VORYS

Publications

Federal Tax Bulletin: Qualified Opportunity Zones: Proposed Regulations Provide Investors with Guidance on Several Important Questions

Related Attorneys

Joseph B. Mann

Kelly B. Bissinger

Related Services

Real Estate

Tax and Economic Development Incentives

Taxation

CLIENT ALERT | 10.31.2018

The federal Qualified Opportunity Zone *(QOZ)* program, enacted as part of overall tax reform at the end of 2017, has generated much interest among potential investors, project developers and others since its enactment. This program provides investors in low-income communities designated as QOZs, with the ability to defer and potentially eliminate capital gains. Congress left many details of the QOZ program to be addressed by the U.S. Treasury Department through regulations and other guidance. As a result, utilization of this program has been largely on hold as taxpayers have waited for Treasury guidance.

On October 19, 2018, Treasury issued Proposed Regulations and a Revenue Ruling (together, the *Guidance*) which address many important QOZ questions, generally in a taxpayer favorable manner. Many questions do still remain open, however. Treasury has indicated that it will issue more regulations in the "near future" addressing additional open questions. The Proposed Regulations are also subject to public comment and could be revised when issued in final form. Fortunately, taxpayers are permitted to rely on the Proposed Regulations pending the issuance of final Treasury regulations. The following summarizes key questions that were addressed by the Guidance.

How long can a Qualified Opportunity Fund (*QOF*) hold cash before being required to invest in property?

A significant issue for investors has been the requirement that 90% of the assets of a QOF must be tangible property meeting QOZ program requirements. The 90% requirement is based upon the average of the QOF's assets at the end of the first 6 months of the QOF's taxable year, and the last day of its taxable year (each, a *QOF Testing Date*). This requirement is a problem for investors that desire to invest a significant amount of cash into a QOF for a project that will be constructed over an extended period of time, because the Internal Revenue Code provides no grace period for a QOF to hold over 10% of its assets in cash during a construction/improvement period. The Guidance does provide for such a grace period, though it does so in a limited way. As a general matter, QOFs are entitled to invest directly in qualifying property and/or to hold equity interests in corporations and partnerships (*QOF Subsidiaries*) that meet QOZ requirements specific to such entities. The Guidance does not provide a QOF itself with flexibility to hold cash, but does provide a QOF Subsidiary with such flexibility. Specifically, cash held by a QOF Subsidiary will not violate QOZ requirements if (i) the amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property, (ii) there is a written schedule for the expenditure of these funds within 31 months consistent with the ordinary start-up of a trade or business, and (iii) the funds are actually used in a manner substantially consistent with such designation and schedule.

Under the Guidance, it is therefore important that projects intending to take advantage of the working capital grace period (i) structure the QOF so that the project is owned by a QOF Subsidiary, rather than directly by the QOF, and (ii) make certain that the QOF contributes the working capital to the QOF Subsidiary in advance of any QOF Testing Date.

If a partnership (including an LLC taxed as a partnership) recognizes capital gains, is it the partnership or its partners that must invest in a QOF in order to obtain QOZ benefits?

Where a partnership recognizes capital gain, the Guidance provides flexibility for making a related QOF investment. The partnership itself is able to make a qualifying investment in a QOF, if it chooses to do so, in which case the partnership must make the QOF investment within the 180 day window beginning on the day that the partnership recognizes the gain. If the partnership does not choose to make a QOF investment, then the partners of the partnership may themselves make separate QOF investments with respect to their shares of the capital gain. The window of time for a partner to make a qualifying QOF investment is 180 days *beginning on the last day of the partnership's taxable year*. (For example, if a partnership is using a calendar taxable year, and the partnership recognizes capital gain in 2018, the 180 day window of the partners would begin on December 31, 2018.) The partners are also able to elect to apply the 180 day window of the partnership instead. Partners will need to be careful to make the QOF investment during one of these 180 day windows (and not during the period between the two windows, if there is a gap).

If a QOF borrows money, will that leverage dilute the QOZ benefits of the QOF investors?

Taxpayers had been concerned that, if a QOF obtains commercial financing, the borrowed amounts might be considered nonqualifying QOF investments that would reduce the QOZ benefits of the QOF equity investors. The Guidance takes the general position that QOF debt does not reduce QOZ benefits available to the QOF equity investors.

Is gain that is treated as depreciation recapture eligible for deferral through investment in a QOF?

An open question had been whether a taxpayer may make an eligible QOF investment with respect to gain that is treated as depreciation recapture (and therefore taxed at ordinary income rates). The Guidance concludes that taxpayers may not make eligible QOF investments with respect to recapture. Rather, only “capital gain” is eligible for QOZ benefits. Therefore, gain from the sale of property used in a business (other than recapture) and unrecaptured 1250 gain (i.e., gain on the sale of real estate that is taxed at a 25% rate for individuals) are eligible for QOZ benefits.

If a QOF purchases a building and land in a QOZ, how is the land taken into account in determining how much capital improvement the QOF is required to make with respect to the building?

If a QOF acquires a building and the land on which it is located (which are in a QOZ), the QOF generally must “substantially improve” the property. The QOF is therefore required to make capital improvements in the property during a 30 month period, in an amount at least equal to the QOF’s tax basis in the property at the beginning of the 30 month period (generally, the amount paid by the QOF for the property). The Guidance helpfully clarifies that, for purposes of this requirement, the QOF only needs to take into account the tax basis of the building, and not the tax basis in the land. (For example, if a QOF were to buy a property for $1,000,000, $200,000 of which is allocable to land, and $800,000 of which is allocable to a building on the land, then the QOF would be required to spend another $800,000 to substantially improve the property.)

Although many issues remain unaddressed, the Guidance provides answers to a number of important threshold QOZ questions. We expect that this Guidance will enable many more projects to move forward with QOZ planning. Taxpayers with specific questions about the Guidance, or general questions about the QOZ program, should contact their Vorys attorney for additional information.