MEMORANDUM

DATE: October 22, 2020
TO: All
FROM: Wendy J. Manson, CPA and William J. Palazzolo, Esq.
RE: Qualified Opportunity Zone Use of Capital Rules

Summary

- The Tax Cuts and Jobs Act enacted new Sec. 1400Z-2, which provides several benefits designed to encourage investment in low-income communities that are designated as qualified opportunity zones (QOZs).
- Under Sec. 1400Z-2, taxpayers may be able to defer realized capital gains by reinvesting them in qualified opportunity funds (QOFs) that conduct or own trades or businesses with property and business activity within the QOZs. These deferred gains may then be partially excluded from gross income if certain holding requirements are met.
- Taxpayers eligible to defer gains under Sec. 1400Z-2 include individuals, C corporations, passthrough entities, and trusts and estates. Gain that is eligible to be deferred is gain that is "treated as capital," would be recognized for federal income tax purposes before 2027, and does not arise from a sale or exchange with a related party.
- Generally, within 180 days of a sale or exchange generating eligible gain, an eligible taxpayer may elect to reinvest all or a portion of the gain into a QOF, deferring its recognition until Dec. 31, 2026, or, if earlier, the date the taxpayer sells or exchanges the QOF interest.
- Once the taxpayer holds the QOF interest for a five-year period, 10% of the deferred gain is permanently excluded. Once the holding period reaches seven years, an additional 5% of the gain is excluded. If the QOF is held for at least five years as of December 31, 2026, the taxpayer will recognize 90% of the initial capital gain in 2026. If the QOF is held for at least seven years as of December 31, 2026, the taxpayer will recognize 85% of the initial capital gain.
- If the holding period reaches 10 years and is sold before January 1, 2048, the gain arising after the 2026 recognition date is entirely excluded.
- QOFs must hold at least 90% of their assets as QOZ property, which includes QOZ business property, QOZ stock, or QOZ partnership interests.

The QOZ life cycle and resulting tax benefits

Sec. 1400Z-2 entails a specific process, complete with critical definitions, deadlines, and quantitative tests that must be satisfied before the promised tax benefits become a reality. The life cycle of an opportunity zone investment can be represented at a high level as follows:

A taxpayer realizes an eligible gain. The taxpayer reinvests the gain within 180 days into a QOF and defers the gain for the year of sale. The QOF conducts business, either directly by holding QOZ business property (QOZBP) or indirectly by holding QOZ stock or a QOZ partnership interest. The taxpayer recognizes the deferred gain on the earlier of Dec. 31, 2026, or the date the taxpayer sells or exchanges the QOF interest.

After holding the interest in the QOF for five years, the taxpayer excludes 10% of the original deferred gain. After an additional two years, another 5% of the original deferred gain is excluded. After an additional three years (a total of 10 years), the taxpayer may sell the investment in the QOF at any time before 2048 and exclude the gain resulting from the sale.

Required timing of reinvestment of eligible gain

- A taxpayer that wishes to defer eligible gain must reinvest the gain into a Qualified Opportunity Fund ("QOF") within 180 days from the date of the sale or exchange that gives rise to the gain.
- For a taxpayer whose gain is from the sale of stocks, the 180 days starts from the date of the sale of the stocks.
- In the case of a partnership that realizes eligible gain, and allocates the gain to its partners, the 180-day period with respect to the partners' eligible gains generally does not begin on the date of the sale. Instead, it begins on the last day of the partnership's tax year.

Election mechanics

A taxpayer must affirmatively elect to defer eligible gain. The election is made on Form 8949, *Sales and Other Dispositions of Capital Assets*, by reporting the eligible gain as a positive number before then removing the gain on a separate line as a negative adjustment.

A taxpayer is not required to reinvest the entire *proceeds* from the sale or exchange giving rise to the eligible gain; rather, to defer the full amount of eligible gain, the taxpayer must reinvest only the *gain* amount. Thus, unlike a Sec. 1031 exchange, a taxpayer reinvesting in a QOF can both take cash off the table *and* defer the full amount of gain resulting from the sale.

A taxpayer may elect to defer some or all of an eligible gain that is reinvested within the applicable 180-day period. The entire amount of the gain need not be reinvested at once; rather, a taxpayer may make multiple deferral elections related to the same gain but may make a deferral election with respect to the same portion of any eligible gain only once.

Qualified opportunity funds - Basic requirements

A taxpayer may defer eligible gain only if, within 180 days of the sale or exchange, some or all of the gain is reinvested into a QOF. A QOF is a special-purpose entity that effectively acts as a conduit, achieving the policy goal of ensuring that invested capital is ultimately employed in a business located within a QOZ.

A QOF may be organized as a corporation or partnership and may be newly formed or a preexisting entity. A QOF does not need to be located within a QOZ, but it must be created or organized in one of the 50 states, the District of Columbia, or a U.S. possession.

Self-certification

A QOF must self-certify that it is a QOF by filing Form 8996, *Qualified Opportunity Fund*, with its tax return for each year the entity intends to operate as a QOF. In the first tax year the entity intends to operate as a QOF, the entity has the option of specifying the first month it wants to be a QOF. If no month is specified, then the first month of the entity's initial tax year as a QOF is treated as the first month that the entity is a QOF. Designation of the initial year and month as a QOF is critical because any eligible gain invested by a taxpayer into an entity before the entity's first month as a QOF is not eligible for deferral.

Eligible investment and basis

A taxpayer that wishes to defer eligible gain must acquire an equity interest in a QOF. For these purposes, an equity interest includes preferred stock in a corporation or a partnership interest with special allocations but does not include any debt instrument. In general, a taxpayer is free to use an interest in a QOF as collateral for a loan.

A taxpayer that elects to defer gain by reinvesting that gain into a QOF takes a basis in the QOF interest of zero. If a taxpayer invests money in a QOF and does not make an election to defer eligible gain with respect to that investment — or if the taxpayer invests more than the eligible gain amount into a QOF — this investment is treated as a separate investment in the QOF, and the taxpayer's basis in that investment in the QOF is determined under general tax principles.

The 90% test

A QOF must hold at least 90% of its assets in QOZ property (the "90% test"), determined by the average of the percentage of QOZ property held in the fund, as measured on:

- The last day of the first six-month period of the tax year of the QOF, and
- The last day of the tax year of the fund.

If an entity's self-certification as a QOF is effective for a month other than the first month of the entity's tax year, then in the QOF's first year, the first six-month period begins on the first day the entity is designated as a QOF, but only if its tax year is longer than six months.

If an entity's first month as a QOF is the seventh month of its tax year or later, there is only one testing date for the year: the last day of the QOF's tax year.

The 90% test does not take into account any months before the first month in which an entity self-certifies that it is a QOF.

If a QOF has an applicable financial statement, then the value of each asset for purposes of the 90% test is the value of that asset as reported on the QOF's applicable financial statement for the relevant reporting period. If a QOF does not have an applicable financial statement, the value of each asset of the QOF for purposes of the 90% test is the QOF's cost of the asset.

If a QOF fails to meet the 90% test for any year, the QOF must pay a penalty for *each month* it fails to meet the requirement. Thus, computing the penalty requires a three-step process. First, the exposure to the penalty is determined by dividing the QOF's QOZ property on each of the two testing dates by the QOF's total assets on those dates and then taking the average of those two percentages. If the result is less than 90%, the penalty is then computed on a monthly basis by multiplying the underpayment rate for that month by the excess of (1) 90% of the QOF's total assets on the last day of each month, over (2) the QOZ property (defined below) owned by the QOF on the last day of the month. The result is then divided by 12 to determine the penalty for that month.

Total assets would not include cash received for equity in the partnership if the contribution occurred within six months of the valuation date and beginning on the fifth business day after the contribution through the valuation date, the cash was held continuously in cash, cash equivalents or debt instruments with terms of 18 months or less. Cash excluded from total assets is also excluded from QOZ property.

In the case of a QOF that is organized as a partnership, the penalty is taken into account proportionally by each partner of the partnership as part of the partner's distributive share.

No penalty is imposed, however, if it is shown that the failure to satisfy the 90% test was due to reasonable cause. The proposed regulations do not provide examples of reasons for failing to satisfy the 90% test that would satisfy the reasonable-cause exception.

QOZ property

By requiring that a QOF hold 90% of its assets in the form of QOZ property, Sec. 1400Z-2 ensures that the QOF is investing in a business located within a QOZ. There are three types of QOZ property:

- QOZ business property,
- QOZ stock, or
- QOZ partnership interests.

The first option permits a QOF to operate a business directly. The latter two options permit a QOF to operate a business indirectly through a subsidiary.

QOZ business property (QOZBP)

A QOF that operates a business directly — and not through a subsidiary — must hold 90% of its assets as QOZBP. To meet the definition of QOZBP, the property must satisfy a number of statutory and regulatory requirements.

First, only tangible property used in a trade or business counts toward the 90% test. Thus, a QOF with substantial intangible value will have difficulty passing the test.

Next, the property must have been purchased by the QOF from an unrelated party after Dec. 31, 2017. This ensures that the QOF is making a new investment into a QOZ.

In addition, as a general rule, the original use of the property within the QOZ must begin with the QOF (the "original use" requirement). This would prove problematic to a QOF that planned, for example, to purchase and renovate a building within a QOZ, because the building will have already existed within the QOZ. The statute and proposed regulations provide an exception to this original-use requirement, however, if a QOF "substantially improves" personal or real property acquired within the QOZ. Property is substantially improved by the QOF if during any 30-month period beginning after the date of acquisition of the property, the QOF spends as much to improve the property (measured by additions to basis) as the QOF's original basis in the property at the beginning of the 30-month period.

Note, it is the *adjusted tax basis* of the property that must be doubled during the 30-month period, not the original cost. While this might motivate some taxpayers to take some time before beginning the improvement process to allow for depreciation to reduce the property's adjusted basis, it is important to remember that the final regulations provide that substantially improved property will count as QOZBP *during the 30-month period it is being improved.* Thus, it stands to reason, the property will NOT meet the QOZBP test prior to the start of the 30-month period, and would not count towards the QOF's 90% test.

If a QOF purchases a building located on land wholly within a QOZ, the "substantial improvement" requirement is measured only by reference to the QOF's original basis in the building; as a result, the QOF is not required to separately substantially improve the land upon which the building is located. In addition, when land is purchased with a building that is substantially improved, the original-use requirement for the land is ignored. This will result in the value of both the land and the improved building being treated as QOZBP for purposes of the 90% test.

The "original use" of tangible property begins when any person first places the property in service for purposes of depreciation. Thus, a QOF could purchase a partially finished business, complete construction and place it in service for depreciation, and the building will satisfy the original use test because it has never before been depreciated within the QOZ.

The “original use” test would also be satisfied if a taxpayer placed back into service property that had sat vacant for at least three years, provided the property were vacant for three years AFTER the surrounding area were designated as a QOF. A further reduction to one year is permitted if the property had been vacant for that long *on the date the area surrounding the property were designated as a QOZ.*

To illustrate, if a QOF purchases property that had sat vacant for one year on the date the area were designated as a QOZ and remains vacant until the QOF places it into service, the property will satisfy the original use test and need not be substantially improved. If instead, the property were vacated two months *after* the area were designated as a QOZ and sat vacant for three years after that date, a QOF could purchase the property and immediately place it into service and satisfy the original use test.

QOZ stock and partnership interests

Alternatively, a QOF may satisfy the 90% test by conducting a business in a QOZ through a subsidiary by holding QOZ stock or a QOZ partnership interest.

Stock in a corporation is treated as QOZ stock if:

- It was acquired by a QOF after Dec. 31, 2017, directly from the corporation or through an underwriter, solely for cash;
- At the time the stock was issued, the corporation was a qualified opportunity zone business (QOZB) or, in the case of a new corporation, was organized for purposes of being a QOZB; and
- During substantially all of the QOF's holding period for the stock, the corporation is a QOZB.

Similarly, an interest in a partnership is treated as a QOZ partnership interest if:

- It was acquired by a QOF after Dec. 31, 2017, directly from the partnership solely for cash;
- At the time the partnership interest was issued, the partnership was a QOZB, or in the case of a new partnership, was organized for purposes of being a QOZB; and
- During substantially all of the QOF's holding period for the partnership interest, the partnership is a QOZB.

If corporate stock or a partnership interest held by a QOF satisfies these requirements, then all of the assets of the subsidiary partnership or corporation are considered QOZ property for purposes of applying the 90% test to the QOF. There is no prohibition on a QOF investing in a preexisting corporation or partnership, but from a practical perspective, if the subsidiary owns significant assets that were acquired prior to 2018, it will be difficult for the subsidiary to satisfy the 70% test (discussed below).

Qualified Opportunity Zone Business (QOZB) requirements

When a QOF operates a business through a subsidiary, for all of the assets of the subsidiary to count toward the 90% test, at the time the subsidiary's stock was issued or its partnership interest was acquired by the QOF, and during substantially all of the QOF's holding period for the stock or partnership interest in the subsidiary, among other requirements, the subsidiary must meet the definition of a QOZB. To be a QOZB, the subsidiary must satisfy a "70% test," an "income-and-assets test," and a "qualifying-business" test.

The 70% test

At least 70% of all of the tangible property owned or leased by the trade or business of the subsidiary must meet the definition of QOZBP. As previously discussed, QOZBP is property that meets the following requirements:

- The property must have been acquired by the subsidiary by purchase after Dec. 31, 2017;
- The original use of the property in the QOZ must have commenced with the subsidiary, or in the alternative, the subsidiary must substantially improve the property; and
- During substantially all of the subsidiary's holding period of the tangible property, substantially all of the use of the tangible property was in a QOZ.

For taxpayers with an applicable financial statement within the meaning of Regs. Sec. 1.475(a)-4(h), the value of each asset, as reported on the financial statement, is used to measure compliance with the 70% test.

Specific to QOZBs, the proposed regulations provide that any tangible property that ceases to meet the definition of QOZBP will nonetheless continue to be treated as QOZBP for the lesser of (1) five years after the date on which the tangible property ceases to so qualify, or (2) the date on which the tangible property is no longer held by the QOZB.

The income-and-assets test

For each tax year, a QOZB must satisfy the following requirements set forth by Sec. 1397C(b).

- At least 50% of the gross income must be derived from the active conduct of a trade or business in the QOZ (the "50%-of-income test");
- A substantial portion of the intangible property must be used in the active conduct of a trade or business in the QOZ (the "intangible test"); and
- Less than 5% of the aggregate unadjusted bases of the property of the trade or business is attributable to nonqualified financial property (the "5%-of-assets test").

Nonqualified financial property includes debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property. Excluded from the definition of nonqualified financial property are reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less.

The 5%-of-assets test would prove problematic for QOZBs that receive a large influx of investment capital but need time before they can convert that capital into tangible property. To illustrate, a QOF may invest significant cash into a subsidiary partnership that intends to build affordable housing. Absent an exception, while the subsidiary partnership is seeking approvals and beginning construction, the cash would be treated as nonqualified financial property. Fortunately, the proposed regulations contain such an exception in the form of a safe harbor.

Working capital assets are considered reasonable — and thus are not treated as nonqualified financial property — if the amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ. In addition, there must be a written schedule consistent with the ordinary startup of a trade or business for the expenditure of the working capital assets within 31 months of the business's receipt of the assets; and the working capital must actually be used in a manner that is substantially consistent with the written plan.

If these requirements are met, any gross income earned on the working capital throughout the 31-month period counts toward the satisfaction of the 50%-of-income test. Likewise, throughout the entire 31-month period, the business is treated as having satisfied the intangible test.

The disqualified-business test

A QOZB may not be a business described in Sec. 144(c)(6)(B) (a so-called sin business). This includes:

- Any private or commercial golf course;
- Country club;
- Massage parlor;
- Hot tub facility;
- Suntan facility;
- Racetrack or other facility used for gambling; or
- Any store, the principal business of which is the sale of alcoholic beverages for consumption off the premises.