Anchin Alert

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April 25, 2019

Insights on the Second Set of Qualified Opportunity Zone Regulations

The long awaited second set of proposed regulations to the Qualified Opportunity Zone (QOZ) program were released on April 17, 2019. Unfortunately, per the U.S. Treasury, certain sections of the regulations can be relied upon by the taxpayer and some cannot.

The following is a brief explanation of the regulations which answers some of the questions that have been puzzling people, and explains why the launching of many of Opportunity Zone Funds has been deferred.

To begin, let's start with the basics that have not changed.

Capital gains invested in a Qualified Opportunity Zone Fund (QOF) after December 31, 2017 will not be taxed until 2026. If the investment is held for 5 years by 2026, there is a step up in the basis of the investment, so that the tax would be on only 90% of the gain. If the investment is held for 7 years by 2026, the basis is stepped up by 15% and therefore only 85% of the gain is taxed. For the 2026 tax year, you will pay tax on 85%-100% of the deferred gain, depending on how long you held the investment. Lastly, the most beneficial scenario is if the investment is held for at least 10 years. In this case, the appreciation over the original investment can be stepped up to fair market value and therefore any gain on such investment will not be taxed.

What did the proposed regulations change?

1. The proposed regulations (although it is stated that this cannot be relied upon) allow an investor to defer capital gain if they invest either cash or other property into a QOF (it should be noted that the statute states that only cash can be invested). If a taxpayer transfers property other than cash to a QOF in a carryover-basis transaction, the amount of the investment equals the lesser of the taxpayer's adjusted basis, or the fair market value of the equity received in the transaction (both are determined immediately after the transaction). The regulations go on to set forth two special rules that treat a taxpayer as having a mixed-funds investment.

   a. If a taxpayer contributes property to a QOF that has a fair market value in excess of the property's adjusted basis;

   b. If the investment exceeds the amount of the taxpayer's eligible gain.

In both of these situations, the excess is treated as an investment which will not qualify for the deferral election.

2. One of the areas that was causing the launching of many funds to be postponed, was how a multi-asset fund liquidates a partner's interest without liquidating the fund. The proposed regulations allow a partner to elect to exclude any gain flowing from the partnership or S-Corporation to their K-1, provided the investment in the QOF has been held for at least 10 years.

3. Another important and open question and concern for many is the tax effect of a distribution to a partner or S-Corp shareholder in a QOF. The regulations state that as long as the distribution does not exceed the investor's basis in the QOF and does not reduce the investor's equity interest in the QOF, such distribution would not cause a recognition of any of the deferred gain. For example: A real estate partnership re-finances its property and makes a distribution to its partners. The partners' basis in the investment starts at zero (the gain invested has a zero basis when the investment is made). If the partners get allocated liabilities equal to or in excess of the distribution made, then the partners' basis is equal to the amount of allocated liabilities and therefore will not cause a recognition of the deferred gain.

4. To determine if a trade or business is a qualified opportunity zone business (QOZB), the substantially all test is now defined as 70%. This means that as long as at least 70% of the tangible property owned or leased by a trade or business is located in a QOZ, then the business will meet this requirement.

5. A QOF is any investment vehicle (partnership or corporation) that holds at least 90% of its assets in a QOZ. The 90% asset test is measured on the last day of the first 6 month period of the taxable year of the QOF and on the last day of the QOF's taxable year.

6. The regulations as previously stated and not changed, state that both real property and tangible personal property owned and used within the QOZ must have its original use within the zone. Tangible personal property previously placed in service in a QOZ by another taxpayer would not be deemed to be original use property. The proposed regulations define original use as the first time the property was eligible for depreciation or amortization in a QOZ. Therefore, the development of property on un-developed land will qualify since it only becomes eligible for depreciation when the property is placed into service. The regulations go on to further clarify when a vacant structure qualifies as original use property. The vacant structure must be vacant for at least five years prior to being acquired by a QOF in order to qualify. In addition, the regulations allow leased property to qualify even if the property was previously leased by an unrelated party. Lastly, improvements made by a lessee to leased property within a zone will satisfy the original use requirement.

7. Leased property after December 31, 2017, will qualify as qualified opportunity zone property provided the property is substantially used in a QOZ for substantially all of the holding period of the property and the lease is a market rate lease.

8. Unlike tangible property purchased by a QOZB (which must be purchased from an unrelated party), leased tangible property can be leased from a related party. The requirements of a related party lease are:

a. The lease is a market rate lease;

b. The lessee cannot make a prepayment to the lessor relating to a period of use of the leased property that exceeds 12 months; and

c. For tangible personal property leased from a related party the lessee must become the owner of the property at any time between taking possession of the property and 30 months from taking possession of the property (or the end of the lease, whichever is earlier).

9. The valuation for leased property is either the value used on an applicable financial statement or the present value of the lease payments discounted at the applicable Federal rate. Once the value is determined, for purposes of meeting the substantially all of the use test and the 90% asset test, the value remains the same throughout all subsequent periods.

10. If a property straddles two tracts that are contiguous, one in a QOZ and one not in a QOZ, then the qualification is based on the square footage of each property. If the square footage within the QOZ is substantial, than the entire property would be deemed to be in the zone.

11. In order for a business to be considered a QOZB, 50% or more of the gross income must be from activities within the zone. There are three safe harbors to satisfy this requirement:

a. the services performed within the zone (based on hours of employees and independent contractors) must be at least 50% within the zone;

b. the amounts paid to employees and independent contractors for services performed within the zone are 50% or more of the total expenditures for these services,

c. the tangible property of the QOZB that is in the zone and the management or operational functions performed for the business in the zone are each necessary to generate at least 50% of the gross income of the trade or business.

Even if these safe harbors are not met, a QOZB may still qualify based on facts and circumstances.

12. The proposed regulations clarified what constitutes working capital in meeting the 90% test. The safe harbor states that a written designation for the use of the working capital will include the development of a trade or business in a QOZ as well as acquisition, construction or substantial improvement of tangible property in the zone, which must be completed within 31 months from the date of the invested funds. The 31 month rule will not be violated if the delay is attributable to waiting for government action.

13. The 180 day investment period for a Section 1231 gain, begins on the last day of the taxable year. The only gain arising from Section 1231 property is the net gain for a taxable year. Therefore the taxpayer must net 1231 gains and losses and can only invest the net amount within the 180 day period.

14. The concern by many funds that a new capital infusion shortly before a semi-annual 90% test would disqualify their fund has seen relief in the proposed regulations. The regulations allow the fund to exclude any investments received within the preceding 6 months.

15. A QOF that sells or disposes of QOZ property, QOZ stock or QOZ partnership interests, can reinvest the proceeds within 12 months in order to still meet the 90% test. The investment does not preclude the taxable gain from being allocated to the QOF investors.

16. The regulations give numerous events that would cause the inclusion of the deferred gain (making the deferred gain currently taxable or a portion thereof). A few of the more common ones are as follows:

a. A corporate distribution that reduces the taxpayer's equity interest in the qualifying investment.

b. A partnership distribution that exceeds the taxpayer's basis in the qualifying investment.

c. A taxable disposition of all or part of a qualifying investment.

d. A taxable disposition of interests in an S-Corporation, which is an investor in a QOF and the S-corporation shareholders interest in the S-Corporation has changed by more than 25%.

e. A transfer by a partner of an interest in a partnership that is an investor in a QOF.

f. A transfer by gift of a qualifying investment.

17. A gift or transfer to the owner's grantor-type trust does not trigger an inclusion event, since the trust is disregarded for income tax purposes. Turning off grantor status (other than death) causes an inclusion event.

18. The transfer of a qualified investment as a result of the death of the investor does not cause an inclusion event. The deferral is considered income in respect of a decedent (IRD) and is trapped until the asset is disposed of.

19. If a taxpayer has an inclusion event, the amount of deferred gain recognized in that taxable year is the lesser of 2 amounts, less the taxpayer's basis. The first amount is the fair market value of the portion of the qualifying investment that is disposed of and the amount that bears the same ratio to the remaining deferred gain as the first amount bears to the total fair market value of the investment immediately before the transaction. For a partnership, the inclusion amount is equal to the percentage of the qualifying QOF partnership interest disposed of, multiplied by the lesser of the remaining deferred gain reduced by any basis adjustments or the gain that would be recognized by the partner if the interest was sold at fair market value in a fully taxable event.

20. Partnership distributions in the ordinary course of business may cause an inclusion event, if the distribution exceeds the partner's basis. In the case of a partnership where the cash flow exceeds that taxable income, the partnership should consider whether or not to distribute the excess to their partners if such distribution would exceed partners' basis.

21. If a partner transfers property to a QOF for its qualified investment, the holding period begins when the transfer is made and the partner's holding period prior to the transfer is disregarded.

22. If an investor disposes of its interest in a qualified investment in a QOF and reinvests within 180 days into another QOF, the holding period of the second QOF investment begins when the investment is made into the second QOF.

23. The IRS anticipates changing Form 8996, the self-certification as a QOF. The anticipated changes are to add requirements to disclose:

a. the Employer Identification Number of the qualified opportunity zone business owned by the QOF,

b. the amount invested by the QOF in such business,

c. the census tract for the business invested in.

The above are some of the more significant regulations and the ones we believe affect most investors. There are other proposed regulations that may affect your transactions and investment. Stay tuned for additional updates to come. Please contact your Anchin Relationship Partner with any questions you may have.