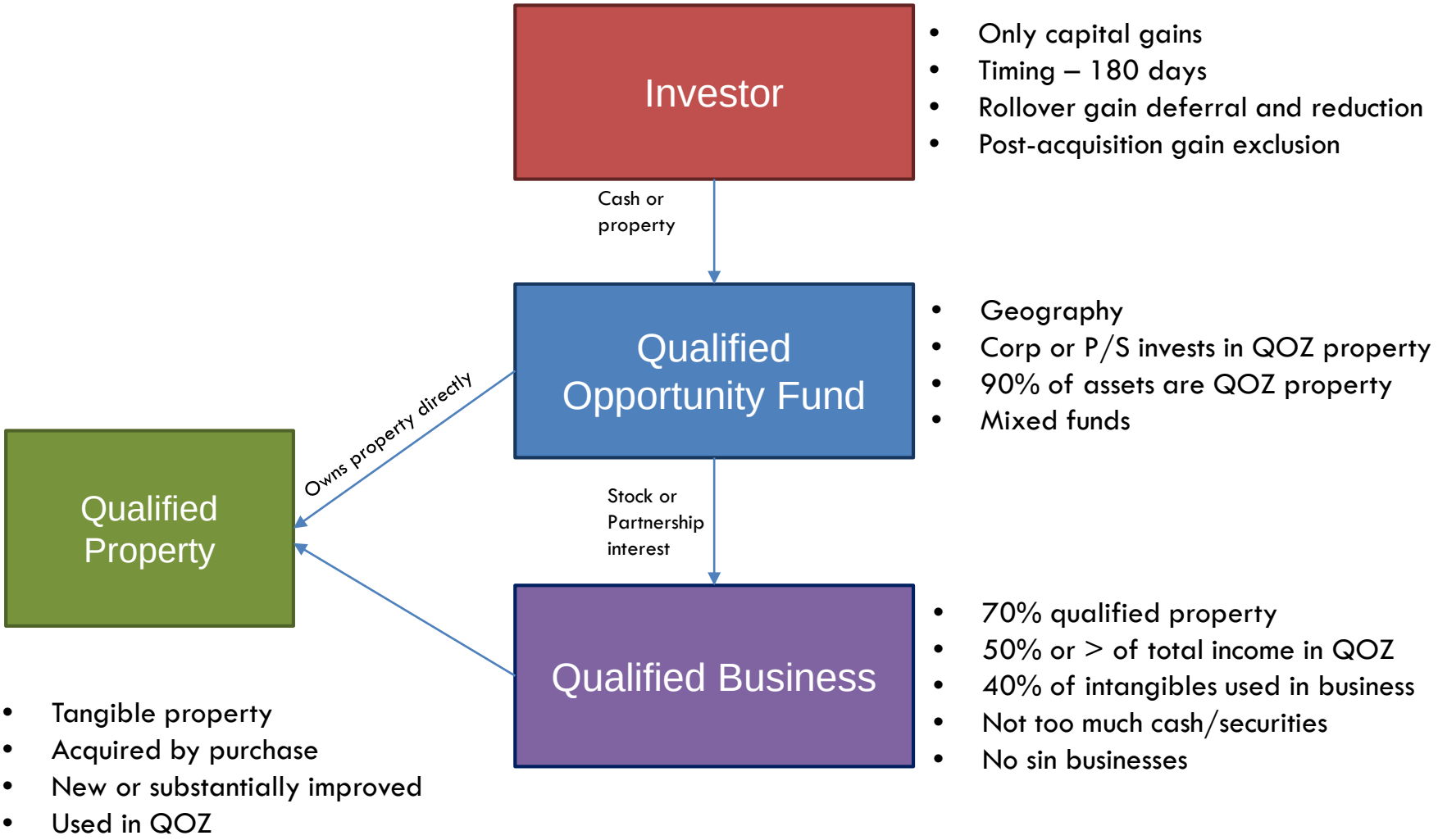
Qualified Opportunity Zones: An Overview



Prepared by the Staff of the Joint Committee on Taxation

June 2019

Overview


Investor
Only capital gains
Timing – 180 days
Rollover gain deferral and reduction
Post-acquisition gain exclusion
Cash or property
Qualified Opportunity Fund
Geography
Corp or P/S invests in QOZ property
90% of assets are QOZ property
Mixed funds
Owns property directly
Qualified Property
Stock or Partnership interest
Qualified Business
70% qualified property
50% or > of total income in QOZ
40% of intangibles used in business
Not too much cash/securities
No sin businesses
Tangible property
Acquired by purchase
New or substantially improved
Used in QOZ

Investor

Investor: Requirements

- Investors (any individual or entity) receive tax benefits by making an equity investment in a Qualified Opportunity Fund (QOF) which will invest in areas designated as Qualified Opportunity Zones (QOZs)
- Any gain treated as a capital gain (including net 1231 gain) generated from a sale with an unrelated party qualifies
  - Only the gain amount needs to be invested, *not* all proceeds and *not* all the gain. If you invest all your proceeds, you will have a mixed fund and some portion will not be eligible for benefits
- Investors have 180 days from the sale or exchange in which to invest the gain in a QOF
  - If the gain flows through from partnership, S corporation, RIC, or REIT, the partner/shareholder generally has 180 days from the end of the entity's tax year (*i.e.*, Dec. 31 to the following June 28)
- Taxpayer files Form 8949 for year taxpayer elects to defer gain

Investor: Tax Benefits

- Taxpayer may reinvest gain from the sale of property ("rollover gain") by acquiring an interest in a QOF and be eligible for the following
  - (1) Deferral of tax on rollover gain and
  - (2) Partial exclusion of rollover gain
  - (3) The permanent exclusion of post-acquisition gains
- Taxpayer makes two elections, one for the rollover gain benefits and one for the exclusion benefits
- The benefits are tied to the period in which Taxpayer holds the QOF investment

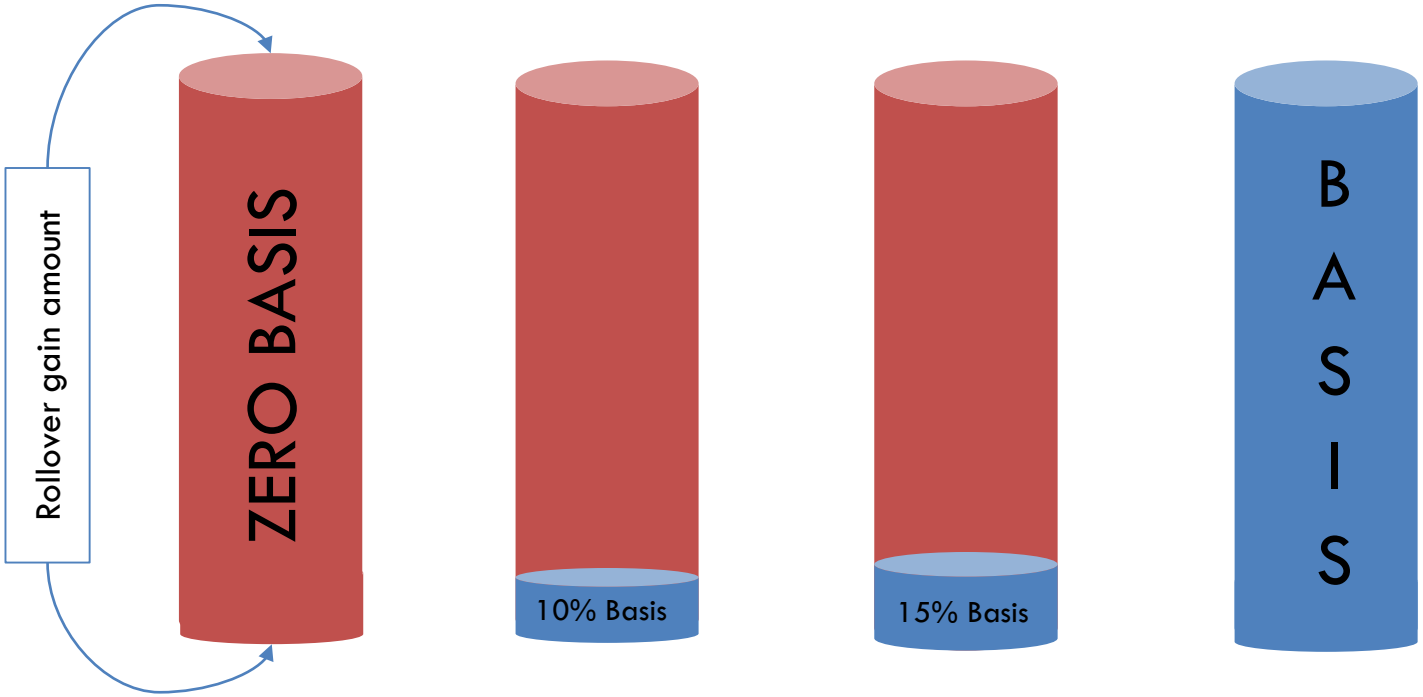
Investor: Tax Benefits

- Tax on capital gains realization can create a "lock-in effect" where taxpayers hold assets too long to defer paying tax
- The deferral and partial exclusion of tax on rollover gain reduces the lock-in effect for existing investments
- Taxpayers have an incentive to sell and invest in a QOZ in order to receive tax benefits
- Instead of paying tax today, taxpayer pays in 2027 when filing 2026 return
  - Taxpayer's rollover gain is recognized the earlier of (i) the date in which the QOF interest is sold or (ii) the taxable year that includes December 31, 2026
- The tax benefits create a lock-in effect with respect to the QOZ investment

Investor: Tax Benefits

- Partial exclusion of tax on gain
  - Taxpayer's initial basis in investment is $0
  - If Taxpayer holds investment for at least five years, Taxpayer's basis is increased by an amount equal to 10% of the rollover gain
  - If taxpayer holds investment for at least seven years (*i.e.*, an additional two years), taxpayer's basis is increased by an amount equal to 5% of the rollover gain, for a total basis increase to 15% of the amount of rollover gain

Investor: Tax Benefits



Basis starts at zero

After 5 years, basis is increased by 10% of the rollover gain

After 7 years, basis is increased by an additional 5% of the rollover gain

At time of sale or exchange or taxable year that includes December 31, 2026, remaining rollover gain is recognized and tax is paid. If investment has lost value, gain is computed using fair market value

Investor

- The proposed regulations provide a nonexclusive list of 11 "inclusion events" that cause the inclusion of the deferred gain, including:
  - A taxable disposition of all or a part of the QOF investment
  - Certain transfers of interests in entities that own QOF interests
  - A transfer of a QOF interest by gift
- Certain events do not cause the inclusion of the deferred gain.
  - A transfer to the beneficiary of an estate is not an inclusion event
  - A QOF selling its underlying assets is not an inclusion event

Investor: Tax Benefits

- Exclusion of post-acquisition appreciation
  - If taxpayer holds investment for at least 10 years, taxpayer may elect, at the time of sale or exchange of investment, to increase basis of investment to fair market value at the time of sale or exchange
  - At this time, taxpayer has already paid tax on rollover gain.
  - This has the effect of excluding additional gain of investment from tax
  - Taxpayer does not have to make election if investment has declined in value
  - The proposed regulations allow for taxpayers to make this election up until December 31, 2047

Investor: Example

6/30/2019:	Taxpayer has a basis in XYZ stock of $40 and sells stock for $140, realizing $100 of gain Taxpayer reinvests $100 gain in a QOF Taxpayer does not have to pay tax on gain and Taxpayer's initial basis in QOF investment is $0
6/30/2024:	Taxpayer has held QOF investment at least 5 years so Taxpayer's basis in investment is increased to $10
6/30/2026:	Taxpayer has held QOF investment at least 7 years so Taxpayer's basis is increased an additional $5 to $15
12/31/2026:	Taxpayer recognizes $85 of gain ($100 less $15) This is true even though Taxpayer has not sold the QOF investment. Taxpayer's basis in investment is now $100
7/1/2029:	Taxpayer has held QOF investment for at least 10 years. Taxpayer sells QOF investment for $219 and pays no additional tax

Investor: Example

- Assume
  - Investor has $100 rollover gain in 2019
  - Capital gains taxed on realization at 20.0%
  - Interest rate is 2.5%
  - Inflation is 2.0%
- If investor chooses non-QOZ investment with a rate of return of 9.0%
  - Pays $20 in tax on $100 rollover gain in 2019
  - $80 asset grows to $231 in 2029
  - Pays $30 in tax on $151 post-acquisition gain in 2029
  - Has $201 in 2029
- A QOZ investment with a rate of return of 6.0% gives the same after tax return
  - Pays $0 in tax on $100 rollover gain in 2019
  - Pays $17 in tax on $85 rollover gain in 2026
  - Pays $1 in interest to borrow $17 from 2026 to 2029
  - $100 asset grows to $219 in 2029
  - Pays $0 in tax on $119 post-acquisition gain in 2029
  - Has $201 in 2029

Qualified Opportunity Fund

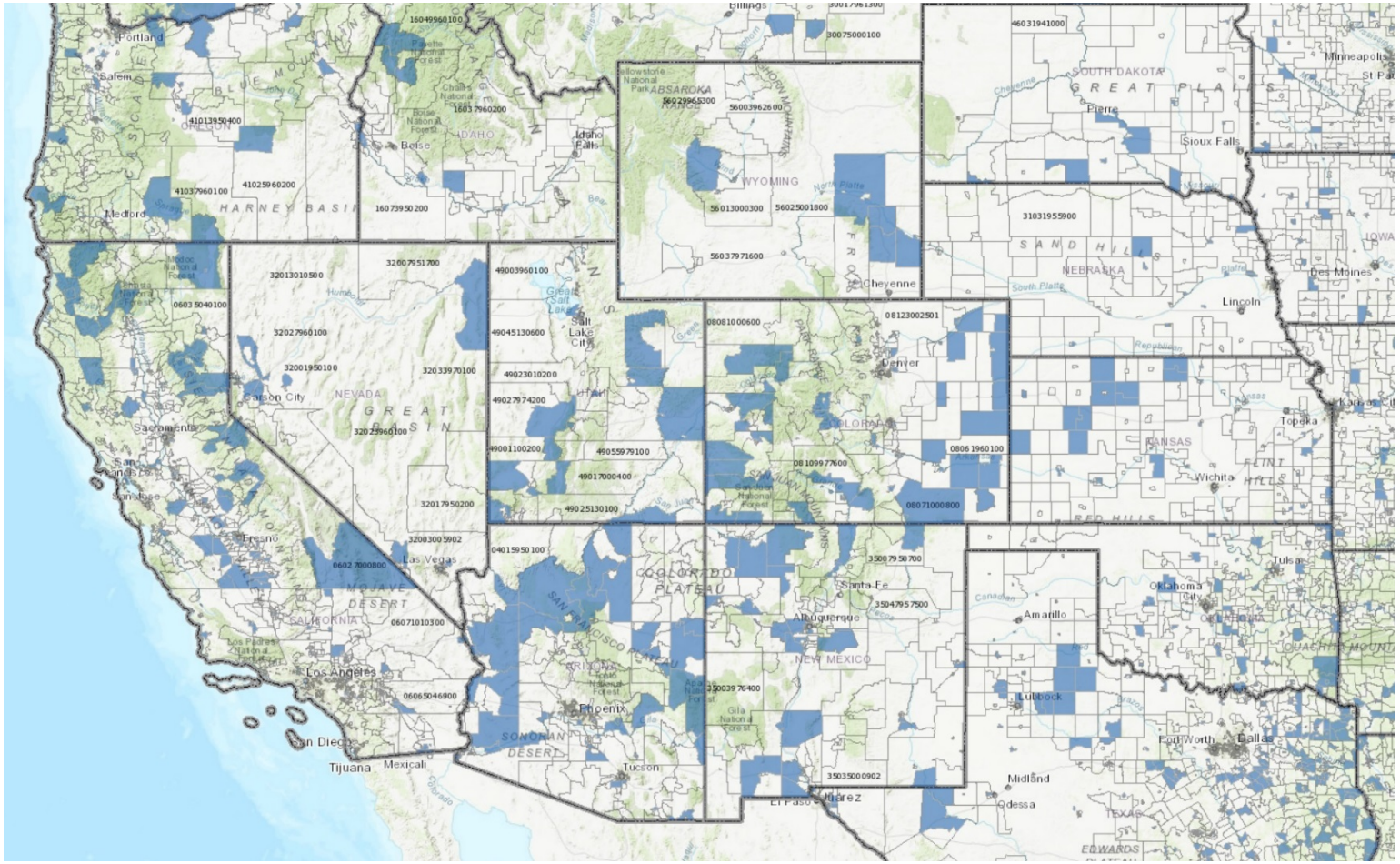
Qualified Opportunity Fund: Geography

- A QOF is an entity formed for the purpose of investing in QOZ property, which is property located in a QOZ
- Census tracts in every State that are "low-income communities" (determined based on the income of residents) were eligible for QOZ nomination and designation. Certain contiguous tracts were also eligible
- QOZs were nominated by the applicable State governor and designated by the Secretary of Treasury
- The number of QOZs was generally limited to 25% of the total number of low-income communities in the State (100% for Puerto Rico)

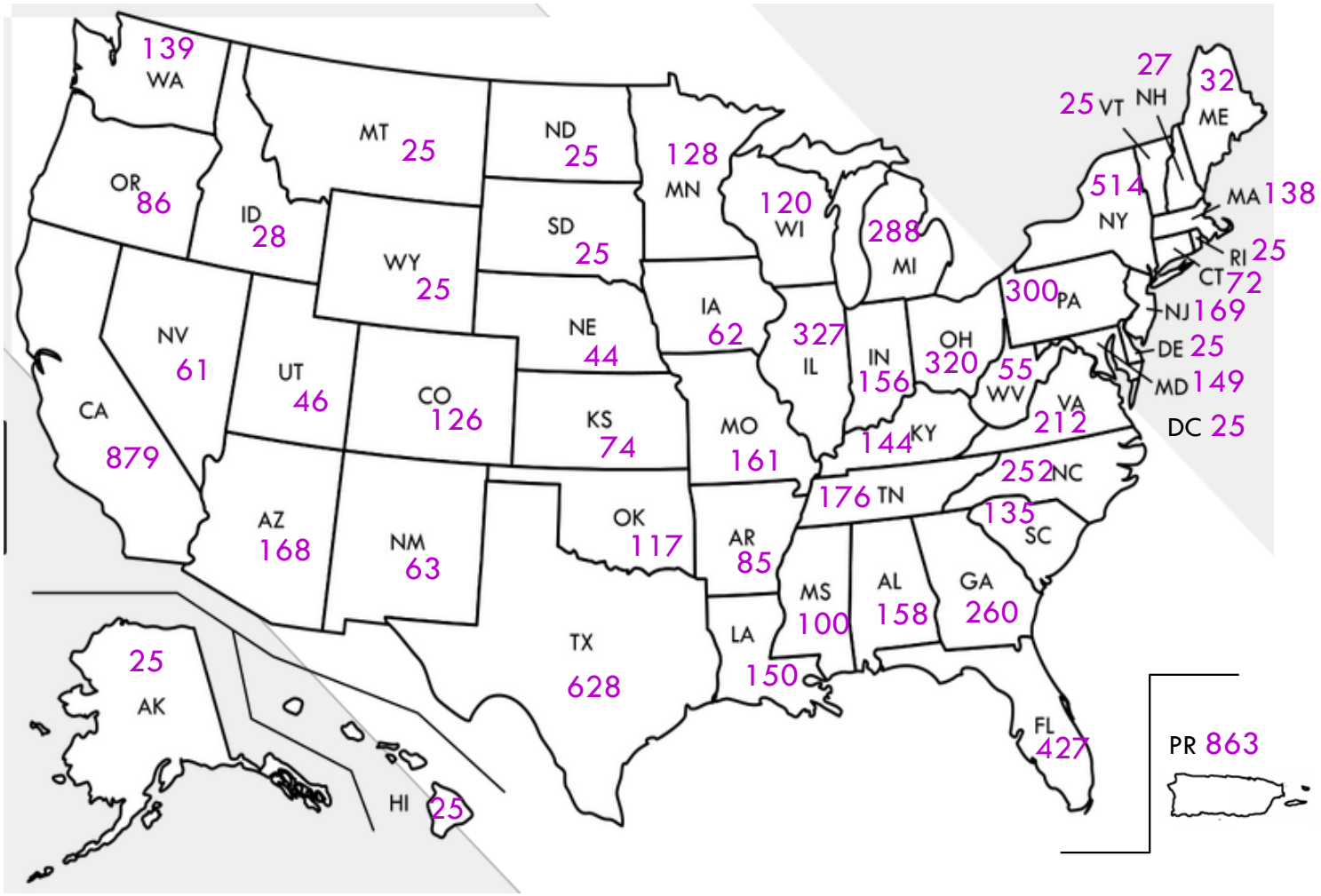
Qualified Opportunity Fund: Geography

- This nomination and designation process has ended and there is no process to designate additional zones
- There are currently 8,764 designated QOZs
- The designations expire at the end of 2028. But the important things are
  - Investments can only be made with respect to a sale or exchange before January 1, 2027
  - The expiration of the designation will not affect the availability of the tax exclusion benefit for existing investments
  - The proposed regulations allow for taxpayers to make this election for the tax exclusion benefit up until December 31, 2047

Qualified Opportunity Fund: Geography



Qualified Opportunity Fund: Geography

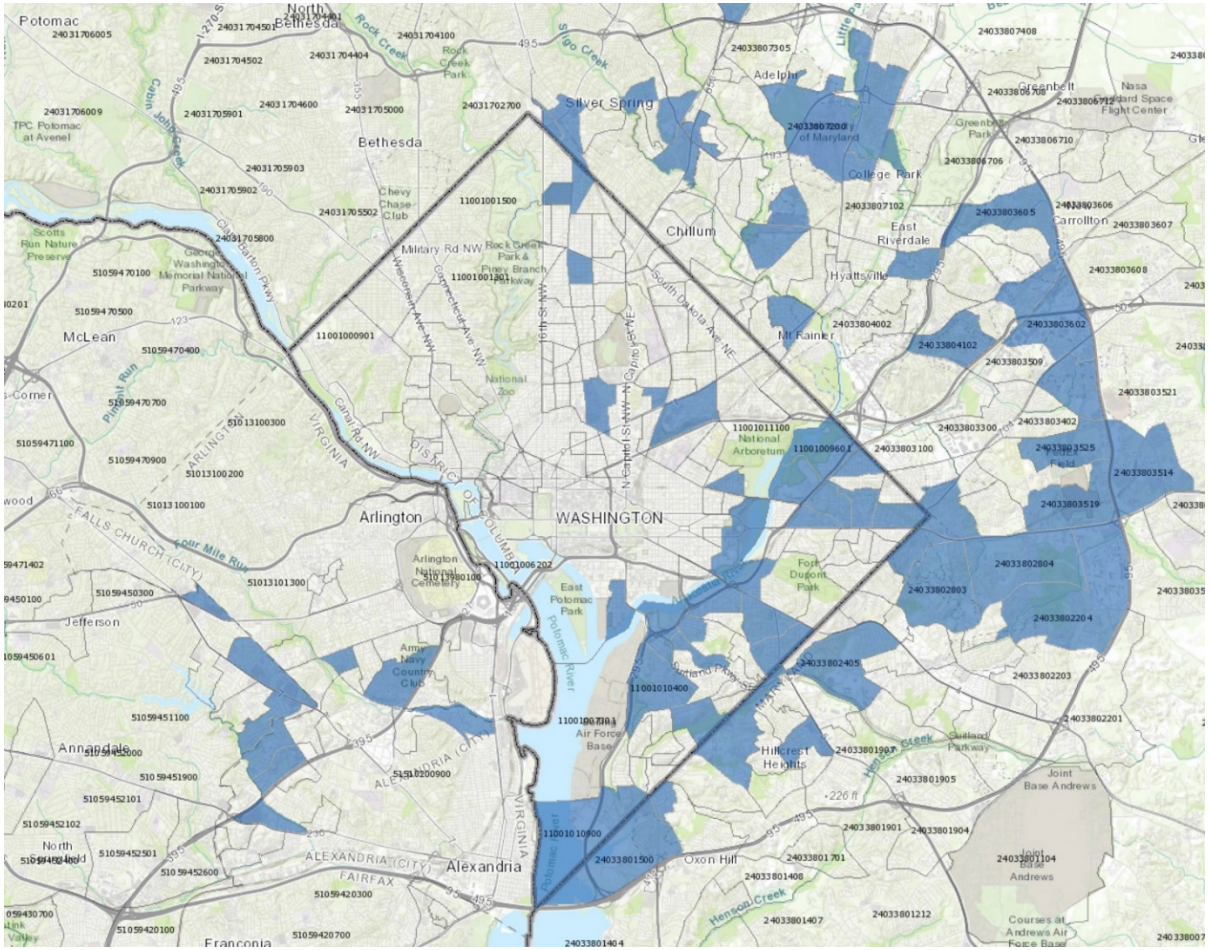


Other possessions: Guam (25), American Samoa (16), Northern Marianas (20), U.S. Virgin Islands (14)

Qualified Opportunity Fund: Geography

- Census tracts are uniquely numbered statistical subdivisions of each county in the United States
- Census tracts average about 4,000 inhabitants each.
  - Minimum population – 1,200
  - Maximum population – 8,000
- Census tracts are semi-permanent, but can be merged, split, or reconfigured with each decennial census
- Because census tracts are based on population, some are geographically large while others are small

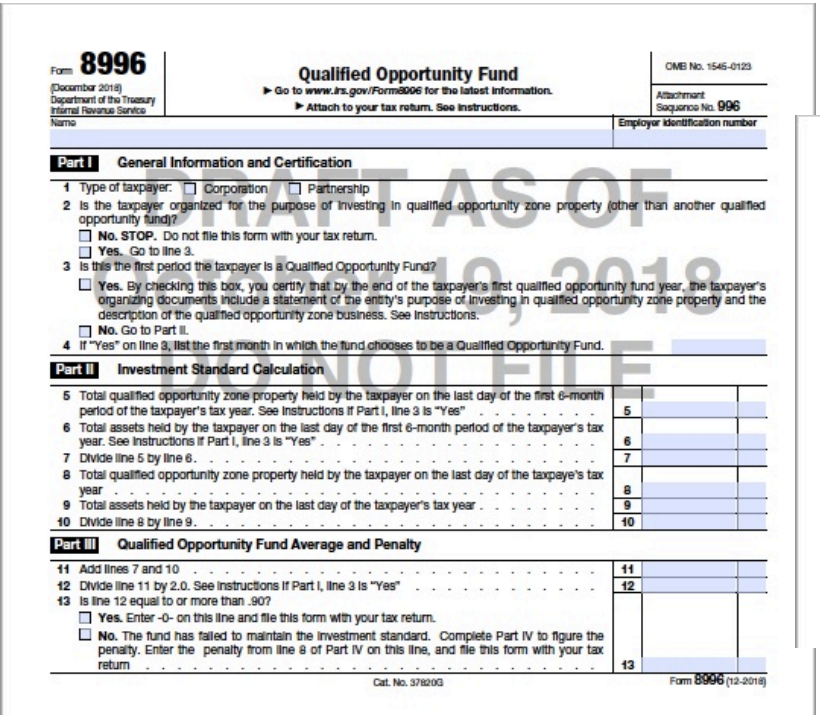
Qualified Opportunity Fund: Geography



Qualified Opportunity Fund

- A QOF must be either a corporation (including a RIC or REIT) or a partnership
- QOFs must have 90% of its assets invested in QOZ property
- Test is measured by the average taken at 6 months from the start of the taxable year and the end of the taxable year.
- There are penalties for failure to comply
  - Penalty equals the shortfall multiplied by the Federal short-term rate + the underpayment rate)
  - Taxpayer can show reasonable cause
- There is no application or approval process for an entity to become a QOF. Instead, an entity simply elects QOF status.
- QOFs must file Form 8996 with their annual income tax return, certifying QOF status

Qualified Opportunity Fund: Form 8996



Form **8996**
(December 2018)
Department of the Treasury
Internal Revenue Service

Qualified Opportunity Fund
▶ Go to *www.irs.gov/Form8996* for the latest information.
▶ Attach to your tax return. See instructions.

OMB No. 1545-0123
Attachment Sequence No. **996**

Name | Employer identification number

Part I General Information and Certification

1 Type of taxpayer: ☐ Corporation ☐ Partnership
2 Is the taxpayer organized for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund)?
☐ **No. STOP.** Do not file this form with your tax return.
☐ **Yes.** Go to line 3.
3 Is this the first period the taxpayer is a Qualified Opportunity Fund?
☐ **Yes.** By checking this box, you certify that by the end of the taxpayer's first qualified opportunity fund year, the taxpayer's organizing documents include a statement of the entity's purpose of investing in qualified opportunity zone property and the description of the qualified opportunity zone business. See instructions.
☐ **No.** Go to Part II.
4 If "Yes" on line 3, list the first month in which the fund chooses to be a Qualified Opportunity Fund.

Part II Investment Standard Calculation

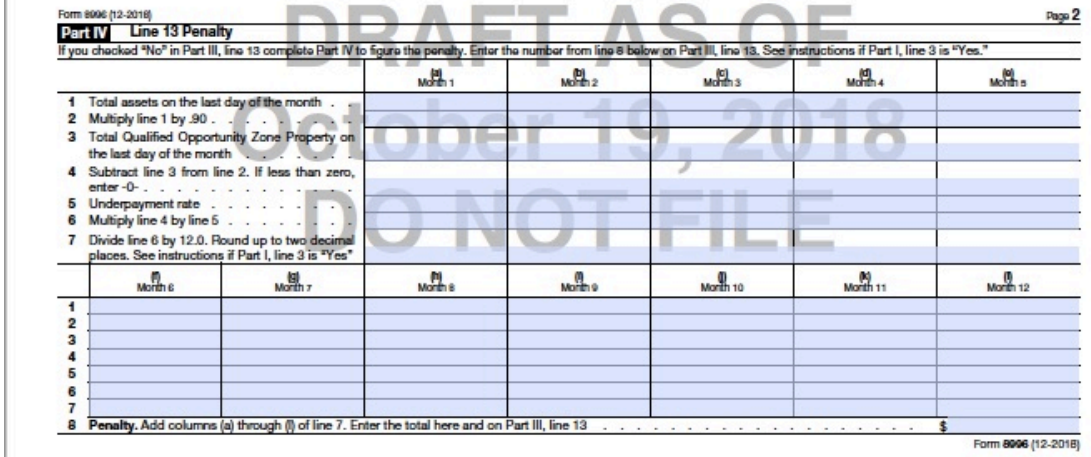
5 Total qualified opportunity zone property held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes" — 5
6 Total assets held by the taxpayer on the last day of the first 6-month period of the taxpayer's tax year. See instructions if Part I, line 3 is "Yes" — 6
7 Divide line 5 by line 6. — 7
8 Total qualified opportunity zone property held by the taxpayer on the last day of the taxpaye's tax year — 8
9 Total assets held by the taxpayer on the last day of the taxpayer's tax year — 9
10 Divide line 8 by line 9. — 10

Part III Qualified Opportunity Fund Average and Penalty

11 Add lines 7 and 10 — 11
12 Divide line 11 by 2.0. See instructions if Part I, line 3 is "Yes" — 12
13 Is line 12 equal to or more than .90?
☐ **Yes.** Enter -0- on this line and file this form with your tax return.
☐ **No.** The fund has failed to maintain the investment standard. Complete Part IV to figure the penalty. Enter the penalty from line 8 of Part IV on this line, and file this form with your tax return — 13

Cat. No. 37820G — Form **8996** (12-2018)

DRAFT AS OF October 19, 2018 DO NOT FILE



Form 8996 (12-2018) — Page **2**

Part IV Line 13 Penalty

If you checked "No" in Part III, line 13 complete Part IV to figure the penalty. Enter the number from line 8 below on Part III, line 13. See instructions if Part I, line 3 is "Yes."

	(a) Month 1	(b) Month 2	(c) Month 3	(d) Month 4	(e) Month 5
1 Total assets on the last day of the month					
2 Multiply line 1 by .90					
3 Total Qualified Opportunity Zone Property on the last day of the month					
4 Subtract line 3 from line 2. If less than zero, enter -0-					
5 Underpayment rate					
6 Multiply line 4 by line 5					
7 Divide line 6 by 12.0. Round up to two decimal places. See instructions if Part I, line 3 is "Yes"					

	(f) Month 6	(g) Month 7	(h) Month 8	(i) Month 9	(j) Month 10	(k) Month 11	(l) Month 12
1							
2							
3							
4							
5							
6							
7							

8 **Penalty.** Add columns (a) through (l) of line 7. Enter the total here and on Part III, line 13 — $

Form **8996** (12-2018)

DRAFT AS OF October 19, 2018 DO NOT FILE

Qualified Opportunity Fund: 90% Requirement

- QOZ property is either
  - Qualified opportunity zone business property ("qualified property")
  - One of two types of entity interests in entities that own qualified property
    - Qualified opportunity zone stock
    - Qualified opportunity zone partnership interests
- Generally, qualified property is new or substantially improved tangible property
- This has led practitioners to describe two types of structures, the "one tier" structure and the "two tier" structure. A QOF could have different structures for different investments

Qualified Opportunity Fund: 90% Requirement

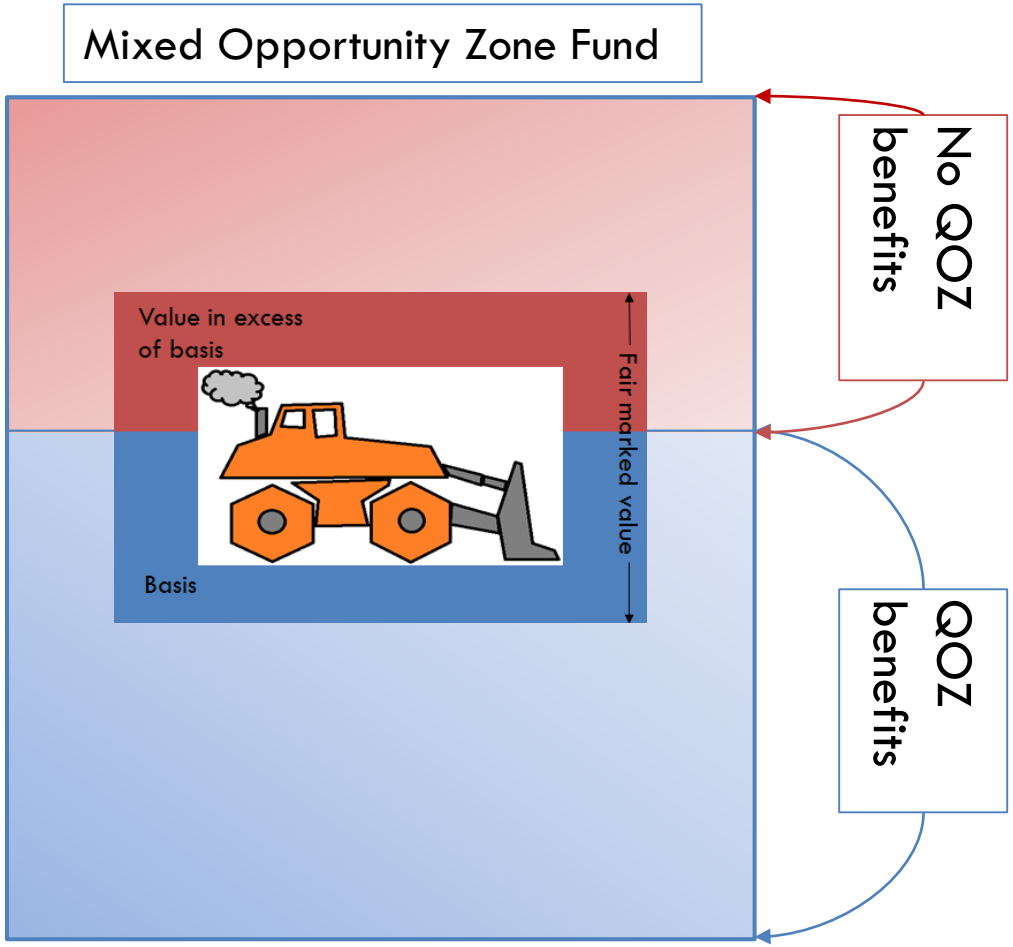
- New capital investments in the QOF (*i.e.*, contributions received in the prior six months) will not be included in the semi-annual testing
- Proceeds from sales of the QOF's underlying QOZ property will not result in penalties if reinvested in new QOZ property within a year
- The new investments and sales proceeds must be kept as cash, cash equivalents or debt instruments with a term of 18 months or less

Qualified Opportunity Fund: Mixed Fund

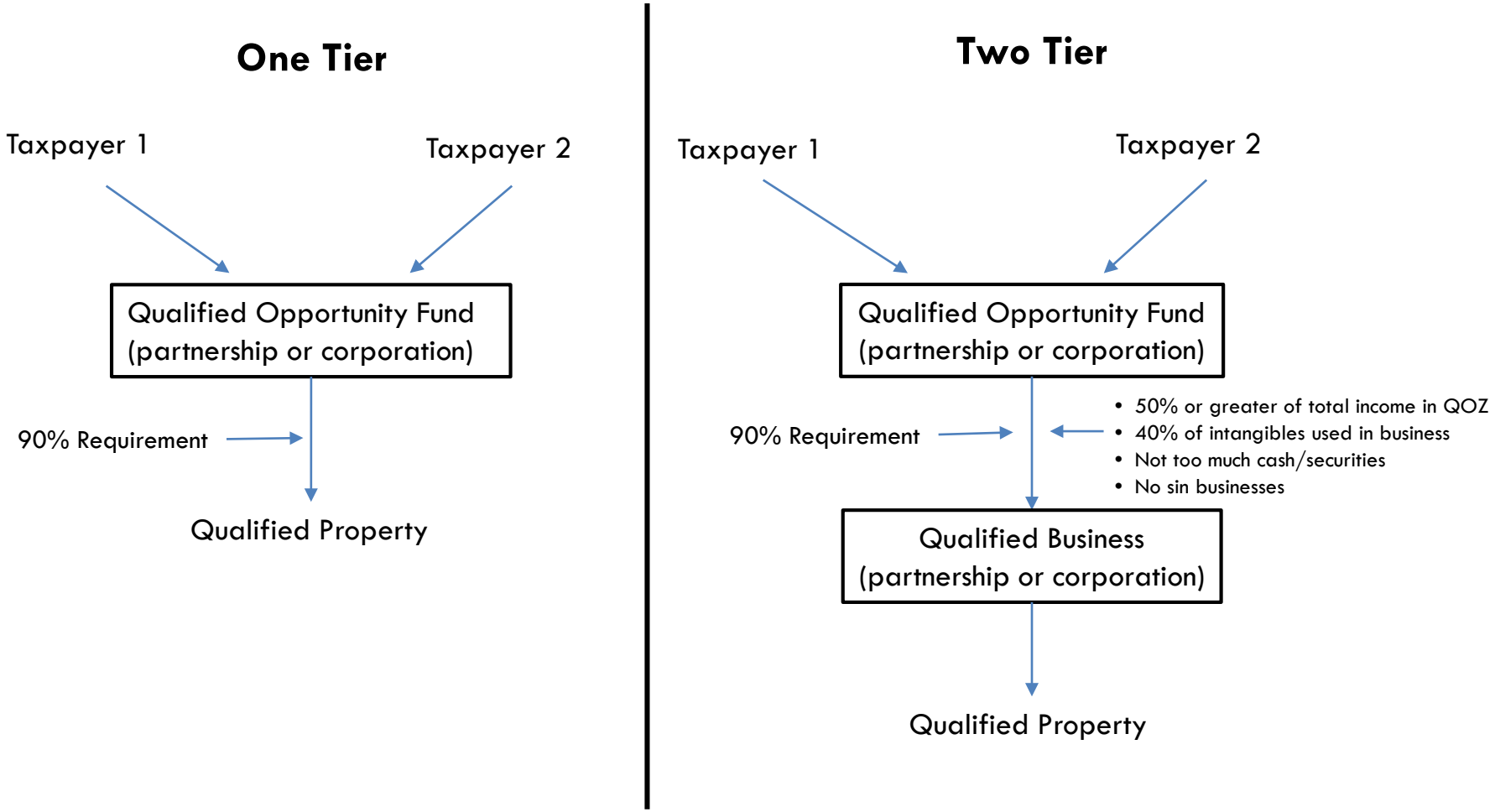
- In the case of any investment in a QOF only a portion of which consists of investments of gain to which an election is in effect, such investment is treated as two separate investments (a mixed fund). Tax benefits are available only with respect to the investment for which an election is in effect
  - For example, if a taxpayer rollovers the entire proceeds from the sale of an appreciated asset, rather than just the gain, the excess will be treated as a separate investment in the QOF and will not be eligible for tax benefits
- If property with a fair market value in excess of basis is contributed to a QOF, the amount in excess of basis is treated as a separate investment

Qualified Opportunity Fund: Mixed Fund

Investor has capital gains but chooses to contribute a partially depreciated asset instead.



Qualified Opportunity Fund: Structure



Qualified Business

Qualified Business

- The entity interest must be acquired by the Taxpayer from the entity, solely for cash, after December 31, 2017
- The entity must be a qualified business at the time of acquisition or, if the entity is new, the entity must be organized to be a qualified business
- The entity must qualify as a qualified business during substantially all (90%) of the qualified opportunity fund's holding period of the entity interest
- The entity must be domestic

Qualified Business

- A qualified business must be a trade or business
- The activities of the business must comprise the active conduct of a trade or business
- The ownership and operation (including leasing) of real property is the active conduct of a trade or business
- However, merely entering into a triple-net lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business

Qualified Business

- A qualified business is a trade or business that satisfies the substantially all requirement, which requires substantially all of the underlying value of the tangible property owned or leased by the business to be qualified property
- For this purposes, substantially all means “at least 70%”
- A qualified business must also satisfy four additional requirements

Qualified Business

$$\frac{\text{qualified property + QOZ p'ship interest + QOZ stock}}{\text{all assets of QOF}} \geq 90\%$$

90% Requirement

- Applies in "one tier" and "two tier" structures
- Looks to all assets of QOF.
- May be a 63% test (90% * 70%) in a "two tier" structure

$$\frac{\text{qualified property}}{\text{all tangible property owned or leased by qualified business}} \geq 70\%$$

Substantially All (70%) Requirement

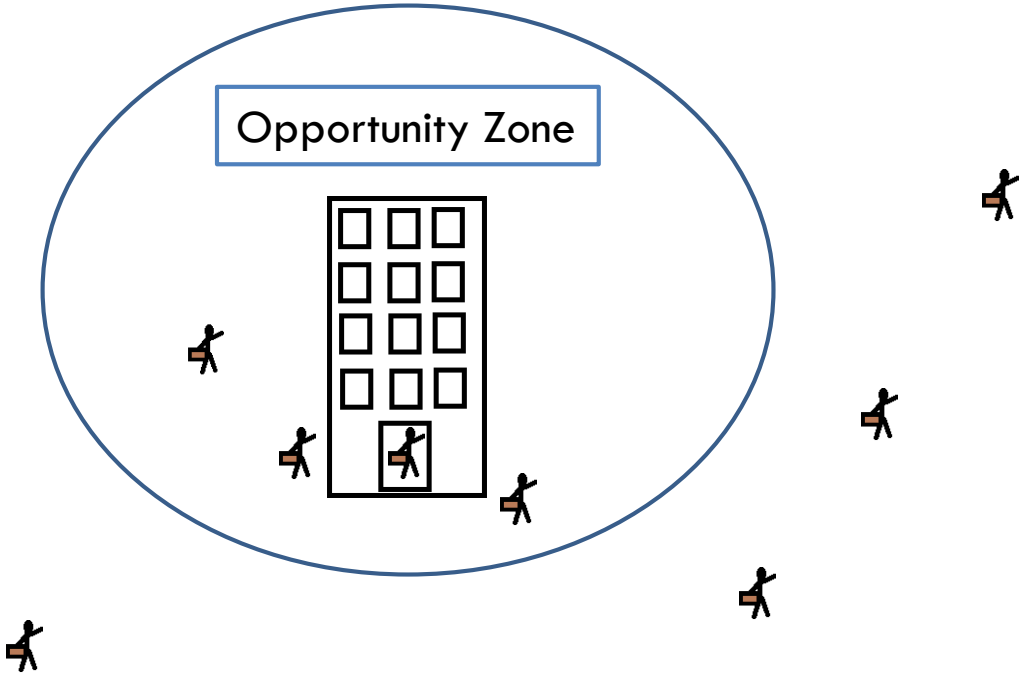
- Applies only in "two tier" structure
- Looks to tangible property of qualified business. Other assets are excluded from test
- Qualified business must also satisfy additional requirements which do not apply in "one tier" structure

Qualified Business

- The first requirement: At least 50% of the total gross income of the qualified business must be derived from the active conduct of business in the QOZ
  - Three safe-harbors are available to meet this test. If unable to meet any of the three, a QOZB may still satisfy this rule based on facts and circumstances

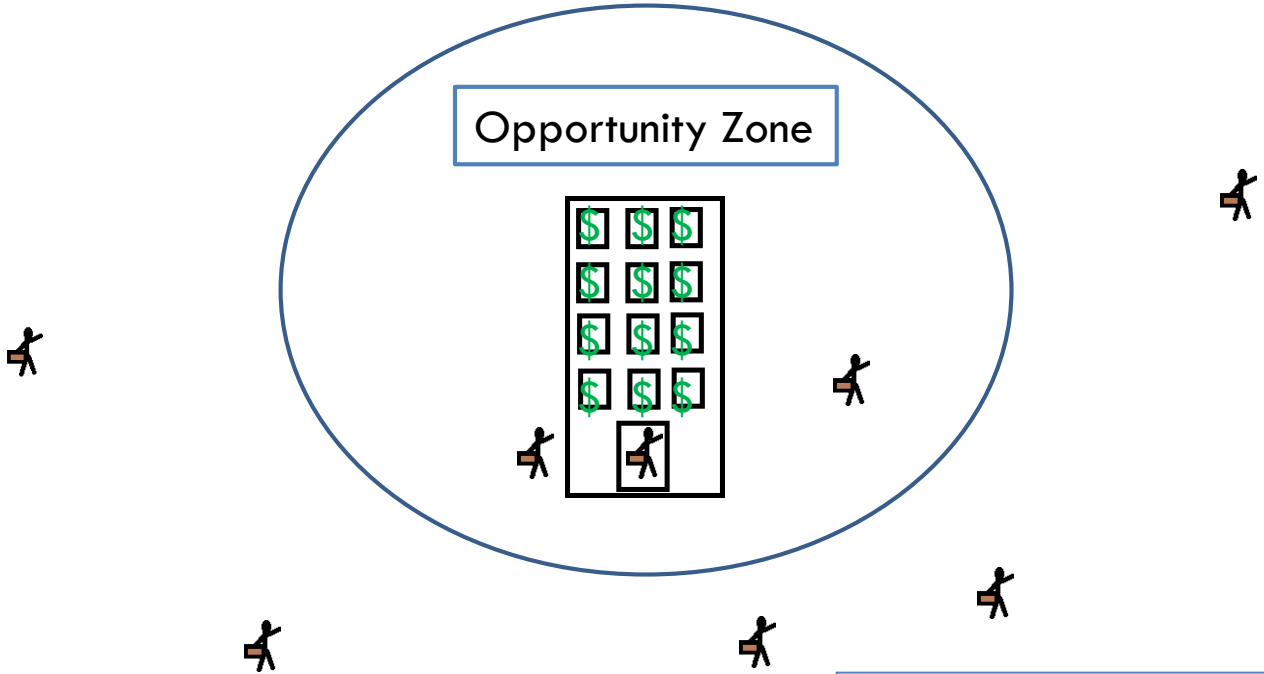
Qualified Business: Sufficient QOZ Activity Safe Harbor

First safe harbor: At least 50% of services performed (based on hours) in the QOZ by employees and contractors



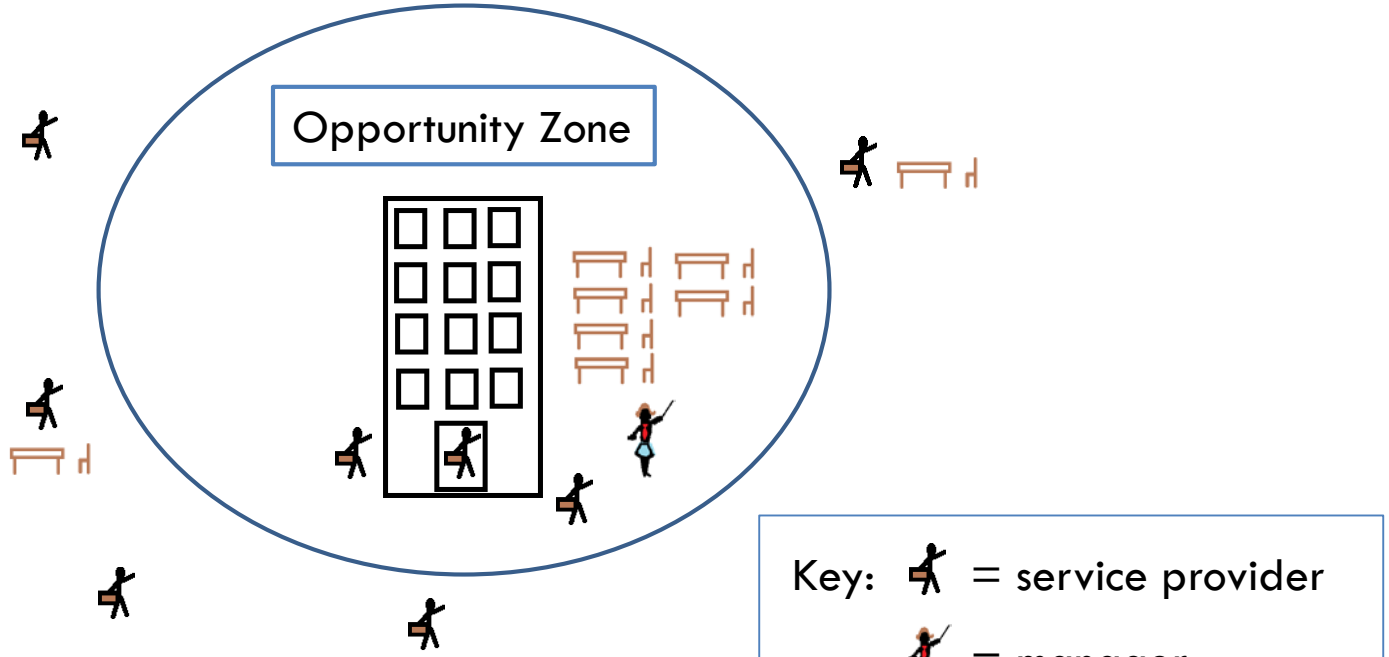
Qualified Business: Sufficient QOZ Activity Safe Harbor

Second safe harbor: At least 50% of amounts paid are for services performed in the QOZ



Qualified Business: Sufficient QOZ Activity Safe Harbor

Third safe harbor: Tangible property and operational functions combine to generate 50% of gross income



Qualified Business

- The second requirement: A substantial portion (40%) of the qualified business's intangible property must be used in the active conduct of business in the QOZ

Qualified Business

- The third requirement: Less than 5% of the average of the aggregate unadjusted bases of the property of the business is attributable to nonqualified financial property
  - Nonqualified financial property includes securities, debt, and certain financial instruments
  - A reasonable amount of working capital is allowed
  - The proposed regulations have a 31-month safe harbor for working capital for all businesses, including real estate projects. It can be extended if a written plan is not completed due to government delays

Qualified Business

- The fourth requirement: The business cannot be a golf course, country club, massage parlor, hot tub or suntan facility, racetrack or other facility used for gambling, or store whose principal business is the sale of alcoholic beverages for consumption off premises
  - This is the longstanding private activity bond blacklist

Qualified Property

Qualified Property

- Qualified property consists of tangible property used in the trade or business of a QOF or qualified business that satisfies the following
  - The property must be acquired by purchase from an unrelated individual after December 31, 2017
  - The original use of the property in the QOZ must begin with the QOF or qualified business, or the QOF or qualified business must substantially improve the property
  - Substantially all (70%) of the use of the property must be in the QOZ during substantially all (90%) of the QOF's holding period

Qualified Property

- To qualify the property must be either originally used in a QOZ or substantially improved
- Original use generally commences when the property is first placed in service within the QOZ for purposes of depreciation. So, existing structures being depreciated will not qualify
- There is exception for buildings that have been vacant for at least five years

Qualified Property

- Substantial improvement must occur within a 30-month period
- Doubling the basis of the property over any 30-month period after the property is acquired would count as substantial improvement
- Each asset must be substantially improved to qualify as qualified property. Assets cannot be aggregated
- Land:
  - Land cannot be original use property
  - The proposed regulations provide that land in a QOZ must be used in a trade or business but does not need to be substantially improved to be qualified property. Anti-abuse rules can be applied where land is acquired without a legitimate business purpose

Qualified Property: Leased Property

- Under the "two-tier" structure, leased property must be qualified property
- Leased property is qualified business property so long as:
  - the leased property is acquired under a lease entered into after December 31, 2017
  - substantially all of the use of the leased property is in a QOZ for substantially all of the period for which the business leases the property
  - the lease is a "market rate lease"
- So, QOFs can lease tribal government lands. There may be future guidance issued
- Like land, leased property need not be substantially improved, nor does its original use need to commence with the lessee
- Unlike purchased tangible property, lessor and lessee can be related parties if certain conditions are met

Comparisons and Additional Resources

Comparisons

New Market Tax Credit

- Section 45D provides tax credits for taxpayers who invest in low-income communities
- Similar to the QOZ rules, taxpayers must invest through entities
- Credit is limited to amounts allocated to investment through application process
- Investors without allocations get no benefits
- No new allocations after 2019

Like-Kind Exchanges

- Section 1031 provides taxpayers who sell property and reinvest in like-kind property with deferral of tax on gain
- In contrast to the QOZ rules, taxpayers must directly acquire replacement property
- The 2017 Tax Act limited the applicability of Section 1031

Comparisons

- QOZ tax benefits can be combined with other tax benefits for the same investment. There are no rules preventing double dipping.
- For example, taxpayers can use the new markets tax credit in a QOZ. Taxpayer can create a QOF, have that QOF qualify as a qualified community development entity ("CDE") and apply for an allocation from the Treasury. If the combined QOF/CDE is awarded an allocation, the entity could make an equity investment in a QOZB and receive both benefits
- Other examples of benefits that can be used in the QOZ include:
  - Low-income housing tax credit
  - Rehabilitation tax credit
  - Like-kind exchange provisions
  - Renewable electricity production tax credit

Additional Resources

- CDFI Fund has a map showing qualified opportunity zones, available at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx
- Notice 2018-48 (listing the qualified opportunity zones), available at https://www.irs.gov/pub/irs-drop/n-18-48.pdf
- Rev. Rul. 2018-29 (measuring substantial improvement), available at https://www.irs.gov/pub/irs-drop/rr-18-29.pdf
- First set of proposed regulations, available at https://www.govinfo.gov/content/pkg/FR-2018-10-29/pdf/2018-23382.pdf
- Second set of proposed regulations, available at https://www.govinfo.gov/content/pkg/FR-2019-05-01/pdf/2019-08075.pdf
- Request for information (reporting), available at https://www.irs.gov/pub/irs-drop/reg-120186-18.pdf