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Recent Developments & Observations

Qualified Opportunity Zones—A Boon with Uncertainty

By Adam M. Cohen and Sarah Ritchey Haradon

Introduction

As discussed in our previous column, many provisions of P.L. 115-97 (commonly referred to as the "Tax Cuts and Jobs Act") raise many questions. One such provision provides for new tax incentives for investors engaged in the development of Qualified Opportunity Zones ("O-Zones"). The purpose of the new law is to encourage private investment in distressed and underserved areas and allows investors to reinvest capital gains from other sources in O-Zones through a "qualified opportunity fund" ("QOF") in exchange for deferred and, potentially, exempt tax treatment on historic and future capital gains. In many ways, the new law seems too good to be true and perhaps it is, as so many questions regarding the scope and extent of the law remain unanswered that most investors have yet to benefit from it. This column explores the new provision for O-Zone investments and raises some of these questions. This column is not intended to be a comprehensive dive into all aspects of O-Zones and the potential benefits of an investment in a QOF, but will help with understanding the new law and will raise some of the difficult questions that arise under this new provision.

Qualified Opportunity Zones and Tax Benefits

Under Code Sec. 1400ZA-1(a), an O-Zone is a population census tract that is a low-income community and is designated as an O-Zone. An O-Zone becomes designated through a process in which the States, Washington, D.C. and U.S. possessions nominate the zone for designation and Treasury makes the final designation.[1] Treasury announced the first O-Zone designations on April 9th and the final round of designations on June 14th.[2]

Investments in O-Zones provide for extraordinary tax benefits. First, the new provision allows taxpayers to elect to defer tax on gains resulting from the sale or exchange of property if such gain is reinvested within 180 days in a QOF and an election is made.[3] The deferral period for the unrealized gain is the earlier of (i) the date on which the taxpayer disposes of the investment in the QOF or (ii) December 31, 2026.[4] The second benefit provides taxpayers with a step-up in tax basis equal to 10 percent of the deferred gain, if the investment in the QOF is maintained for five years, and an additional five percent step-up in tax basis if the investment is maintained in the QOF for seven years.[5] Thus, long-term investors in QOFs potentially can permanently exclude from gross income as much as 15 percent of their originally deferred gain. Lastly, taxpayers who maintain their investment in the QOF for at least 10 years receive a basis step-up equal to the fair market value of the investment on the sale or exchange date, potentially allowing for a complete exemption from tax on all *post-acquisition gain* on the QOF investment.[6]

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Qualified Opportunity Funds

A QOF is any investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property ("O-Zone Property") that holds at least 90 percent of its assets in O-Zone Property and that has been certified as a QOF.[7] The QOF must meet this 90-percent test by averaging its O-Zone Property as of the last day of the first six-month period of the QOF's taxable year and on the last day of the QOF's taxable year. It is unclear how a QOF is to measure its O-Zone Property on these dates (*e.g.*, by acquisition basis, by adjusted basis on the measurement dates, by fair market value on acquisition, by fair market value on the measurement dates, *etc.*). If adjusted basis is to be used, this will raise questions regarding how to divide a tax year into partial years (*e.g.*, should the property's adjusted basis be reduced by half (or some other portion) of the depreciation for the year). Another issue where there is lack of clarity is whether and how often the QOF must meet these requirements after its first year.

Regardless of how and when the measurement is done, it is clear that the statute requires the QOF to be quickly invested in O-Zone Property. To dive into what is O-Zone Property, one must become acquainted with a host of additional definitions (all with "opportunity zone" in the name). O-Zone Property includes qualified opportunity zone stock ("O-Zone Stock"), qualified opportunity zone partnership interests ("O-Zone Partnership Interests"), and qualified opportunity zone business property ("O-Zone Business Property").

The tests for O-Zone Stock and O-Zone Partnership Interests are similar, but O-Zone Business Property is unique. O-Zone Stock and O-Zone Partnership Interests include stock and interests in a corporation or a partnership, respectively, that are (i) acquired by a QOF for cash after December 1, 2017, and (ii) acquired directly from the corporation or partnership. Further, during substantially all of the QOF's holding period for the stock or partnership interests, the corporation or partnership must qualify as a qualified opportunity zone business ("O-Zone Business").[8] Lastly, as to O-Zone Stock (but not O-Zone Partnership Interests), rules similar to Code Sec. 1202(c)(3) apply.[9] O-Zone Business Property is tangible property used in a trade or business of a QOF if, first, the property was acquired by the QOF by purchase after December 1, 2017, second, the original use of the property commences with the QOF or the QOF substantially improves the property and, third, during substantially all of the QOF's use of the property, the property is located in an O-Zone.[10]

For O-Zone Stock and O-Zone Partnership Interests, the definition of O-Zone Business is critical. An O-Zone Business is a trade or business that meets five tests. Substantially all of the tangible property owned or leased by the business must be O-Zone Business Property. At least 50 percent of the total gross income of such business must be derived from an active trade or business. A substantial portion of the intangible property of such business must be used in an active trade or business. Less than 5 percent of the average of the aggregate unadjusted bases of the property of such business is attributable to debt, stock, partnership interests, options, futures contracts, forward contract, warrants, notional principal contracts, annuities and similar property, and, for purposes of this test, one ignores a reasonable amount of working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less and accounts and notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of stock in trade or inventory. Finally, the O-Zone Business may not provide a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or liquor store (or land for such purposes).[11]

This definition of an O-Zone Business will make it difficult to invest in many businesses. Even if a business starts out in an O-Zone, to grow, the business may need to expand to locations outside of O-Zones. If that expansion causes the business to use its intellectual property outside of O-Zones, it will cease to be an O-Zone Business. Similarly, the requirement for the O-Zone Business to have substantially all of its tangible property be O-Zone Business Property will mean most of the business's tangible assets that are acquired will have to be new (or "substantially improved" by the acquirer) after December 31, 2017.

Substantial Improvements

One issue that arises in determining whether a purported QOF meets the requirements of Code Sec. 1400Z-2 is what is included in the definition of "property" and the extent to which such property must be improved in order to be O-Zone Business Property. The statute provides that property will be treated as "substantially improved" by a QOF (and, thus, treated as O-Zone Business Property) only if during any 30-month period beginning after the date of the acquisition of the property, additions to basis with respect to such property exceed an amount equal to the adjusted basis of such property at the beginning of such 30-month period.[12]

However, the statute provides no guidance as to how "property" is defined. For example, if a QOF (or a business in which a QOF invests) acquires a group of buildings and adds new floors to all of the existing buildings, presumably this could be an improvement to the property for purposes of Code Sec. 1400Z-2 because the improvement increases the basis of the property. But, what if the QOF builds an additional building on the acquired land? Or, what if the QOF demolishes the existing buildings and builds one or more new buildings on the acquired land? Can the costs associated with the new buildings be considered an improvement to the overall property or is the new building a separate property? Does it matter if the new buildings are operated as part of the existing set of buildings or not (*i.e.*, what if the new building serves a different purpose)?

Because the statute focuses on additions to basis, it might be appropriate to utilize the capitalization rules under Code Sec. 263 or the UNICAP rules under Code Sec. 263A to determine whether the costs for the new buildings would be included in the basis of the existing building (and, thus, part of the "property") or whether the new building would receive its own basis.[13] But, even if a purported QOF got comfortable that Code Secs. 263 and 263A are appropriate to reference in this context, these provisions can be interpreted to both prohibit and permit the additional buildings to be included in the property for purposes of Code Sec. 1400Z-2.[14] Further, land itself is never new but also typically has its own tax basis but, if land is not included within the "property" that can be improved, it may be very difficult for any entity to be a QOF.[15]

If a non-real estate business were to be acquired, the "property" definition becomes even more difficult. Such a business would have many pieces of tangible property (*e.g.*, desks, computers, *etc.*). Surely, the business need not substantially improve each of those assets. If the business acquired new property, would that be treated as separate "new" property and the used assets as non-qualifying? This seems a harsh result and one that would defeat the intent of the new statute.

Whatever type of business one is looking to acquire in an O-Zone, meeting these rules is paramount to obtaining the tax benefit and to the statute accomplishing its goal of promoting investment. Without additional guidance on how used and existing property becomes O-Zone Business Property, investment will be limited.

The 30-month rule also presents challenges as to when, and if, O-Zone Business Property becomes disqualified. If used property is acquired by a purported QOF or a corporation or partnership issuing O-Zone Stock or O-Zone Partnership Interests, respectively, one would expect that it must be treated as O-Zone Business Property, in case sufficient additions to basis are made. Moreover, there does not appear to be any intent requirement in the statute or its legislative history with respect to the acquisition of used property. There is, however, a "special rule" providing that tangible property that ceases to be O-Zone Business Property retains that treatment until it is no longer held by the O-Zone Business or, if shorter, five years after it ceases to qualify.[16] Considering these rules together, does this mean that an O-Zone Business can hold used property without meeting the substantial improvement test for almost eight years?[17] This certainly appears to be the Congressional intent and would provide the O-Zone Business some leeway, especially in harsh cases (*e.g.*, if the additions to basis end up being 49 percent of the acquisition basis).

Impact of Non-Qualifying Assets

Another issue that will arise will be the extent to which non-qualified property can be included in a QOF. As described above, there is a 90 percent requirement that the QOF hold O-Zone Property.[18] Thus, at least on initial blush, the QOF may hold up to 10 percent of its assets in something that is not O-Zone Stock, O-Zone Partnership Interests and O-Zone Business Property.

However, the amount of non-qualified property that is allowed is complicated by the contemplation in the statute that a QOF's O-Zone Stock or O-Zone Partnership Interest must be in a corporation or partnership with an O-Zone Business. As described above, among the requirements for an O-Zone Business is that substantially all of the tangible property owned or leased by the taxpayer must be O-Zone Business Property. O-Zone Business Property, for purposes of an O-Zone Business, uses the same definition that the QOF uses (but substitutes the O-Zone Business for the QOF).

It is unclear how iterative these rules can be. Recall that 90 percent of the QOF's investments can be held in an O-Zone Partnership Interest and 10 percent can be something else (say, cash). The O-Zone Partnership Interest must be an O-Zone Business, which is required to have substantially all of its property in O-Zone Business Property and less than five percent of the O-Zone Business's assets can be non-working-capital cash. This would appear to mean that, if a taxpayer invests $100× into a QOF, 10 percent of that cash can be held by the QOF and another five percent of the remainder can be held by the O-Zone Business in cash, for a total of $14.5× (over and above any working capital that the O-Zone Business might need). If the funds are not held in the listed assets, the amount that can be held outside the business presumably will depend on what "substantially all" means for this purpose.

Basis Implications

As described above, the mechanism that is used to keep track of the deferral of gain and the amount of gain deferral permitted is the tax basis in the investment made by the taxpayer in the QOF. However, this would appear to create basis disparities between the basis that the taxpayer has in the QOF (*i.e.*, the "outside basis") and the basis that the QOF has in its assets (*i.e.*, the "inside basis"). That inside-outside basis disparity is bound to create a host of issues.

Because Code Sec. 1400Z-2 permits the deferral of gain recognition, the taxpayer's initial outside basis in its QOF is zero.[19] The QOF (which, for this discussion, will assumed to be a partnership) may be invested in an O-Zone Partnership Interest or O-Zone Business Property (or O-Zone Stock, which we will ignore for purposes of this discussion). The initial inside basis of the QOF in the O-Zone Partnership Interest or O-Zone Business Property would be the cost basis for that investment. Because of the overlap of many of the same requirements, it is likely that most, if not all, O-Zone Business Property will be eligible for bonus depreciation under Code Sec. 168(k). If the QOF does not have significant income, it is also likely that the QOF will have a tax loss if it does not elect out of bonus depreciation (and may have a tax loss even if it does elect out). It would appear that this tax loss would be suspended by the application of Code Sec. 704(d) because the taxpayer has no basis in its QOF interest.

A tax loss suspended under Code Sec. 704(d) will be freed up when the taxpayer has additional basis in its QOF interest. This could occur if the QOF has income. Alternatively, it could occur simply by operation of the rules that were intended to reduce the tax on the original gain that was invested in the QOF. If the QOF investment is held for at least five years, the basis in the QOF increases by 10 percent of the originally deferred gain.[20] Rather than reduce the ultimate gain recognition, this additional basis might be used to free up previously suspended losses. The same could be true after the seven-year hold period is met and basis is increased by an additional 5 percent of the originally deferred gain.[21]

Even if one assumes that the QOF will be profitable, the basis rules for QOFs will produce additional oddities and issues. If the QOF is held for 10 years and is sold or exchanged and an election is made, the basis in the QOF investment becomes the fair market value on the date of sale or exchange. Assume that a QOF is a partnership and is profitable, but does not distribute its profits. Pursuant to the normal rules of Subchapter K, the basis in the interest in the QOF will increase by the profit shown on the QOF's Schedule K-1. After 10 years, the benefit of the increase in the basis to the fair market value on date of sale or exchange may not be as significant as the taxpayer may have initially expected due to the accumulation of the QOF's undistributed profits.

And, going back to a QOF that has suspended losses under Code Sec. 704(d), the 10-year basis adjustment would potentially create a timing problem. Does the basis adjustment occur sufficiently before the sale or exchange such that the suspended losses are freed up (which would then reduce the basis and cause gain to be recognized on the sale)? The taxpayer-friendly answer would allow the suspended losses (which may be ordinary losses) to be freed up with a consequential capital gain on the sale or exchange. A taxpayer-unfriendly answer would require there to be no gain or loss on the sale or exchange and for the suspended losses to be lost forever. It is unclear from the statute which was intended by Congress.

Regardless of the profits or losses of the business during the holding period, the basis adjustment at the sale or exchange of the investment in the QOF does nothing if the QOF is invested in partnerships and the partnerships sell the underlying assets. In fact, if the basis in the QOF is increased by the gains allocated by the underlying partnerships from sales of underlying assets to the QOF, the basis adjustment may eliminate a tax loss. As such, taxpayers will need to be careful to not make the 10-year adjustment election in some cases.

The application of certain other provisions will also be complicated by the basis mechanisms of QOFs. For example, Code Sec. 731 will trigger gain if a QOF makes a cash distribution (as, at least initially, the taxpayer's basis in the QOF is zero).[22] If an election under Code Sec. 754 has been made, this will trigger a basis adjustment under Code Sec. 734. However, the inside basis may already be equal to fair market value, leading to assets with inflated bases. Another example would be Code Sec. 751(a), which treats the selling partner as having a portion of the amount realized recast as from the sale of non-capital assets to the extent attributable to certain assets held by the partnership, where the elimination of gain on the sale of the QOF through a basis adjustment could lead to ordinary income and capital loss by application of Code Sec. 751.

Conclusion

The ability to defer gain (and possibly eliminate a portion of it) and to eliminate all gain on a further investment is likely to tempt many taxpayers to consider investments in QOFs. Until guidance is provided on the issues discussed above (and many more), such investments will involve potential peril of the tax benefits being ephemeral. Your authors are hopeful that the IRS and Treasury will move swiftly to address the many unknowns so that the brief availability of the O-Zones lives up to its promise and Congressional intent.

ENDNOTES

1 Code Sec. 1400Z-1(b).

2 *https://home.treasury.gov/news/press-releases/sm0341*; *https://home.treasury.gov/news/press-releases/sm0414*. The list of O-Zones can be found in Notice 2018-48, 2018-28 IRB(June 20, 2018).

3 Code Sec. 1400Z-2(a). How the election is made is an open question. And, the scope of what "gain" can be deferred is also an open question.

4 Code Sec. 1400Z-2(b)(1)(a) and (b).

5 Code Sec. 1400Z-2(b)(2)(B)(iii) and (iv). As discussed below, this step-up in basis was designed to reduce the deferred gain at the end of the deferral period but actually may have other consequences.

6 Code Sec. 1400Z-2(c). As discussed below, the interaction of this basis step-up with other Code provisions raises additional questions.

7 Code Sec. 1400Z-2(d)(1). Recent IRS guidance indicates that eligible investment vehicles will be allowed to become a certified QOF by filing a form with the IRS. *www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions*.

8 Code Sec. 1400Z-2(d)(2)(B) and (B). If the entity is new and does not have an O-Zone Business at formation, it must be organized for the purpose of being an O-Zone Business.

9 Code Sec. 1202(c)(3) provides that stock is not qualified small business stock if certain redemptions have occurred. During the four-year period beginning on the date two years before the issuance, the issuing corporation cannot have purchased (directly or indirectly) any stock from the taxpayer or a person related to the taxpayer. Likewise, during the two-year period beginning on the date one year before the issuance, the issuing corporation cannot have made one or more purchases of its own stock with a value exceeding five percent of the aggregate value of all of its stock as of the beginning of the two-year period.

10 Code Sec. 1400Z-2(d)(2)(D).

11 Code Sec. 1400Z-2(d)(3).

12 Code Sec. 1400Z-2(d)(2)(D)(ii).

13 *See, e.g.*, Reg. §§1.263(a)-3(e) and 1.263A-10.

14 For example, Reg. §1.263(a)-3(e) defines a unit of property using a functional interdependence standard, with special rules for buildings which provide that each building and its structural components is a single "unit" of property and amounts paid to improve the structural components are considered amounts paid to improve the building. These rules reference Reg. §1.48-1(e)(1) for the definition of "building," which is generally limited to the structure or edifice enclosing a space within its walls and usually covered by a roof, meaning that the construction of a new building would not be considered an improvement because the building would be a new unit of property with its own basis. In contrast, the UNICAP rules under Reg. §1.263A-10 also generally use a functional interdependence test, but a "unit" of real property includes the portion of land on which the real property (including a common feature) is situated. Thus, presumably, an improvement that caused an addition to the basis of the land in which both the buildings are situated (or a common feature which services both of the buildings) may be considered an improvement to the entire "unit" of real property.

15 If land cannot be O-Zone Business Property, depending on how much tax basis (or value) is in the land, it may ruin the ability to satisfy the requirement to have "substantially all" O-Zone Business Property in an O-Zone Business and may ruin the QOF's ability to satisfy the 90-percent O-Zone Property test.

16 Code Sec. 1400Z-2(d)(3)(B).

17 For example, if the O-Zone Business buys used property on January 1, 2019, and fails to "substantially improve" it by June 2021, does

it cease to qualify as of June 2021 and become subject to the special rule until June 2026?

[18] Code Sec. 1400Z-2(d)(1). Whether a QOF meets this requirement is determined by the average of the percentages held in O-Zone Property on the last day of the first six-month period of the QOF's taxable year and the last day of the QOF's taxable year. It is unclear whether, after the first taxable year, how the percentage is to be determined.

[19] Code Sec. 1400Z-2(b)(2)(B)(i).

[20] Code Sec. 1400Z-2(b)(2)(B)(iii).

[21] Code Sec. 1400Z-2(b)(2)(B)(iv).

[22] It is unclear also whether this gain under Code Sec. 731 will be considered a partial sale or exchange of the investment in the QOF that would trigger the end of the deferral (perhaps, in part) of the originally deferred gain.