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Qualified Opportunity Zones, An Unqualified Opportunity?



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Qualified Opportunity Zones,
An Unqualified Opportunity?

- QOZ=Qualified Opportunity Zone
- QOF=Qualified Opportunity Fund
- QOZP=Qualified Opportunity Zone Property
- QOZB=Qualified Opportunity Zone Business
- QOZPI=Qualified Opportunity Zone Partnership Interest
- QOZS=Qualified Opportunity Zone Stock Interest

Qualified Opportunity Zones

- The new law is riddled with ambiguities. The IRS issued proposed regulations and promised a second set by year's end. The regulations, which can still change, leave many open issues. Knowledgeable lawmakers agree that a legislative fix will be required for the law to perform as advertised.

Qualified Opportunity Zones

- Taxpayers can roll over gains from a sale or exchange of property within 180 days to a Qualified Opportunity Fund. The Taxpayer must elect QOZ treatment. Tax on gain can be deferred until the earlier of sale or 12/31/26. The regulations interpret the statute to apply to all gains taxed as capital gains. The statute simply says "gains" although the heading says "capital gains." Short term capital gains qualify as does section 1231 gain. Unlike 1031, no roll over of basis.
- Taxpayers that may make QOZ elections in connection with a gain rollover are persons "that may recognize gains for purposes of Federal income tax accounting" so it includes entities.
- A taxpayer cannot make a second election with respect to a gain or a portion of a gain.

Qualified Opportunity Zones

- An election can only be made for an equity interest, including a preferred interest
- A QOF interest can be pledged as collateral, including in connection with acquisition of the QOF interest
- An investment in a QOF which is not a gain rollover or a cash investment of gain rollover where no election is made is treated as a normal partnership interest.
- While partnership liabilities can be deemed contributions to cash for other tax law purposes, they do not give rise to a contribution for QOZ purposes.

Qualified Opportunity Zones

- Deferral can only be elected on sales to non-related parties, look to 267(b) and 707(b)(1) substituting 20% for 50%
- Taxpayer has a zero basis in rolled over gain
- Even if interest in a QOF is not sold, tax deferral ends on 12/31/26, but up to 15% of gain can be permanently avoided
- 10% basis if QOF interest is held at least 5 years and another 5% if held at least 7 years at the time of taxation
- Gain recognized at sale or in 2026 equals the excess of the lesser of deferred gain or FMV of QOF interest over basis

Qualified Opportunity Zones

- No further gain if interests in the QOF are sold after a 10 year hold and before 2048 (note: 12/31/26 end of deferral is prior to any possible 10 year hold)-Advertised result-but see below

Qualified Opportunity Zones

- After 10 years investment in a QOF, basis equals the FMV of the investment in the QOF on the date the interest is sold---What if the QOF has distributed refinance proceeds? The FMV of the interest is cash received. Taxable gain on a sale of real estate commonly exceeds cash received.

- Basis step up (gain elimination or reduction) only applies on a sale of a qualifying interest in a QOF. What if the QOF sells a QOZP?

- The law provides that the IRS is to issue regulations giving the QOF a “reasonable period of time” to reinvest return of capital or sale of QOZP.

Qualified Opportunity Zones

- 180 day rollover period begins on date of recognition
- Last day of the taxable year for a partnership
- Can elect date of partnership recognition
- Pass through entities other than partnerships have analogous rules
- 180 day rollover period from dividend payment date for REIT or RIC capital gain dividend
- 180 days from end of year for REIT or RIC undistributed capital gain

Qualified Opportunity Zones

- When an interest in a QOF is sold or in 2026, recognized gain keeps its original character, e.g., short or long term, 1250 recapture, etc.
- When fungible interests are sold, use FIFO to identify which interests have been sold

Qualified Opportunity Zones

- QOF is an entity taxed as a corporation or partnership which invests 90% of its assets in QOZP. Do not look at the common meaning of "fund."
- 90% of QOF assets must be in QOZP acquired by purchase after 2017 from a non-related party.
- QOZP means QOZS, QOZPI and QOZB.
- Investment in another QOF does not count
- A QOF must self certify-see Form 8996

- 90% test is measured on 2 days of the year, June 30 and December 31, for most QOF's. In the first year, the first measurement date is 6 months after the elected start date, if prior to July 1.

Qualified Opportunity Zones

- 90% is determined from applicable financial statements (see 1.475(a)-4(h)) generally a reporting entity or an entity with GAAP audited statements. Otherwise, it is determined on a cost basis. Cost is apparently undepreciated cost.

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- QOZB must have substantially all (70%) of its tangible property in a QOZ
- QOZP is tangible property in a QOZ acquired by purchase-original use with new owner or cost of improvements during any 30 month period must exceed basis at the beginning of the 30 month period
- Cost of improvements is measured without land value-Rev. Rul. 2018-29.
- Cash for construction is a good assets as long as there is a written description of the purpose of the cash and a reasonable schedule for use of the cash within a 30 month period, as long as the entity follows these. Apparantly, this rule only applies to QOZB's and not to QOF's.
- Is the land ever a good asset?

Qualified Opportunity Zones

- Businesses listed in Section144(c)(6)(B) are disqualified
  - Golf course
  - Country club
  - Massage parlor
  - Hot tub facility
  - Suntan facility
  - Racetrack or gambling facility
  - Liquor store (non-premises consumption)

Qualified Opportunity Zones
Examples

- Mr. Smith sells $2 million of Facebook stock which he purchased for $500,000. Within 180 days he invests $150,000 in each of 10 businesses which are QOZB's. Tax result?
- Suppose Mr. Smith establishes a QOF, he invests $1.5 million in the QOF and the QOF makes the ten investments? Mr. Smith also elects to have 1400Z-2 apply to his investment in the QOF.
- If Mr. Smith made his investment before the end of 2019, held his investment and his interest in the QOF was worth more than $1.5 million on 12/31/2026, what would be his tax consequences?
- If Mr. Smith sold his interest in the QOF for $15 million in 2020, what are the tax consequences? What if the sale were in 2030?

Qualified Opportunity Zones
Examples

- QOF solicits investors for funds to purchase 2 parcels of unimproved land for development and a third parcel to rehabilitate a shell. Each property will be separate, and suppose the cost of the third parcel is $7 million for the land and shell. QOF raised $10 million of equity and has development lines for $20 million.
- Can QOF qualify as a QOF if more than 10% of its assets are cash?
- What it QOF places cash in QOZB's?
- QOF encounters permitting issues and does not begin construction or rehabilitation until 24 months after closing. Can QOF pass the 30 month test if construction takes 18 months?

Qualified Opportunity Zones
Examples

- Mrs. Iceberg sells $26 million of FAANG stock on April 1, 2019 realizing a $25 million capital gain. On May 1, 2019 she invests $25 million in a QOF that constructs 3 buildings located in QOZ's.   On May 1, 2029, she still has her interest in the QOF and the Fund still owns the 3 buildings (which were completed and placed in service on December 31, 2019). The buildings have done well. The QOF has distributed $5 million to Mrs. Iceberg from operating cash flow, but no taxable income as the QOF has depreciation deductions.   The QOF also was able to distribute $15 million of refinance proceeds to Mrs. Iceberg in 2026 so she could pay her taxes and enjoy a return beyond that available from operating cash flow. Her interest in the QOF has a fair market value of $50 million on 12/31/29.
- On January 1, 2030, the QOF sells it assets and liquidates. Mrs. Iceberg receives $50 million and her share of the gain is $70 million. Does she recognize any taxable income?

Qualified Opportunity Zones
Examples

- QOZB leases offices in existence on 12/31/2017, as its office. What effect does the premises have on the substantially all test?
- QOZB2 leases the building mentioned above pursuant to a long term lease. It plans to improve the building and to sublease offices. The cost of the improvements will exceed the lessor's basis in the building, but not the FMV of the building (excluding land). Is the building a qualifying QOZ asset?
- What if a QOZB leases a garage in a QOZ?

Thank You!

Questions, Comments or Remarks?