TCJA: Qualified Opportunity Zones

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Overview

One of the tax incentives created by the Tax Cuts and Jobs Act ("TCJA") relates to investments made in a Qualified Opportunity Zone ("QOZ").[1] In sum, the QOZ tax incentive operates to:

1. Defer inclusion in gross income for certain gains to the extent that corresponding amounts are reinvested in a QOZ; and

2. Exclude from gross income the post-acquisition gains on investments in QOZs that are held for at least 10 years.

Proposed regulations related to the QOZ incentive were issued by the IRS on October 22, 2018.[2] In particular, the proposed regulations address the application to real property of the "original use" requirement and the "substantial improvement" requirement in §1400Z-2(d)(2)(D).

Designation of Qualified Opportunity Zones

Similar to past rehabilitation incentives,[3] the QOZ incentive is aimed at encouraging economic growth and investment in distressed communities by providing Federal tax benefits to businesses located within designated boundaries. On June 20, 2018, the IRS provided an official list of population census tracts designated as QOZs.[4] An interactive map of all designated QOZs can be found at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

Qualified Opportunity Fund

To qualify for the beneficial tax treatment, the investment must be made through a qualified opportunity fund ("QOF"). Generally, a QOF is any investment vehicle organized as a corporation or partnership that holds 90% of its assets in qualified opportunity zone business property ("QOZ Business Property").[5]

1. **Investment Time Limitation**. A taxpayer must generally invest in a QOF during the 180-day period beginning on the date of the sale or exchange giving raise to the capital gain elected to be deferred. The proposed regulations recognize that some capital gains are deemed to occur during a taxable year without a particular date. In such case, the first day of the 180-day period is the date on which the gain would be recognized for Federal income tax purposes.

2. **Sale and Reinvestment of Original QOF Investment Permitted**. If (i) a taxpayer acquires an original interest in a QOF in connection with a gain-deferral election under §1400Z-2(a)(1)(A); and (ii) a later sale or exchange of that interest triggers an inclusion of the

[1] IRC §§ 1400Z-1 and 1400Z-2; Com. Rpt. ¶ 14,00Z-11.9 (P.L. 115-97, 12/22/2017).
[2] Notice of Proposed Rulemaking, REG-115420-18.
[3] *See, e.g.*, DC Enterprise Zone; Gulf Opportunity Zone; New Markets Tax Credit.
[4] IRS Notice 2018-48, I.R.B. 2018-28, 6/20/2018.
[5] IRC § 1400Z-2(d)(1).

deferred gain; and (iii) the taxpayer makes a qualifying new investment in a QOF, then the proposed regulations provide that the taxpayer is eligible to make a §1400Z-2(a)(2) election to defer the inclusion of the previously deferred gain. However, in order to be eligible for a second election a complete disposition of the original QOF investment is necessary.

How the Tax Incentive Operates

Assume that Taxpayer holds an investment in securities (the "Securities") and, upon a sale of Securities, realizes gain in the amount of $100,000. Taxpayer then "rolls over" the $100,000 of gain into a QOF that holds an investment in a QOZ (the "QOF Investment").

1. **Deferral of Gain on Securities**. At the taxpayer's election, gain on the sale of Securities may be deferred until the earlier of –

a. December 31, 2026, or

b. The date on which Taxpayer sells its investment in the QOF Investment.

2. **Amount of Deferred Gain Recognized on Securities**. The amount of deferred gain from the sale of Securities that will ultimately be recognized by Taxpayer depends upon how long Taxpayer holds its investment in the QOF Investment. Taxpayer's initial basis in its investment in the QOF Investment from its deferred gain is zero. To the extent that the Taxpayer invested more than his or her deferred gain in the QOF Investment, he or she will have a separate basis in that additional investment equal to the amount of such investment. However, Taxpayer's basis in the QOF Investment attributable to the deferred gain will be increased if Taxpayer holds the investment for at least 5 years; and will be further increased if held for 7 years.

a. *5 year holding period*. After Taxpayer's investment in QOF Investment has been held for 5 years, its basis in the investment will increase by 10% of the deferred gain from the sale of Securities.

b. *7 year holding period*. If held for 7 years, Taxpayer's basis in its investment in the QOF Investment increases by an addition 5%, resulting in a total basis increase of 15% of the deferred gain from the sale of Securities.

c. *10 year holding period*. If held for 10 years, Taxpayer excludes 15% of the deferred gain from Securities, and recognizes zero gain on appreciation related to the QOF Investment.

Example: At the end of Year 5 the value of Taxpayer's investment in the QOF Investment is $200,000. Taxpayer's basis in the investment will be increased from $0 to $10,000 [$100,000 deferred gain X 10% = $10,000]. If Taxpayer disposes of its investment in the QOF Investment at that time, Taxpayer will recognize gain of $190,000 [$200,000 value - $10,000 basis = $190,000]. If held at the end of Year 7, Taxpayer's basis will be increased by an additional 5% to $15,000 [($100,000 x 10%) + ($100,000 x 5%) = $15,000].

Year	Deferred Gain on Securities	Value of QOF Investment	Securities: Gain Excluded	Securities: Gain Recognized	QOF Investment: Gain Excluded	QOF Investment: Gain Recognized
1	$100,000					
5		$200,000	($10,000)	$90,000	$0	$100,000
7		$250,000	($15,000)	$85,000	$0	$150,000
10		$300,000	($15,000)	$85,000	($200,000)	$0

3. **Gain Deferral Period**. Per statute, there is a sunset provision wherein the areas that have been designated as QOZs will lose such designation on December 31, 2028. The loss of the QOZ designation raises issues regarding gain deferral elections that are still in effect when the designation expires on December 31, 2018. For example, the issue would arise where a taxpayer invests in a QOF in 2023 and elects gain deferral, but the designation expires five years later in 2018, thus denying the taxpayer the 100% gain deferral for a QOF investment held for 10 years. However, the IRS has recognized this problem and the proposed regulations provide that an eligible deferral election made during the QOZ designation period will remain in effect until December 31, 2047. From a practical standpoint, this proposed rule would permit an investor in a QOF that makes an investment as late as the end of June, 2027 to hold the investment in the QOF for the entire 10-year holding period, plus another 10 years.

Hurdles

The significant hurdle to obtaining this benefit is the requirement that the QOZ Business Property be "substantially improved."[6] For such purposes, a substantial improvement means additions to the property's basis that exceed the QOF's initial basis in the property.

1. **Real Property**. The proposed regulations provide that, where a building is acquired by a QOF, the basis attributable to the land on which such building sits is not taken into account in determining whether the building has been substantially improved.[7] In the Notice of Proposed Rulemaking, the IRS states that: "excluding the basis of land from the amount that needs to be doubled under §1400Z-2(d)(2)(D)(ii) for a building to be substantially improved facilitates repurposing vacant buildings in qualified opportunity zones."

For example, assume the QOF purchased Building for $2,000,000, of which $500,000 is attributable to the land. The QOF must make capital improvements to Building that equal or exceed $1,500,000 –

[6] IRC § 1400Z-2(d)(2)(D)(ii)
[7] *See also* Rev. Rul. 2018-29

	$2,000,000	purchase price
	($500,000)	basis of land
=	$1,500,000	basis for purposes of substantial improvement

Because capital improvements to Building must equal the amount of the original basis (net of land), the true cost to purchase the real property is $3,500,000 –

	$2,000,000	purchase price
	$1,500,000	capital improvements
=	$3,500,000	total cost of building to meet requirements of § 1400Z-2

2. **Time Limitations for Making Capital Improvements**. The QOF has 30 months from the date property is acquired in order to make capital improvements equal to the amount of the initial basis. Thus, the QOF must not only raise the additional $1,500,000 within 2 ½ years from the date of acquisition, but must also complete the capital improvements within the same time limit. The proposed regulations do not provide relief where the improvements have begun prior to the expiration of the 30-month period, but have not completed the improvements.

Thoughts

Taxpayers who are eligible for the QOZ incentive will enjoy significant tax benefits. However, the substantial improvement requirements may discourage investors who do not want to commit the amount of cash needed to increase the basis of the property.