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Opportunity Knocks: Qualified Opportunity Zones - Jonathan Hilton, Managing Director, Andersen Tax

When I was in my third year of law school, I interviewed to work for the IRS. My interviewee asked me, "What are your thoughts on deferral? Should it be permissible?" My response then is similar to what it is now, "if the code provides for it then why would it be bad?" Although my initial response came from someone who knew very little about tax law, I still feel similarly today.

There has been some incredible legislation, passed and signed, that has provided amazing opportunities over the years to those who can and want to take advantage of it: retirement accounts, 1031 exchanges, international corporate structuring, and qualified small business stock, to name only a few.

One of the interesting components of the new Tax Cuts and Job Acts of 2017 includes a new deferral mechanism known as qualified opportunity funds. In a nutshell, IRC § 1400Z-2, provides the following benefits:

- Tax deferral on capital gains invested in a qualified opportunity fund (QOF) until 2026
- Elimination of up to 15% of the gains invested in a QOF
- Exclusion of capital gains earned from a QOF

Imagine an individual that realizes $10 million of capital gain from the sale of stock. If the individual invests those gains (not proceeds, just the gain amount) in a vehicle that is set up to invest in a qualified opportunity zone, that individual can defer the $10 million of capital gains until 2026 (assuming the investment is held that long). In addition, if the individual holds the investment for five years, she eliminates $1 million of the gain entirely and if it is held for seven years, she eliminates $500,000 more, for a total of $1.5 million of capital gain exclusion. Finally, if the new investment is held for 10 years and its value goes up to $15 million, then the gain on the difference between the $15 million and $10 million (or $5 million) is excludable and completely tax free for federal purposes[1].

This is an opportunity for those willing and able to take advantage of it. Here are the basic components:

- Capital gain on sale of capital asset to an unrelated party[2]
- Invested in a qualified opportunity fund during 180-day period after closing[3]

[1] It could be state tax free as well, but this will depend on state law.
[2] IRC § 1400Z-2(A)(1)
[3] Ibid.

- Gain recognized in year of sale or by December 31, 2026[4]
- If investment is held for five years, then there is a 10% increase in basis based upon the amount invested/gain deferral.[5]
- If investment is held for seven years, then there is an additional 5% increase in basis based upon the amount invested/gain deferral.[6]
- If investment is held for at least 10 years, then the basis is the fair market value at the time of disposition.[7]

Though the benefits are consequential, qualified opportunity zone rules require that the taxpayer's situation neatly fit inside the narrowly defined box to qualify. Those rules fall under the following basic concepts: qualified fund, qualified property, qualified business, and qualified zone.

The realized gains must be invested into a qualified fund, which is either a partnership or corporation organized for the purpose of investing in "qualified opportunity zone property."[8] The fund must maintain 90% of its assets invested in qualified opportunity zone property.[9] If fund does not maintain 90% of its asset invested in qualified opportunity zone property, there is a monetary penalty prescribed.[10]

Qualified property can be either original issued stock in a qualified business (domestic C-corporation), a partnership interest in a qualified fund, or actual qualified business property.[11] In order for any of these to qualify, they must be or own a qualified business.[12]

To be a qualifying business, substantially all of the use of the assets of the business needs to be within the opportunity zone through substantially the entire holding period of the investment[13]. At least 50% of total gross income is derived from qualified property. The business cannot have 5% or more of its aggregate unadjusted basis of property attributable to nonqualified financial property (i.e., stock, partnership interest, options, futures contracts, forward contracts, warrants annuities, etc.).[14] Finally, the business cannot be a "private or

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[4] IRC § 1400Z-2(b)(1)
[5] IRC § 1400Z-2(b)(2)(B)(iii)
[6] IRC § 1400Z-2(b)(2)(B)(iv)
[7] IRC § 1400Z-2(c)
[8] IRC § 1400Z-2(d)(2)(A), (B), and (C)
[9] IRC § 1400Z-2(d)(1)
[10] IRC § 1400Z-2(f)(1)(A)
[11] IRC § 1400Z-2(d)(2)(A)
[12] IRC § 1400Z-2(d)(2)
[13] IRC § 1400Z-2(d)(2)(D)(iii)
[14] IRC §§ 1400Z-2(d)(3)(A)(ii) and 1397C(b)(8), 1397C(e), and 1221(a)(4). Nonqualified financial property includes debt instruments, but not to the extent it relates to working capital, the term is less than 18 months, and any accounts receivable relates to inventory.

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 premises."[15]

Each state proposed qualified opportunity zones and those proposals were approved by the Treasury. Information on the location of qualified opportunity zones can be found at the following site: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx. The areas were designated based on the following criteria: focus on poverty, areas with business activity, and geographic diversity. They are not, as one might think, few and far between. There are huge swaths of land in basically every state.

Long Term Investment

The purpose of qualified opportunity funds is to create economic growth and opportunities for areas that are underserved. To create this economic growth, the rules around qualified opportunity funds foster long-term holding periods. This is done through the basis exclusions and permanent exclusion discussed previously. This is also accomplished by allowing taxpayers to make successive deferral elections as long as the investment continues to be in a qualified opportunity zone.[16]

Proposed Regulations/Future Guidance

The overall purpose of long-term investing in underserved and underdeveloped communities is relatively clear, but the legislation has opened up a field of questions that have left many practitioners stymied. Fortunately, the much anticipated proposed regulations issued on October 19, 2018 clarify a variety of issues, which include:

1) only taxable income classified as capital gains can be deferred,[17]
2) in partnership context, partners or partnerships can defer gains and the 180-day clock starts at the end of the taxable year for partners,[18]
3) the disposition of one QOF investment can be rolled into another with continual gain deferral,[19]
4) for purposes of the 10-year holding rule, investments can be held until December 31, 2047 and not owe any tax on the appreciation,[20] and

[15] IRC §§ 1400Z-2(d)(3)(A)(iii) and 144(c)(6)(B).
[16] Prop Reg § 1.1400Z-2(a)-1(b)(2).
[17] See Prop Reg §§ 1.1400Z-2(a)-1.
[18] See Prop Reg §§ 1.1400Z-2(a)-1.
[19] Prop Reg § 1.1400Z-2(a)-1(b)(2).
[20] See Prop Reg § 1.1400Z-2(c)-1.

5) the mechanics for self-certification.[21]

Nonetheless, there are still many unanswered questions by the proposed regulations, or which include:

1. What is precise treatment of distributions from a QOF organized as a partnership? Is there sufficient basis?
2. Can there be a QOF aggregator (entity that owns QOFs) and still get deferral treatment for partners?
3. Is there a tacking of the holding period when one QOF investment is rolled into another?

Answers to these operational type of questions may be the subject of additional guidance that is supposed to be coming out from the Treasury Department in January 2019.

Planning Opportunities

As practitioners try to grapple with the still present unknowns regarding some of the open questions of qualified opportunity zones, planning opportunities still exist.

Real Estate Investing

Due to the requirements regarding what can be a qualified business, much of the potential advantages relating to qualified opportunity zones may likely revolve around real estate development. This is the situation because one of the key requirements is to "substantially improve" property that a qualifying business acquires unless the original use of the property commenced with the particular QOF.[22] The fund must make improvements that exceed the original basis during a 30-month period.[23] This improvement requirement removes the possibility of just speculative real estate investment in a qualified zone, it requires actual improvement to the property in the zone. In addition, it will likely be easier to create a plan to develop property than to create a profitable business where employees are incentivized to work in not as desirable locations.

Nevertheless, there are potential issues even with real estate development. In the development context, as discussed above, a qualified business can't have more than 10% in cash. In capital intensive projects such as real estate development, there will likely be more than 10% cash at the state of the project. Initially, practitioners were concerned that excessive cash may not be considered working capital. The proposed regulations address this issue by

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[21] See Prop Reg § 1.1400Z-2(d)-1 .
[22] IRC § 1400Z-2(a)(2)
[23] IRC § 1400Z-2(d)(2)(D)(ii)

providing a safe harbor for extra cash being working capital.[24] Nonetheless, practitioners are still concerned about whether the capital needs to be held at the QOZ business level or if it can be held at the QOF level. In addition, practitioners continue to question if renting the new development is the aim of the project, whether rental income qualifies as a qualifying trade or business.

Grantor Trust Planning

Often times when discussing with a client the opportunity to fund a grantor trust, clients express concern because they don't want to be on the hook for the annual income tax hit. However, if they could utilize the deferral of the gain to give time to absorb the taxes due, the planning is more attractive. For example, if a client has an asset worth $5 million with built-in gain of $4 million, the client could give or sell the asset to a grantor trust. The grantor trust in turn sells the asset, recognizes gain taxable to the grantor, and then takes the gains and reinvests in a qualified opportunity fund. The client does not have to pay tax on the gain until 2026 and the trust now can take advantage of potentially eliminating tax on future gains if it holds it for more than ten years. If the client lives in a high tax jurisdiction, it could give the client ten years to move to a non-tax jurisdiction and eliminate any gain on the subsequent sale (assuming that the underlying asset of the fund is not in a state that imposes income tax).

Charitable Planning

Impact investing, investing with the perceived intent of making a larger societal benefit (such as green energy, for example), is something that has been more and more important to clients. Though there is no actual charitable deduction for investing in a qualified opportunity zone, it is still an opportunity for clients to potentially positively impact an underserved and underprivileged segment of society.

Conclusion

In summary, the introduction of QOFs has opened a new door for substantial tax deferral for high net worth clients. The planning considerations discussed above are a few illustrations as to the many opportunities QOFs can provide to clients. Nonetheless, finding an investment opportunity in a QOF is the bigger challenge than doing any associated planning.

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[24] See Prop Reg § 1400Z-2(d)-1 (d)(5)(iv).