IDAHO BUSINESS REVIEW

An overview of the final Qualified Opportunity Zones regulations

By: Coni Rathbone and Jonathan McGuire January 21, 2020 0

Coni Rathbone

The Qualified Opportunity Zones program was an element of the 2017 Tax Reform and Jobs Act designed to provide Americans who have capital gains built into assets they own some incentive to sell those assets and put their gains to work on economic development projects in the QOZs — low-income areas designated as in need of new development. There are presently more than $6 trillion in capital gains sitting on the sidelines in America. These gains are essentially trapped in the assets: The owners will not sell the assets because they do not want to pay tax on the gains.

Jonathan McGuire

This program is not a tax break for developers. It is a tax incentive for individual American investors. In fact, because developers typically deal with "dealer property" or "inventory," they rarely have capital gains.

This program applies to investors across the board. It applies to the mom and pop who started a family business years ago, but who now hesitate to sell because of the tax hit. It also applies to anyone who owns stocks or bonds who wants to sell but refrains because of the taxes they would face.

As a result, a massive amount of potential revenue sits on the sideline and is not productive.

How it works

There are three incentives in the program. The benefits to the investor apply if a person sells an asset for which there will be a long-term or short-term capital gain (such as stocks, bonds, businesses, partnerships, equipment or real property). The benefits apply if the person reinvests the gain portion of the sales proceeds into a Qualified Opportunity Fund ("QOF") within 180 days, the QOF does business in a QOZ and the QOF spends the funds acquiring and improving the property within 30 months.

Of course, there are many more bells and whistles related to the program, but if these four elements are met, the following benefits come into play:

1. A deferral of the payment of tax on the capital gains until Dec. 31, 2026. This is not a waiver of the tax, it is a delay of the tax.

2. If the property is held for five years, the investor receives a 10% step up in basis for determining the amount of tax to be paid in 2026.

3. There is no tax on any gain accrued during the investment hold period if it is held for a minimum of 10 years, up to 30 years.

Making Gains

The Opportunity Zone program has been criticized by some as just another one of the "Trump tax cuts." Not true. This program was conceived in 2015 by the Economic Innovation Group with the help of Facebook's Sean Parker and former Obama administration senior economic advisor Steve Glickman.

The resulting early 2017 legislation was first proposed in the bipartisan Investing in Opportunity Act, which was introduced in the House and Senate with nearly 100 bipartisan congressional supporters. The support was not only politically diverse, but regionally diverse as well. Because it did not move forward, it was simply packaged into the Trump tax reform act.

Some have also proposed that this program will deny the states substantial tax revenue. However, if the capital gains are never triggered because the owners of the assets refuse to sell, then the gains would never result in revenue to the states.

The QOZ program allows the revenue from the gains to be put to work improving our communities.

Creating a performing asset inside a zone will increase the tax base through new or improved businesses and properties. There will be income from operations that will be taxed. There will be increased property values, thus increasing real property taxes. The jobs created from the construction of assets and employment within the zone will increase the income tax base or even increase wages. Why keep investing in Walmart, Google and other equities when you can physically direct how your investment dollars are used and invest with purpose in your community?

The IRS and Treasury gave all of us a very Merry Christmas gift just before the holiday in the Final Regulations for Qualified Opportunity Zones. These regulations will go into effect 60 days after they are issued in the federal register based upon the draft of the final regulations released. Although not technically issued until they are published in the federal register, they will materially be unchanged. The rules state that the regulations are effective for tax years beginning on or after 60 days after publishing. Therefore, you can still rely on proposed regulations for 2019 and even 2020. There were two sets of proposed regulations issued. This is a summary of the new issues in the final regulations.

Here are the highlights of the proposed regulations:

1. §1231 capital gains are applying a gross calculation rather than a net calculation. What this means is you do not need to net 1231 gains against your 1231 losses. Additionally, prior year 1231 losses are not required to re-characterize 1231 gains that are currently being deferred. Instead, this loss recapture will take place in the year the deferred gain comes due.

2. §1231 capital gains 180 days will now begin on the date of sale for the taxpayer. As you no longer need to net with 1231 losses, there is no reason to defer the gain recognition date for purposes of a QOZ investment until year-end.

3. Self-dealing is explicitly prohibited, even if it is a non-related party. Therefore, you can no longer acquire an investment in a QOF after selling property to the QOF or underlying business with the sole intent of reinvesting the gain into the fund, even if it is not a related party sale.

4. Installment sales can elect to have the 180 day for reinvestment to apply at Dec. 31st (or taxable year-end if fiscal year taxpayer), OR when the cash is received.

5. Upon recognition of gain from an inclusion event (where a previously deferred gain is deemed taxable prior to 12/31/2026), this gain may be reinvested into a new QOF as long as it is an eligible investment. You do lose your existing holding period for purposes of the 10-year exclusion, but having this option to make a reinvestment is helpful if a deal falls through.

6. It is possible to specifically identify which interest in a QOF a taxpayer is selling within certain guidelines. Therefore if you need to sell a portion of the investment in a QOF and you have multiple tax lots, you can pick and choose which lot is sold.

7. A pass-through entity can still elect to defer its capital gains at the entity level. Should the entity pass-through the gain to its owners, the owners have 180 days to invest after the original due date of the entity tax return. Therefor if you receive a K-1 from a partnership or S Corp, you have 180 days from March 15th the following year to make an investment. The election for the taxpayer to utilize the entity's 180 days is still available. The proposed regulations previously said the "end of the tax year" of the entity. This effectively allows a person inside of a hedge fund, who not receiving their K-1 until the beginning of September, to potentially reinvest the capital gain. Oftentimes, the taxpayer nor tax preparer have insight as to what gains and what amounts might be flowing off these large and cavernous K-1s.

8. A QOF may elect to decertify itself if it finds that it will no longer qualify as an Opportunity Fund to avoid the continuance of penalties for failure to qualify as a fund. If done, it will be an inclusion event resulting in deferred gain being recognized.

9. If a fund fails to qualify as a QOF for purposes of the 90% test at the interim testing date, the regulations allow for the fund to cure this non-compliance by year-end at no penalty.

10. It appears the final regulations are relatively unchanged for rules regarding the death of a taxpayer with a QOZ investment and gifts of a QOF interest.

11. For operating businesses, inventories may be excluded from the 90% or 70% asset test pending fund structure.

12. 70% of the use of real and tangible property must be in the confines of a QOZ. This is based on the number of days used inside and outside a zone. There are clarifications about property used in a service trade or business that generates income inside and outside a zone. There is also a safe harbor for leasing of tangible property as long as the length of lease is no more than 30 days (including extension). The car rental business would be a perfect example of a leasing business that fits the safe harbor. Long term leasing of equipment will not qualify if less than 70% of its use is outside a QOZ.

13. The final regulations liberalize the "sin business" rules allowing for a de minimis amount of "sinning." If no more than 5% of gross income and no more than 5% of the total square footage for space used in a QOZ business for activities described as sin businesses, the activity will be disregarded for purposes of a QOZ business. For example, an athletic club could include a tanning bed and a place for massage as an amenity. As long as it does not occupy a significant portion of the club and does not account for a 5% portion of revenue, these would be deemed

de minimis and not disqualifying the entire business. Additionally a grocery store that sells alcoholic beverages may also still qualify if the space and income meet the 5% test.

14. For real estate businesses, a single triple-net lease will not qualify as an eligible trade or business. However, a portfolio of triple net leases or combination between triple net and non-triple net leases will likely qualify. This is a facts and circumstances test to be looked at under each fund's particular business dealings.

15. The 31-month rule for the working capital safe harbor has the availability to be doubled to 62 months. I need to follow up on some clarifications on this rule change along with the crossover with the 30-month substantial improvement rules for pre-existing QOZ property.

16. The regulations now allow you to aggregate assets for purposes of the substantial improvement requirement if on the same QOZ or contiguous QOZ. The example from the regulations explains this rule exceptionally well.

Example: An investor purchases the assets of a hotel business located in a qualified opportunity zone for $5 million. The purchased assets include land, a building, linens, furniture and other fixtures attached to the building. A million dollars of the purchase price is allocated to land and the remaining $4 million is allocated to the building, furniture and fixtures. During the course of renovations over the 30-month substantial improvement period, the QOF spent $1 million replacing linens, mattresses and furniture, $500,000 on the purchase of new exercise equipment for a gym located in the hotel building, $1 million on renovations for a restaurant (including restaurant equipment) attached to the hotel, and $1.5 million on structural renovations to the hotel.

Analysis: The amount of basis allocated to the hotel was $4 million. QOF A must expend $4 million to improve the hotel within the 30-month substantial improvement period. Even though the linens, mattresses and furniture are all new and deemed original use assets, a QOF can choose to include these costs as part of the substantial improvement requirement. The combined renovation costs amount to $4 million upon allowance to treat the personal property as part of the substantial improvement. Therefor the property will be deemed substantially improved and the asset qualifying for purposes of the QOZ rules.

This change is enormously helpful as one can acquire a business and invest substantially into the personal property used in the business so long as the functional interdependence of the building and business coincide with each other.

Coni Rathbone is a partner in the law firm of Dunn Carney LLP in Portland, Oregon.

Jonathan McGuire is a Certified Public Accountant with the firm of Aldrich CPAs + Advisors LLP in Lake Oswego, Oregon.

ABOUT CONI RATHBONE AND JONATHAN MCGUIRE