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INSIGHT: IRS Issues Eagerly Awaited Guidance on Qualified Opportunity Zones While States Decide Whether to Conform



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On Dec. 22, 2017, President Trump signed the Tax Cuts and Jobs Act (TCJA) into law. The TCJA introduced a new federal income tax incentive regime to encourage growth and investment in economically distressed communities throughout the U.S. by the creation of qualified opportunity zones (QOZs) and providing federal income tax benefits for private investment in these communities. Qualifying investments include a broad range of commercial and residential investments such as transit-related development, residential housing, mixed-use development, and energy efficient and renewable energy projects on public and private assets.

Summary of Proposed Regulations

On Oct. 19, 2018, the IRS released proposed regulations that address and clarify many of the questions left unanswered by the statutes enacted to create the QOZ regime. As described in more detail below, the QOZ regime provides three significant and distinct federal income tax benefits to encourage QOZ private investment:

(1) To the extent a taxpayer invests the capital gain from the disposition of appreciated property into a qualified opportunity fund (QO-Fund), the taxpayer may defer recognition of the capital gain until the earlier of the disposition of the QO-Fund investment or Dec. 31, 2026 (the “deferral period”).

(2) The taxpayer may permanently exclude up to 15 percent of the deferred capital gain if the QO-Fund investment is held for at least seven years prior to Dec. 31, 2026.

(3) The taxpayer may permanently exclude 100 percent of the appreciation in value attributable to its QO-

Fund investment if the investment is held for at least 10 years.

The tax benefits of a QOZ investment are available to any taxpayer that recognizes capital gains for federal income tax purposes (e.g., individuals, pass-through entities, corporations, and trusts and estates).

Tax Benefit #1—Federal Income Tax Deferral on Capital Gains. The first tax benefit of the QOZ regime is the temporary deferral of federal income tax on realized capital gain until the earlier of the taxpayer’s disposition of its QO-Fund investment or Dec. 31, 2026. To obtain this benefit, the taxpayer must realize the capital gain as a result of a sale or exchange with an unrelated person and invest the capital gain into a QO-Fund within 180 days of the capital gain triggering event. An added benefit of the deferral is that the federal income tax eventually due with respect to the deferred gain is not subject to an interest charge. However, as a word of caution, a potential investor should consider targeting a potential QOZ project or business before selling the property that will generate the capital gain and start the 180-day period given the tight deadline for making the QO-Fund investment.

For purposes of the QOZ regime, capital gain includes short and long-term capital gain, such as capital gain from the sale of real estate, stock investments, artwork and other collectibles, as well as any gain that is treated as capital gain for federal tax purposes. Presumably tax code Section 1231 gain (e.g., gain from the sale of real estate used in a trade or business) would satisfy this requirement. If the capital gain is realized by a pass-through entity (e.g., partnership, S corporation) and the entity chooses not to elect to defer recognition of the capital gain, each owner may separately elect to defer its distributive share of the gain by reinvesting its distributive share into a QO-Fund either within the en-

tity's 180-day investment period or within 180 days of the last day of the entity's taxable year. If the pass-through entity chooses to retain, rather than distribute, the capital gain proceeds to an owner wishing to defer its distributive share of the capital gain, the proposed regulations do not seem to prevent the owner from using another source of money, including a loan, to make the QO-Fund investment.

The deferral election will be made on an IRS Form 8949 attached to the taxpayer's tax return for the tax year in which the taxpayer would have recognized the capital gain had the deferral election not been made.

Taxpayers cannot take advantage of the QOZ tax incentives through a direct investment in a QOZ but rather must make their investment through a QO-Fund. A QO-Fund can be structured as either a partnership or corporation (including a limited liability company treated as a partnership or corporation for federal income tax purposes) organized for the purpose of investing in a QOZ that has at least 90 percent of its assets invested in QOZ property (QOZ Property).

QOZ Property can be assets that consist of a direct interest in a business conducted in a QOZ (QOZ Business Property) or interests in a partnership or corporation (QOZ Entity) in which at least 70 percent of the assets are included in a business conducted in a QOZ (QOZ Business). The definition of "QOZ Property" prevents a QO-Fund from investing in a QOZ through another QO-Fund.

QOZ Business Property is tangible property used in a trade or business if:

- (1) the property was acquired by purchase after Dec. 31, 2017;
- (2) either (a) the original use of the property in the QOZ commences with the QO-Fund, or (b) the QO-Fund substantially improves the property; and
- (3) during substantially all of the QO-Fund's holding period, substantially all of the use of the property is within the QOZ.

With regard to requirement (2)(b), substantial improvement of the property occurs if during the 30-month period after the date of acquisition, improvements to the property more than double the adjusted basis of the property that existed at the beginning of the 30-month period. The tax basis of land included in the acquisition is not considered in the calculation. For example, if a QO-Fund purchases real estate for \$1,000 consisting of a building worth \$300 and land worth \$700, the QO-Fund will meet the "substantially improves" requirement if it invests more than \$300 to improve the building over a 30-month period.

If the QO-Fund chooses to invest in a QOZ through the acquisition of an equity interest in a QOZ Entity:

- (1) at least 70 percent of the tangible property owned or leased by the QOZ Entity must be QOZ Business Property;
- (2) at least 50 percent of the entity's total gross income must be derived from the *active* conduct of a trade or business in a QOZ;
- (3) a substantial portion of the intangible property of the QOZ Entity must be derived from the *active* conduct of a trade or business in a QOZ; and
- (4) less than 5 percent of the average unadjusted basis of QOZ Entity property must be attributed to "nonqualified financial property" that includes stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principle contracts and

annuities (but excludes a reasonable working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less).

Recognizing that significant time may be needed to substantially improve a property after acquiring it, the proposed regulations also include a working capital safe harbor for purposes of applying the "nonqualified financial property" requirement. Under this safe harbor, working capital assets will be considered reasonable if (1) the working capital amounts are designated in a written plan for the acquisition, construction and/or substantial improvement of tangible property in a QOZ, (2) the QOZ Entity complies with a written schedule for spending the working capital, and (3) the working capital is spent within 31 months of receipt.

The decision as to whether a QO Fund should invest in a QOZ directly or through a QOZ Entity will depend on such factors as: (1) whether the QOZ business is expected to be an active trade or business, (2) the amount of capital to be invested by the QO-Fund in the QO Business Property (90 percent if invested directly and as little as 63 percent if invested through a QOZ Entity (90 percent x 70 percent)), and (3) the amount of assets that will consist of nonqualified financial property.

Tax Benefit #2—Elimination of a Portion of Deferred Capital Gain.

At the end of the deferral period, the taxpayer must include in its gross income an amount equal to the excess of (a) the amount of deferred capital gain (or the fair market value of the QO-Fund investment if lower) over (b) the taxpayer's basis in the QO-Fund which is initially treated as zero. The second significant federal income tax benefit of the QOZ regime is that up to 15 percent of the deferred gain invested in a QO-Fund is eliminated if the investment is held for at least seven years prior to Dec. 31, 2026. This is accomplished through a basis increase in the QO-Fund investment equal to 10 percent of the deferred gain if the taxpayer holds the investment for five years and an additional basis increase in the QO-Fund investment equal to 5 percent of the deferred gain if the taxpayer holds the investment for seven years. To receive the full 15 percent benefit, a taxpayer would need to invest in a QO-Fund no later than Dec. 31, 2019. To receive the 10 percent benefit, a taxpayer would need to invest in a QO-Fund no later than Dec. 31, 2021.

When it is ultimately recognized, the capital gain keeps the character it originally had. For example, short-term capital gain that is invested in a QO-Fund will still be treated as short-term capital gain in the year the gain is finally recognized. In addition, in the pass-through entity context, the owners who receive the benefit of the capital gain deferral may not be the same owners who are required to recognize the capital gain (i.e., phantom gain) when the deferral period concludes. This will likely be an important consideration in situations such as the purchase of a QO-Fund investment from a seller and the transfer of a QO-Fund investment between family members since in such situations, the transferee, rather than the transferor, could be subject to capital gain recognition without the benefit of the tax deferral.

The following example illustrates the first two tax benefits of the QOZ regime:

A realizes \$5 million of long-term capital gain on the sale of publicly-traded stock on Dec. 31, 2018, and immediately invests the gain into a QO-Fund. A's tax basis

in its QO-Fund investment is initially zero. On Dec. 31, 2023 (five years later), A's zero basis in its QO-Fund investment is increased by \$500,000 (10 percent of the original capital gain) and on Dec. 31, 2025, A's basis in its QO-Fund investment is increased by another \$250,000 (5 percent of the original capital gain). On Dec. 31, 2026, A becomes liable for federal income tax on \$4,250,000 calculated as the difference between the original \$5 million deferred capital gain less the \$750,000 aggregate basis increase (assuming the fair market value of the QO-Fund investment is higher than the deferred gain).

Tax Benefit #3—No Taxable Gain on QO-Fund Post-Acquisition Appreciation. The third significant tax benefit of the QOZ regime is that a taxpayer may permanently exclude 100 percent of the appreciation in value attributable to its QO-Fund investment if the investment is held for at least 10 years. This is accomplished by a taxpayer election to increase its tax basis in its QO-Fund investment to fair market value at the time of the sale or exchange of the investment. This election, however, can only be made for sales or exchanges of a QO-Fund investment that occur on or before Dec. 31, 2047. Thus, if a taxpayer timely invests the capital gain from the sale of property in a QO-Fund and holds the investment for at least 10 years, the taxpayer would recognize only 85 percent of the original deferred capital gain in December 2026 but would have no further taxable gain and owe no further federal income tax in connection with the disposition of its QO-Fund investment.

The following example illustrates tax benefit #3:

Using the same facts as in the example above, on Dec. 31, 2030, when A has a \$5 million tax basis in its QO-Fund investment (tax basis in QO-Fund investment is increased by an additional \$4.25 million due to the recognition of capital gain on Dec. 31, 2026), A accepts a \$10 million offer for its investment. If A elects, A may step up its tax basis in its QO-Fund investment to \$10 million so that it pays no federal income tax on the sale.

As a word of caution, investors who take advantage of the QOZ regime will unconditionally be required to recognize the deferred capital gain on Dec. 31, 2026, and pay federal income tax on this gain, if they have not sold previously the QO-Fund investment. Therefore, investors need to make sure they have sufficient liquidity to pay this tax. Furthermore, this capital gain tax is payable even if the QO-Fund investment decreases after Dec. 31, 2026, and results in an overall capital loss in a later year.

The proposed regulations are proposed to be effective on or after the date of publication of the final regulations. However, the proposed regulations may generally be relied upon so long as taxpayers apply them in their entirety and in a consistent manner.

Investment Opportunities in Connecticut, Massachusetts, and New York

The TCJA permitted the governor of each state to nominate a certain number of census tracts in the state as qualified opportunity zones. The nominations were subject to the approval of the U.S. Treasury, which has now certified 72 QOZs in Connecticut, 138 QOZs in Massachusetts, and 514 QOZs in New York. The com-

plete list of the officially designated QOZ locations may be found in Internal Revenue Service Notice 2018-48.

While Connecticut has not announced whether it will adopt the federal income tax treatment of the QOZ regime, Connecticut personal and corporate income tax statutes generally adopt federal tax code changes as they occur (rolling conformity). Therefore, in the absence of decoupling legislation, both the deferral and exclusion of capital gains from federal income tax should flow through to Connecticut taxpayers who invest in a QOZ. This means those gains should be deferred and excluded from taxable income in Connecticut as well as for federal income tax purposes.

Massachusetts has also not indicated whether it will follow the federal income tax benefits of the QOZ regime for Massachusetts income tax purposes. Like Connecticut, Massachusetts corporate income tax statutes generally adopt federal tax code changes as they occur. However, unlike Connecticut, Massachusetts personal income tax statutes conform to the federal tax code as of the year 2005 (static conformity). Therefore, it is likely that Massachusetts corporate taxpayers that invest in a QOZ will receive the same income tax benefits for Massachusetts income tax purposes as they will for federal income tax purposes absent decoupling legislation. In contrast, it seems that Massachusetts would need to affirmatively pass conforming legislation under its personal income tax statutes before Massachusetts individual taxpayers could obtain the income tax benefits of a QOZ investment for Massachusetts income tax purposes.

New York has also adopted rolling conformity with the federal tax code and has affirmatively stated that both the deferral and exclusion of the capital gains from federal income should flow through to New York taxpayers that invest in a QOZ. This means those gains should also be deferred and excluded from taxable income in New York as well as for federal income tax purposes.

Whether other states will adopt the federal tax benefits of the QOZ regime for state tax purposes will depend on factors such as whether a state has rolling or static conformity with the Internal Revenue Code as well as the state's particular fiscal situation. Taxpayers in states that decouple from the QOZ regime will likely lose state tax benefits and face additional administrative burdens due to the mismatch between federal and state tax treatment of QOZ investments, including the need to track the capital gains of a QOZ investment separately for federal and state tax purposes.

Conclusions

The proposed regulations provide welcome and helpful guidance on a number of open questions raised following the enactment of the QOZ regime but also leave a number of unanswered questions. The QOZ regime provides taxpayers with significant federal (and possibly state) income tax benefits but may also subject QO-Fund investments to a significant amount of uncertainty and risk given the QOZ locations. The technical requirements that must be satisfied to achieve the significant tax benefits associated with a QO-Fund investment, as well as decisions regarding the manner in which a QO-Fund investment should be made, are extremely complex. For these reasons, taxpayers considering a QO-Fund investment should do so only with the assistance of competent legal and tax advisors.

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