

Initial Qualified Opportunity Fund Guidance Released — Taxpayers may now Seize Qualified Opportunity Fund Program Benefits

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On October 19, 2018, the Department of Treasury and Internal Revenue Service (“IRS”) issued initial proposed regulations,¹ a Revenue Ruling,² and draft Form 8996³ and instructions⁴ for investments in qualified opportunity funds (“QOF”). This long-anticipated guidance is expected to allow investors, business owners, real estate developers, and fund managers to be able to confidently seize the powerful tax deferral, reduction, and exclusion benefits provided by the QOF program.

Background

The Tax Cuts and Jobs Act of 2017 added section 1400Z to the Internal Revenue Code to create qualified opportunity zones (“QOZ”) and QOFs. This program is designed to incentivize the reallocation of capital to designated low-income census tracts called QOZs. It presents a potentially remarkable opportunity for taxpayers to defer and reduce capital gain and subsequently exclude the appreciation of a QOF interest from income.

New Code section 1400Z-1 addresses QOZs. A QOZ is a designated population census tract that is in a low-income community. Under Code section 1400Z-1, the chief executive of each state and U.S. territory can nominate low-income census tracts to be designated by the IRS as QOZs. To date, the IRS has designated over 8,700 QOZs,⁵ 44 of which are located in Nebraska.⁶

New Code section 1400Z-2 creates QOFs. As discussed in more detail below, a QOF is an investment vehicle for investing in eligible property that is located in a QOZ. A QOF must be taxed as a corporation or partnership for federal income purposes and invest at least 90% of its assets in QOZ property.

¹ IRS REG-115420-18, *Investing in Qualified Opportunity Funds*, is available [here](#).

² Rev. Rul. 2018-29, *Special Rules for Capital Gains Invested in Opportunity Zones*, is available [here](#).

³ Draft Form 8996, *Qualified Opportunity Funds*, is available [here](#).

⁴ Draft Instructions for Form 8996 are available [here](#).

⁵ IRS Notice 2018-48, *Designated Qualified Opportunity Zones under Internal Revenue Code § 1400Z-2*, is available [here](#).

⁶ Information about the designated QOZs in Nebraska can be found [here](#) and [here](#).

Potential Benefits

Taxpayers who timely reinvest a capital gain realized after December 31, 2017 from the sale of property to an unrelated third party into a QOF can qualify for three tax benefits. While qualifying for any of the benefits would generally be considered a tax planning success, qualifying for all of the benefits (especially if the value of the interest in the QOF interest substantially appreciates) would be a “homerun” result.

First, recognition of (and the payment of taxes on) the reinvested capital gain is deferred until the earlier of the date that the QOF interest is sold or December 31, 2026.⁷

Second, the amount of the deferred gain ultimately recognized is reduced by up to 10% if the QOF interest is held for 5 years and by up to an additional 5% to a total of 15% if the QOF interest is held for 7 years.⁸ To take full advantage of this up to 15% permanent exclusion, taxpayers must reinvest their deferred capital gain in a QOF on or before December 31, 2019.

Finally, if held for 10 years, taxpayers may make a tax-free sale of a QOF interest and permanently exclude from income the appreciation of the QOF interest.⁹ The original deferred gain would still be taxed, but only 85% of such gain would be taxed if it was timely reinvested in a QOF on or before December 31, 2019.

The following example illustrates the potential benefits of the QOF program. In this example, an individual taxpayer is assumed to:

- Sell stock, business assets, or other assets to an unrelated person and realize a \$10 million long-term capital gain in November 2018;
- Reinvest the \$10 million capital gain in a QOF on December 31, 2018; and
- Sell the QOF interest on January 1, 2029 for \$20 million.

⁷ Code § 1400Z-2(b)(1).

⁸ Code § 1400Z-2(b)(2)(B).

⁹ Code § 1400Z-2(c).

Deferral and up to 15% Permanent Exclusion

The following table illustrates the deferral and up to 15% permanent exclusion of the deferred capital gain benefits for an individual taxpayer who is assumed to be a Nebraska resident and an individual taxpayer who lives in a state like Florida, South Dakota, or Texas, which does not impose a state income tax. The investor who does not reinvest in a QOF in the below example is assumed to reinvest all after-tax proceeds of the \$10 million long-term capital gain in a non-QOF investment.

	NE QOF Investment	NE No QOF Investment	FL, SD, TX QOF Investment	FL, SD, TX No QOF Investment
LTCG Realized	\$10,000,000	\$10,000,000	\$10,000,000	\$10,000,000
LTCG Recognized	\$0	\$10,000,000	\$0	\$10,000,000
Federal Taxes ¹⁰	\$0	(\$2,380,000)	\$0	(\$2,380,000)
State Taxes ¹¹	\$0	(\$684,000)	\$0	\$0
Reinvestment	\$10,000,000	\$6,936,000	\$10,000,000	\$7,620,000
Deferred Federal Taxes ¹²	(\$2,023,000)	\$0	(\$2,023,000)	\$0
Deferred State Taxes ¹³	(\$581,400)	\$0	\$0	\$0
Total Taxes	(\$2,604,400) due in 2027	(\$3,064,000)	(\$2,023,000) due in 2027	(\$2,380,000)
Present Value of Total Taxes Paid as of 2019 ¹⁴	(\$1,762,760)	(\$3,064,000)	(\$1,369,246)	(\$2,380,000)

¹⁰ Federal income taxes are assumed to be 20% for the long-term capital gain plus 3.8% for the net investment income tax.

¹¹ Nebraska state income taxes are assumed to be 6.84% and non-deductible. It is also assumed in these calculations that Nebraska will follow the federal QOF provisions and not decouple from the federal QOF benefits.

¹² \$8,500,000 of the original \$10,000,000 capital gain would be recognized on December 31, 2026.

¹³ *Id.*

¹⁴ Present value of total taxes on QOF Investments calculated using a 5% discount rate from 2019 (when the taxes would be due) until 2027 (when the taxes are ultimately due).

Permanent Exclusion of Gain on Sale of QOF Interest

The following table builds on the above table and illustrates the potential permanent exclusion benefit for an individual taxpayer who sells his or her interest in a QOF to an unrelated third party after holding the interest for at least ten years. Tax rates are assumed to remain at their 2018 levels, the investors who invested in the QOFs are assumed to have paid their taxes on the deferred long-term capital gains that were recognized on December 31, 2026 with other available cash and to have not sold any interest in the QOF to pay the deferred taxes, and the value of the investment is assumed to have doubled.

	NE QOF Investment	NE No QOF Investment	FL, SD, TX QOF Investment	FL, SD, TX No QOF Investment
Invested Amount (2018)	\$10,000,000	\$6,936,000	\$10,000,000	\$7,620,000
Sales Proceeds (2029)	\$20,000,000	\$13,872,000	\$20,000,000	\$15,240,000
Federal Taxes on Sale	\$0	(\$1,650,768)	\$0	(\$1,813,560)
State Taxes on Sale	\$0	(\$474,422)	\$0	\$0
Deferred Federal Taxes ¹⁵	(\$2,023,000)	\$0	(\$2,023,000)	\$0
Deferred State Taxes ¹⁶	(\$581,400)	\$0	\$0	\$0
After-Tax Cash	\$17,395,690	\$11,746,810	\$17,977,000	\$13,426,440

Basic Statutory Requirements

The three general requirements imposed by Code section 1400Z-2 are:

- A capital gain from the sale or exchange of stock, business assets, or any other asset to an unrelated third party that is realized after December 31, 2017 and on or before December 31, 2026;¹⁷
- A reinvestment of the capital gain to be deferred in a QOF within the 180-day period, beginning on the date of the sale or exchange that triggered the capital gain;¹⁸ and
- The investment by the QOF of at least 90% of its assets in QOZ property.¹⁹

¹⁵ \$8,500,000 of the original \$10,000,000 long-term capital gain would be recognized on December 31, 2026.

¹⁶ *Id.*

¹⁷ Code § 1400Z-2(a)(1) and (2).

¹⁸ Code § 1400Z-2(a)(1)(A).

¹⁹ Code § 1400Z-2(d)(1).

A QOF must (i) be organized as a partnership or corporation for federal income tax purposes, (ii) be organized to invest in QOZ property, and (iii) invest at least 90% of its assets, calculated as the average of two semiannual testing dates, in QOZ property.²⁰

Qualified opportunity zone property consists of (i) QOZ business property, (ii) QOZ corporate stock, and (iii) QOZ partnership interests.²¹ A QOF can hold a direct investment by investing in QOZ business property or an indirect investment by investing in a portfolio company that issues QOZ corporate stock or partnership interests.

Qualified opportunity zone business property is tangible business property if used in a trade or business if (i) the property is acquired by purchase from an unrelated third party after 2017, (ii) the original use of the property in the QOZ commences with the QOF or the QOF substantially improves the property, and (iii) during substantially all of the QOF's holding period for the property, substantially all of the property is in the QOZ.²² Property is treated as substantially improved if, during any 30-month period, capital expenditures are made with respect to such property at least equal to the property's acquisition cost.²³

Qualified opportunity zone stock and QOZ partnership interests are equity interests of a domestic entity if (i) the equity interest was acquired by a QOF after December 31, 2017 at its original issue solely in exchange for cash, (ii) at the time of issuance, the issuing entity was a QOZ business (or if newly formed, was being organized to be a QOZ business), and (iii) during substantially all of the QOF's holding period for the equity interest, the issuing entity qualified as a QOZ business.²⁴

A QOZ business is a trade or business in which (i) substantially all of the tangible property, if any, owned or leased by the business is QOZ business property; (ii) at least 50% of the gross income is derived from the active conduct of a trade or business in the QOZ; (iii) a substantial portion of the intangible property of the entity is used in the active conduct of a trade or business; (iv) less than 5% of the basis of the property of such business is attributable to "nonqualified financial property;" and (v) the entity does not engage in, or lease land to, a "sin business."²⁵ Nonqualified financial property includes debt, stock, partnership interests, options, future contracts, forward contracts, warrants, notational principal contracts, and annuities but excludes reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a

²⁰ *Id.*

²¹ Code § 1400Z-2(d)(2)(A).

²² Code § 1400Z-2(d)(2)(D)(i).

²³ Code § 1400Z-2(d)(2)(D)(ii).

²⁴ Code §§ 1400Z-2(d)(2)(B) and 1400Z-2(d)(2)(C).

²⁵ Code § 1400Z-2(d)(3)(A).

term of 18 months or less.²⁶ Sin businesses include golf and country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks, gambling facilities, and liquor stores.²⁷

October 2018 Guidance

The statutory language raised many questions and, because of the tax risk and uncertainty, many investors, business owners, real estate developers, and fund managers (and their advisors) were wary of moving forward with QOF investments and projects until the IRS provided further clarity. The October 2018 guidance, while not answering all questions, did provide sufficient clarity to allow many interested parties to confidently move forward with QOF investments and projects. Taxpayers and QOFs may generally immediately rely on the proposed regulations, assuming that the taxpayer or QOF follows the applicable rules in their entirety and in a consistent manner.²⁸

Working Capital Safe Harbor

The proposed regulations provide a working capital safe harbor for QOF investments in QOZ businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in an opportunity zone. Under this safe harbor, working capital assets are treated as reasonable in amount if (i) these amounts are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ; (ii) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital within 31 months of the receipt by the business of the assets; and (iii) the working capital assets are actually used in a manner substantially consistent with (i) and (ii) above.²⁹

The working capital safe harbor alleviates significant concerns that a QOZ business would have had to invest up to 90% of its cash within no more than six months of being formed, as this cash would be a “bad” asset for purposes of the QOZ property testing requirements. The safe harbor, which does not yet apply to directly owned QOZ business property, should provide a sufficient amount of time for QOZ businesses to deploy contributed cash from deferred capital gains.

²⁶ Code § 1397C(e).

²⁷ Code § 1400Z-2(d)(3)(A)(iii).

²⁸ Prop. Treas. Reg. §§1.1400Z-2(a)-1(e), 1.1400Z-2(c)-1(d), 1.1400Z-2(d)-1(f), and 1.1400Z-2(e)-1(c).

²⁹ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(iv).

Favorable Guidance for Land

Prior to the issuance of Rev. Rul. 2018-29, there was concern as to whether the original use of land could ever be considered to have commenced with a QOF and constitute QOZ business property. Rev. Rul. 2018-29 provides that a QOF is not required to substantially improve land in order for it to qualify as QOZ business property. Under Rev. Rul. 2018-29, a building located on land within a QOZ is treated as substantially improved if, during any 30-month period beginning after the date of acquisition of the building, additions to the taxpayer's basis in the building exceed an amount equal to the taxpayer's adjusted basis of the building at the beginning of such 30-month period. Further, the fact that the cost of the land within the QOZ upon which the building is located is not included in the taxpayer's adjusted basis in the building does not mean that the taxpayer is required to separately substantially improve the land for it to qualify as QOZ business property. Rev. Rul. 2018-29 provides welcome relief and a feasible path for QOFs to rehabilitate existing buildings located in QOZs.

In addition, the examples contained in the proposed regulations provide comfort with respect to the purchase of land and the new development of a building in a QOZ. In one example, a taxpayer timely reinvests a capital gain in a QOF, which immediately acquires a partnership interest with the cash from the deferred gain. In the example, the partnership had written plans to acquire land in a QOZ on which it planned to construct a commercial building. The written plan called for a portion of the cash to be used to purchase land, a portion of the cash to be used to construct the building, and a portion of the cash to be used on ancillary project expenses. All expenditures were timely made within 31 months in accordance with the written plan. The example notes that all the cash is reasonable working capital, that the partnership satisfies the QOZ business requirements, and that the QOF's interest in the partnership is a QOZ partnership interest for purposes of the 90% test.³⁰

Reinvesting Pass-Through Capital Gains

The proposed regulations provide that a partnership and other pass-through entities (including S corporations, trusts, and decedents' estates) are eligible taxpayers that may elect to defer capital gain recognition by timely reinvesting a capital gain in a QOF.³¹ In addition, if a partnership or other pass-through entity does not elect to defer capital gain by reinvesting in a QOF, the 180-day period with respect to the reinvestment of a partner's, shareholder's, or beneficiary's eligible capital gains generally begins on the last day of the partnership's or pass-through entity's taxable year.³² The proposed regulations also have an elective rule allowing a

³⁰ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(5)(viii).

³¹ Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(1) and -1(c)(3).

³² Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(2)(iii)(A) and -1(c)(3).

partner of a partnership or shareholder or beneficiary of a pass-through entity that is not reinvesting its capital gain in a QOF to reinvest the pass-through capital gain within 180 days of the partnership or other pass-through entity realizing the capital gain.³³ This rule allows flexibility for a partner, shareholder, or beneficiary to still timely reinvest an eligible capital gain that was realized by a partnership or other pass-through entity early in 2018 into a QOF, despite more than 180 days passing since the gain was realized by the partnership or other pass-through entity.

70% Tangible Asset Test for Opportunity Zone Businesses

As discussed above, a QOF must invest 90% of its assets in QOZ property, which includes QOZ stock and QOZ partnership interests. The entity issuing QOZ stock or QOZ partnership interests must be a QOZ business. Only “substantially all” of a QOZ business’s tangible assets must be QOZ business property. Under the proposed regulations, “substantially all” for this purpose is defined as 70% of the tangible property owned or leased by a QOZ business.³⁴ This provides needed flexibility for operating companies that are not real estate businesses, such as technology startups, to satisfy the QOZ business requirements. In light of this flexibility, it is likely that most QOF investments in operating companies will be structured as indirect investments in which the QOF invests in QOZ stock or QOZ partnership interests issued by an entity that is a QOZ business. This tangible asset flexibility, combined with there being no requirement that a QOZ business own any tangible assets, makes it possible for a technology startup located in a QOZ that owns only intellectual property to issue QOZ stock or QOZ partnership interests. Accordingly, a carefully structured investment, even in a startup, can qualify for QOF benefits.

Valuing Assets

Prior to the issuance of the proposed regulations, there was uncertainty about how assets would be valued for purposes of determining whether 90% of a QOF’s assets are QOZ property. For purposes of the calculation of the 90% test, the proposed regulations require the QOF to use the asset values that are reported on the QOF’s applicable financial statement for the taxable year, as defined in Treas. Reg. §1.475(a)-4(h) (which generally includes a financial statement that has significant business use).³⁵ QOFs that use GAAP financial statements may find it difficult to satisfy the 90% test because GAAP accounting takes into account impairment and depreciation charges. If a QOF does not have an applicable financial statement, the proposed regulations require the QOF to use the cost of its assets to determine whether the 90% test is satisfied.³⁶

³³ Prop. Treas. Reg. §1.1400Z-2(a)-1(c)(2)(iii)(B) and -1(c)(3).

³⁴ Prop. Treas. Reg. §1.1400Z-2(d)-1(d)(3)(i).

³⁵ Prop. Treas. Reg. §1.1400Z-2(d)-1(b)(1).

³⁶ Prop. Treas. Reg. §1.1400Z-2(d)-1(b)(2).

QOF and Investor Borrowings

Prior to the issuance of the proposed regulations, there was substantial concern that the deemed contribution rules for partnership borrowings under Code section 752(a) could result in a deemed additional investment if a QOF that is taxed as a partnership uses leverage. This could have jeopardized an investor's ability to meet the 180-day capital gain reinvestment timing requirements, with the deemed additional investment being treated as a separate non-qualifying investment. Under the proposed regulations, the deemed contribution of money described in Code section 752(a) does not create or increase an investment in a QOF that is taxed as a partnership.³⁷ This guidance will allow QOFs that are taxed as partnerships to use leverage.

The proposed regulations also allow taxpayers to use their interest in a QOF fund as collateral for a loan, whether as part of a purchase-money borrowing or otherwise.³⁸ This guidance will allow taxpayers to potentially access their invested capital by borrowing against a QOF interest without losing the QOF tax benefits.

Tax-Deferred Reinvestment of Previously Deferred Gains

If a taxpayer acquires an original interest in a QOF in connection with a capital gain deferral election, a later sale or exchange of that interest generally triggers taxable recognition of the deferred gain. Under the proposed regulations, a taxpayer who has sold his, her, or its entire interest in a QOF may continue to defer the original gain by making a qualifying new investment in a QOF before the earlier of 180 days of the sale of the entire QOF interest or December 31, 2026.³⁹ This provides flexibility for taxpayers to potentially exit an underperforming QOF investment and invest in another QOF investment without losing the tax deferral and other benefits. The proposed regulations note that forthcoming regulations will address what "reasonable period" a QOF has to reinvest proceeds from the sale of qualifying assets without paying a penalty.

QOF Self-Certification and Reporting

In order to facilitate the certification process and minimize the information collection burden placed on taxpayers, the proposed regulations generally permit any taxpayer that is a corporation or partnership for tax purposes to self-certify as a QOF, provided that the self-certifying entity is statutorily eligible to do so. The proposed regulations permit the Commissioner to determine the

³⁷ Prop. Treas. Reg. §1.1400Z-2(e)-1(a)(2).

³⁸ Prop. Treas. Reg. §1.1400Z-2(a)-1(b)(3)(ii).

³⁹ Prop. Treas. Reg. §1.1400Z-2(e)-1(b)(4)(ii)(Ex 4).

time, form, and manner of the self-certification in IRS forms and instructions or in guidance published in the Internal Revenue Bulletin.⁴⁰ The IRS published draft Form 8996, Qualified Opportunity Fund, which QOFs will use for both initial self-certification and annual compliance reporting with respect to the requirement that 90% of the QOF's assets be held in QOZ property. The Explanation of Provisions contained in the proposed regulations notes that taxpayers will make elections to defer capital gains that are timely reinvested in a QOF on Form 8949. Form instructions for how a taxpayer may elect to defer a capital gain reinvested into a QOF are expected to be released in the near future.

Open Items

Unanswered questions following the issuance of the October 2018 guidance include:

- Will the working capital safe harbor in the proposed regulations for indirectly owned QOZ businesses be extended and apply equally to directly owned QOZ business property?
- What “reasonable period of time” will a QOF have to reinvest capital from the sale of QOZ property?
- How will losses from a QOF taxed as a partnership for federal income tax purposes be treated in light of the zero basis rule for QOF interests?
- What constitutes a “trade or business” for purposes of the QOF program?
- What constitutes “active conduct” for purposes of the QOF program?
- How will “substantially all” be defined when used in Code section 1400Z-2 other than in the context of tangible personal property, which the proposed regulations address?

Conclusion

The QOF program offers potentially remarkable tax planning and tax savings benefits. While the October 2018 guidance does not address all concerns regarding the program, it does provide significant guidance which should give investors, business owners, real estate developers, and fund managers a high degree of confidence in moving forward with appropriate and carefully structured QOF investments and projects. If you have any questions about the QOF program, please contact the authors at jeff.schaffart@koleyjessen.com or at 402-343-3716 or michael.keblesh@koleyjessen.com (402-343-3801).

⁴⁰ Prop. Treas. Reg. §1.1400Z-2(e)-1(a)(1)(i).

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