

Qualified Opportunity Zones: Where Do We Stand?

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On December 19, 2019, the Internal Revenue Service (IRS) issued Final Regulations relating to Qualified Opportunity Zones.

The basic benefits of the Qualified Opportunity Zone Program are outlined below:

1. If the Qualified Opportunity Fund (QOF) investment is held for seven years, the taxpayer will pay tax in 2026 on 85% of their gain invested. Since we are now in 2020, this benefit has lapsed for new investment in QOFs.
2. If the QOF investment is held for five years, the taxpayer will pay tax in 2026 on 90% of the gain invested.
3. If the QOF investment is held for at least 10 years by the time it is sold, the gain on the investment in the QOF would be free of tax.

The major changes that the final regulations have made to the program are explained below.

Section 1231 gains

The final regulations take a gross approach to 1231 gains. This means that if you have a 1231 gain (a gain from the sale of rental real estate), you can invest the gain proceeds in a QOF. Prior to the issuance of the Final Regulations, the taxpayer had to wait until year-end and net 1231 gains. 1231 losses and only a net gain could be invested in a QOF.

Sale of QOF assets

Under the Final Regulations, a QOF investor can exclude gains, including depreciation recapture, that flow to the taxpayer from a pass-through QOF. This now clarifies the concern that an investor would need to sell their QOF investment after 10 years in order to exclude the gain.

How to value improvements to existing property

Certain betterment expenses, such as environmental remediation or utility upgrades, can currently be included in the costs for the improvement requirement, even though they are included in land on the balance sheet of the QOF. In addition, QOFs can now aggregate multiple properties to measure the improvement requirement provided the properties are included in one deed, or in multiple deeds as long as the properties are contiguous and related in use or management.

Vacant property

Property that has been vacant for three years, or vacant on the date of publication of the QOZ designation and has been vacant for one year, is qualified as new use property under the plan. Prior to this change, the vacancy period was five years.

90% investment standard

A taxpayer can choose one of two methods in valuing the investment as tangible property. The taxpayer can either use the value as stated on their applicable financial statement (audited statement), or their unadjusted cost basis. Leases are always valued using present value at the start of the lease and remain constant for future periods.

Leased property

Leased property located in a QOZ may be treated as QOZ property when calculating the 90% test for QOZ assets. To calculate the 90% test, you must count the present value of the lease in the numerator and denominator.

50% of gross-income test

A Qualified Opportunity Zone Business (QOZB) must derive at least 50% of its gross income within the QOZ. The QOZB has a safe harbor if 50% of its labor input is derived in the QOZ. The labor can be measured in terms of hours or dollars. Guaranteed payments to partners qualify as wages for this test. Labor includes employees, independent contractors and employees of independent contractors. Lastly, this test will be met if 50% of the tangible property is in the QOZ, and the management and operational functions performed in the QOZ are necessary to generate at least 50% of the gross income.

Re-investment

A QOF can re-invest sale proceeds or a return of capital from an investment in another QOZB within 12 months and still meet the 90% test and not be taxed on the gain.

Expiration of QOZ designation

An investment in a QOZB will satisfy the 10-year holding period even if the QOZ designation expires within the 10 years, as long as the disposition of the investment is before January 2048.

Gain from an installment sale

A gain from an installment sale can be invested in a QOF in the year any proceeds are received which trigger recognition of a gain. You have 180 days from either the date the payment was received or from December 31 in which to invest the gain proceeds from an installment sale.

Other than cash investment

The value of a noncash asset invested in a QOF is equal to the investor's basis in the asset transferred to the QOF.

Inclusion event

An inclusion event is an event that triggers (accelerates) the recognition of the deferred gain or portion of the deferred gain. This includes:

- Any event that reduces the investor's equity investment in a QOF
- Distribution from a QOF in excess of the investor's basis
- A QOF losing its QOF status
- A transfer of ownership, other than upon death

When do you have to invest your gain proceeds by?

If the gain is from a pass-through entity that has not elected to defer the gain, a taxpayer has three options for when they can invest their gain proceeds in a QOF:

1. Within 180 days from the time the pass-through entity recognized the gain
2. Within 180 days from the pass-through entity's year-end (usually 180 days from December 31)
3. Within 180 days from the original due date of the pass-through entity's tax return (usually 180 days from March 15)

The above is a summary of the key points of the more than 500 pages of the regulations based on the most commonly asked questions I receive.

The Qualified Opportunity Zone Program is quite complex, so be sure to consult with experts in the area before diving in.

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