LANE POWELL

Topics

Real Estate
Tax
Tax Reform
Federal Tax

Related People

Lewis M. Horowitz
horowitzl@lanepowell.com

Eric J. Kodesch
kodesche@lanepowell.com

Related Practices & Industries

Tax
Real Estate
Tax Reform

November 1, 2018 Publication

Tax Delayed Is Tax Avoided: Qualified Opportunity Zones Let You Do Both

Tax Reform Update

The December 2017 federal tax reform law, commonly (but incorrectly) referred to as the Tax Cuts and Jobs Act or TCJA, included a new tax regime for investments in qualified opportunity zones (each, a **QOZ**). As described in more detail below, the new provision allows taxpayers to (1) defer gain from a sale of appreciated assets until 2026, (2) eliminate 15 percent of the deferred gain if they hold the assets long enough, and (3) avoid tax on any appreciation from the reinvestment of the gain if they hold the reinvestment long enough. Although the QOZ regime is designed to stimulate investments in low-income areas, due to the reliance on 2010 census information and the discretion given to governors to designate the QOZs in their states, in many cases taxpayers will be able to obtain the QOZ benefits for investments in neighborhoods that are already attracting investors. The IRS recently answered most of the questions necessary to launch this game-changing, tax-planning tool.

Summary of the Tax Benefits

The QOZ regime generally applies to "eligible taxpayers" that reinvest their "eligible gains" into an "eligible interest" in a qualified opportunity fund (**QOF**). A QOF generally is a partnership or corporation for which 90 percent of its assets consist of direct interests in a business conducted in a QOZ or interests in a partnership or corporation in which "substantially all" (70 percent pursuant to the proposed regulations) of the assets are in a business conducted in a QOZ.

© 2020 Lane Powell PC. Lane Powell & LP logo, Reg. U.S. Pat. & Tm. Off.

To qualify, a partnership or corporation simply has to self-certify as a QOF by attaching the applicable form (Form 8996, Qualified Opportunity Fund) to its tax returns. Accordingly, any LLC (with two or more members or that elects to be taxed as a corporation, including an S corporation) that a taxpayer otherwise would form for an investment in a QOZ can be a QOF. In addition, the market is about to descend on all of us with widely-held QOFs that will only make qualified investments.

Now that you know a QOZ from a QOF, you just need to master a few more terms of art to avoid making mistakes.

- Eligible Taxpayer: Broadly defined to include individuals, C corporations, partnerships (including LLCs taxed as partnerships), S corporations and trusts.
- Eligible Gain: Generally, capital gain from a sale to an unrelated person.
- Eligible Interest: An equity interest in a QOF — loans to a QOF do not count but participating preferred equity should qualify.

Of course, the tax world is never as simple as it sounds when Congress announces how it made America Great Again. For example, (1) special rules apply in determining whether a trade or business in a QOZ is eligible (*e.g.*, liquor stores and tanning salons are not eligible QOZ businesses), (2) a taxpayer's investment in a QOF must be bifurcated if the taxpayer invests in the QOF amounts other than the deferred gain, (3) penalties apply if the QOZ does not satisfy the 90 percent asset test on the applicable testing dates, and (4) "original use" or "substantial improvement" requirements apply in determining whether a business is a QOZ business.

Moreover, as pointed out by the IRS in the preamble to the proposed regulations, the 70 percent test for the substantially all requirement for partnerships or corporations in which a QOF invests allows for investment in a smaller amount of QOZ property compared to a QOZ business operated directly by the QOF. For example, a QOF with $10 million to invest in real estate would have to make a $9 million investment in QOZ real estate if the QOF made a direct investment, but a partnership or corporation in which the QOF invested $9 million would have to make only a $6.3 million investment in QOZ real estate. So, the general warning you hear on TV commercials applies here as well — don't try this alone. Most tax advisors will quickly become familiar with these rules and can

© 2020 Lane Powell PC. Lane Powell & LP logo, Reg. U.S. Pat. & Tm. Off.

help ensure that you achieve the tax benefits you seek when investing in a QOF.

The tax benefits of the QOZ regime include:

1. **Gain Deferral**: Gain from the sale of assets invested in a QOF are deferred until the earlier of (a) sale of the interest in the QOF or (b) December 31, 2026. For example, if a taxpayer sells stock in 2018 or 2019 with $10 million of gain, recognition of that gain can be deferred until December 31, 2026.

2. **Gain Elimination**: If the taxpayer holds the QOF investment for five years, 10 percent of the deferred gain is eliminated. But wait, there’s more. If the taxpayer holds the QOF investment for seven years then 15 percent of their original gain is eliminated from taxable income. For example, a taxpayer who realizes $10 million of capital gain in 2018 but reinvests that amount in a QOF will not only defer tax on that gain, but can reduce the gain recognized in 2026 to $8,500,000. The net present value of the benefit obviously supercharges the benefit.

3. **No Tax on Appreciation**: But wait, there’s still more. If the taxpayer holds the QOF investment for ten years, no tax applies to gain on the sale of the QOF investment. For example, if the $10 million investment increases in value to $25 million, none of the $15 million appreciation is included in taxable income. In this manner, a QOF investment is like an investment in qualified small business stock. Proposed regulations impose a date by which a taxpayer must sell the QOF investment.

Investment Opportunities in Washington and Oregon

The TCJA allowed each governor to designate a number of QOZs equal to 25 percent of the state’s low-income census tracts, based on the 2010 census. For the most part, QOZs are also low-income tracts but certain contiguous census tracts could be designated as a QOZ. Washington has 139 QOZs and Oregon has 86 QOZs. The U.S. Department of Treasury, Community Development Financial Institutions (CDFI) Fund’s website has a map of all of the QOZs, searchable by street address here. The Oregon Business Development Commission’s website has a map of the Oregon QOZs that can be zoomed to street level here.

© 2020 Lane Powell PC. Lane Powell & LP logo, Reg. U.S. Pat. & Tm. Off.

These maps demonstrate how QOZs include prime investment areas notwithstanding their status as “low income” in the 2010 census. For example, the SoDo neighborhood of Seattle is a QOZ. Similarly, downtown Portland and the area across the Willamette River on the eastside is a QOZ. Investments in these areas have been sizzling hot, even without the QOZ incentive so it should be interesting to watch the impact of adding a material tax incentive to the fire.

Rural areas are also well represented on the QOZ map.

As noted, QOFs must invest at least 90 percent of their assets directly into businesses conducted in a QOZ or interests in a partnership or corporation substantially all of the assets of which are in a business conducted in a QOZ. The proposed regulations have a placeholder for rules for this QOZ location requirement, but do not provide the applicable rules. Because real estate does not move, real estate investments in a QOZ presumably will satisfy the location requirement and many QOFs will take the easy way out and simply invest in real estate located in the QOZ so long as such investment rises to the level of a trade or business. (The active trade or business requirement is designed to preclude investments in raw land that is not developed by the taxpayer.) So expect a good many sale leasebacks of real property located in QOZs, including warehouses and fast food businesses. Special rules require improvements to existing real property for which the original use did not begin with the QOF, so expect many complaints from local residents about the impact of gentrification on their communities as QOFs acquire older properties for rehabilitation/upgrade. Other QOFs will specialize by investing in businesses located in the QOZs. These QOFs will need to police their investments to insure that they either stay in the zone or that the funds can be reinvested if the business goes bankrupt or moves, especially for periods before the IRS issues guidance on the location requirement.

In sum, the QOZ regime provides taxpayers with a substantial tax benefit. It potentially applies to investments a taxpayer would have made absent the new law, without the need to restructure the investment in order to qualify. In addition, investment funds created to make qualifying investments will allow taxpayers not directly investing in a QOZ to receive the tax benefits. If you would like to know more about the QOZ regime, please contact us.

© 2020 Lane Powell PC. Lane Powell & LP logo, Reg. U.S. Pat. & Tm. Off.

LANE POWELL

© 2020 Lane Powell PC. Lane Powell & LP logo, Reg. U.S. Pat. & Tm. Off.