpayer has to use the exact same funds received from the transaction creating the capital gain in the QOF investment. Fortunately, we have clear guidance. The answer is No. The funds received from the transaction generating the capital gain do not have to be the same funds invested in the QOF. Consequently, for example, a taxpayer could sell stock in a company, invest the proceeds in treasury notes, and then borrow money to invest in the QOF. Any amount invested in the QOF up to the amount of gain from the sale of the stock could be eligible for tax deferral under the QOF regime.

5. Forming a QOF that Owns Property Outside of a QOZ

One misnomer floating out in the atmosphere is the notion that a QOF cannot own property outside of a QOZ. That is wrong!

A QOF can own property outside of a QOZ, as long as at least 90% (in the case of property owned directly by the QOF) or 70% (in the case of a partnership or corporation owned by a QOF) of the assets of the QOF qualify as QOZBP. **Note:** In the latter case, only 5% of the assets may be cash or other financial property, subject to an allowance for reasonable working capital during the build out or improvement of the QOZBP.

6. No Deferral of QOF Operating Income

Another question being asked by taxpayers and their advisers is whether a QOF can defer the tax on its operating income. Like other allowable tax deferral opportunities contained in the Code, there are limitations. QOFs are not an exception to this rule.

QOFs cannot defer the income (e.g., rents) derived from operations. Any income of the QOF (such as interest, rent, and operating income) is recognized and, in the case of pass-through entities like partnerships, it passes through to the taxpayer.

Note: The gain on a QOF’s sale of property it owns will also be subject to tax, at least in the absence of further guidance. The basis step up to fair market value only applies to taxpayers on the sale of their QOF units, not to the QOF on the sale of its property. Thus, unless subsequent guidance from Treasury provides otherwise, or Congress changes the letter of the law, QOFs cannot sell property and reinvest the proceeds without triggering gain that will pass through to the fund owners.

Code Section 1400Z-2(e)(4)(B) provides that Treasury will issue regulations to ensure that a QOF has a reasonable time to reinvest the return of capital from investments in Qualified Opportunity Zone Stock and Qualified Opportunity Zone Partnership Interests, and to reinvest the proceeds from the sale of QOZP. The preamble to the proposed regulations provides that forthcoming regulations are expected to address what constitutes a reasonable period for such purposes without paying a penalty. Whether such guidance will only speak to continued qualification as a QOF for testing purposes or also provide for some kind of nonrecognition regime like Code Section 1031 is unknown. It is likewise unclear whether a QOF can obtain the benefit of Code Section 1031. We expect Treasury will weigh in on many of these issues soon.

7. Timing of Investment in a QOF to Maximize Tax Benefits

Timing is everything in the world of tax law. It is especially true in the world of QOFs.

Investors must invest by December 31, 2019 to obtain the full 15% basis step up.

In order to obtain the benefit of the 10% basis step up for holding a QOF investment for five years, investors must invest no later than December 31, 2021. This is because the deferred gain must be realized no later than December 31, 2026, and investors only get the 10% step up in basis if they hold the QOF investment for five years.

Similarly, the additional 5% basis step up for holding the QOF investment for seven years means that investors must invest no later than December 31, 2019 in order to obtain this benefit. Since the investor's basis will equal the fair market value on the eventual sale of the QOF investment, any further basis step up after the initial gain recognition event in 2026 would be of no assistance.

Timing is critical. These dates need to be adhered to in order to benefit from this new regime.

8. Deferral of Gains from the Sale of Assets Other than Real Estate

One of the many misconceptions floating around in the tax ozone is that only capital gain from the sale of real estate may be used to obtain QOF tax deferral. The law appears as clear as can be that any gain that is treated as capital gain can be deferred under this regime. In addition to the sale of real estate, sales of stocks and bonds, personal property, and even collectibles qualify (as long as you're not a dealer). The law in this regard is fairly broad.

Note: Because recapture gain is not treated as capital gain, such gain is not eligible for deferral through an investment in a QOF.

9. Additional Guidance Coming Soon

Treasury is expected to issue the next set of regulations very soon. According to a news report, the next batch was delivered to the White House's regulatory review office on March 12, 2019. Expect more analysis soon!

CONCLUSION

With more guidance from Treasury expected soon, we will continue to report our observations on QOFs and the opportunities for tax deferral.

Tags: capital gains tax, City of Portland, Governor Kate Brown, improvements, Internal Revenue Code, Internal Revenue Service, IRS, operating income, Opportunity Zone Funds, Oregon, Portland, Qualified Opportunity Funds (QOFs), qualified opportunity zone business (QOZB), Qualified Opportunity Zone Business Property (QOZBP), Qualified Opportunity Zone Property (QOZP), Qualified Opportunity Zones (QOZs), real estate, Tax Deferral, Taxpayer, Treasury