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New Opportunity Zones Guidance from IRS Clarifies Key Provisions of Program

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Real Estate

Tax Controversy

Corporate

From its recent inception, the Qualified Opportunity Zone program has generated a lot of interest from potential investors, but many have waited until receiving further guidance from the Internal Revenue Service about how, exactly, a variety of aspects of the program will be handled.

As of April 17, 2019, the waiting is over, with the second – and apparently final – set of proposed regulations for the QOZ program issued by the IRS. Depending on what investors are seeking, the new rules might push their participation from neutral into full steam ahead.

A quick refresher: QOZs were created as part of the Tax Cuts and Jobs Act of 2017, providing taxpayers with a way to defer recognition of capital gains through an investment in a qualified opportunity fund (QOF), which in turn invests in designated QOZs. [Click here](#) to see prior coverage from Gould & Ratner.

Here are the highlights of the proposed regs:

Section 1231 Gain

Only the net gain arising from Sec. 1231 property is eligible for gain deferral under the QOZ program. The net amount of Sec. 1231 gain is determined at the end of the year, and the 180-day period to invest in a QOF begins on the last day of the taxable year. Thus, instead of being able to defer Sec. 1231 gain when the taxpayer realizes such gain, the taxpayer must wait until the end of the taxable year to determine whether the taxpayer has eligible Sec. 1231 gain.

Inclusion Events

The proposed regs provide a nonexclusive list of “inclusion events” that will trigger the recognition of all or a portion of the deferred gain. Generally, an event that reduces the taxpayer’s equity interest in the QOF investment will trigger all or a portion of the deferred gain, a/k/a an inclusion Event.

The transfer of an investment in a QOF by gift is considered an inclusion event. In addition, distributions by a QOF partnership to an investor in excess of that investor’s basis in the QOF partnership is considered an inclusion event.

Subject to the excess distribution situation just discussed and the disguised sale rules, though, the proposed regs generally allow debt-financed distributions. Additional events that are not considered inclusion events encompass:

- transfer of an investment in a QOF by reason of the taxpayer’s death
- transfer of an investment in a QOF to a grantor trust of which the taxpayer is the grantor

- transfer of an investment in a QOF partnership pursuant to a nonrecognition transaction, such as a Sec. 721 contribution to another partnership

QOF Reinvestment of Proceeds

One of the requirements of a QOF is that the QOF must own 90% of its assets in QOZ property. A QOF may continue to meet the 90% asset test if the QOF sells or disposes of QOZ property and then reinvests the proceeds of the sale or disposition within 12 months, if the proceeds are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less. However, if the QOF realizes any capital gain from such a sale or disposition, the taxpayer must recognize the capital gain allocated to them, unless the taxpayer has held its investment in the QOF for a period of at least 10 years (see below). The disposition of QOZ property by a QOF does not affect the taxpayer's holding period in the QOF.

Exclusion of Gain on Disposition of QOZ Property

If a taxpayer has held an investment in a QOF partnership or a QOF S corporation for at least 10 years, and the QOF partnership or the QOF S corporation disposes of QOZ property after a 10-year holding period, the taxpayer may make an election to exclude from gross income all or some of the capital gain allocated to them on a Schedule K-1 arising from the disposition of the QOZ property. The taxpayer's basis in the QOF partnership or QOF S corporation is increased accordingly by the amount of the gain.

Substantially All

In addition to the 90% asset test to qualify as a QOF, during "substantially all" of the QOF's holding period of such QOZ property, the QOZ property must either qualify as a QOZ business or "substantially all" of the QOF's direct use of such QOZ property that is QOZ business property must have been used in a QOZ.

The proposed regs clarify that in testing a QOF's holding period of QOZ property, the term "substantially all" means at least 90%. For example, if QOZ property is an interest in a partnership that is a QOZ business, then during at least 90% of the time the QOF owns that partnership interest, the partnership must have met the requirements of a QOZ business.

Further, in testing the use of QOZ business property in a QOZ, the term "substantially all" means at least 70%. For example, if a QOF directly owns QOZ property that is a QOZ business property, then during at least 90% of the time the QOF owns the QOZ business property, at least 70% of the use of the QOZ business property must have been in a QOZ.

Leased Property as a QOZ Business Property

Leased property may qualify as a QOZ business property if the lease was entered into after December 31, 2017, and the terms of the lease are at a market rate and reflect an arms-length transaction. A lease may be entered into with a related person, subject to additional limitations.

Original Use

To qualify as a QOZ business property, the "original use" of the property must commence with the QOF (if owned directly by the QOF) or the QOZ business. The proposed regs clarify that the "original use" begins at such time that tangible property in a QOZ is first placed into service for purposes of depreciation or amortization. If property has been unused or vacant for a period of at least five years, then the original use of such property begins on the date after that period when any person first uses or places such property in service in a QOZ. Used property may qualify for "original use" if such property has not been previously used or placed in service in a QOZ.

Improvements made to leased property may satisfy the original use requirement if the improvements are made for an amount equal to the unadjusted cost basis under Sec. 1012 of the improvements.

Acquisition of QOF investment from a person other than the QOF

A taxpayer may acquire an investment in a QOF from a person other than the QOF. The taxpayer may defer eligible capital gain in an amount equal to the purchase price of the QOF investment.

Conclusion

Although the QOZ program has been one of the most widely anticipated incentives of the 2017 tax changes, investors have been cautious in investing in a QOF until more guidance was released. These newly proposed regs provide much needed clarity, although questions still remain unanswered.

However, the IRS and the Treasury Department have recently indicated they have no plans for a third set of proposed regulations, and that any further guidance may take various other forms than formal proposals like these issued in April.

With the guidance we now have, many hope the QOZ program will provide investors with an attractive opportunity to defer their capital gains, and in turn revitalize communities and spur economic growth.

If you have questions about QOZs and QOFs or want to discuss them further, please don't hesitate to contact one of partners in Gould & Ratner's [Tax Practice](#), [Real Estate Practice](#) or [Corporate Practice](#).