Understanding Qualified Opportunity Zones: What Estate Planners Need to Know

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Introduction

- The Tax Cuts and Jobs Act of 2017 added *Internal Revenue Code Section 1400Z*, which created a new program to encourage investment and job creation in economically distressed communities designated as *qualified opportunity zones* (QOZs)

- At its core, this program provides *preferential tax treatment and benefits for investors who reinvest capital gains into QOZs*

- Much has been written about the tax benefits of the QOZ program; however, there has been less discussion of whether these investments are appropriate for individual investors
Overview of the QOZ Program
Background and Definitions

• A QOZ is an **economically-distressed community** where new investments, under certain conditions, may be eligible for preferential tax treatment.

• A community qualifies as a QOZ if it is **nominated by the state** where it is located, and that nomination has been **certified by the IRS**.

• A complete list of all QOZs, updated as of December 14, 2018, is available at the U.S. Department of the Treasury’s Community Development Financial Institutions Fund website: [https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx](https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx)
How an Investment is Made in a QOZ

There are in essence two ways in which an investment can be made in a QOZ:

1. For institutional-scale investors, a direct investment can be made in a property or a business located in a QOZ, e.g., a real estate development firm may buy a building located in a QOZ, or a company may choose to locate an office in a QOZ, e.g. through a long-term lease rather than a purchase of property.

2. For non-institutional scale investors, a qualified opportunity fund (QOF) is an investment vehicle that allows individual investors to partake in the tax benefits of the QOZ program:
   - A QOF is set up as either a domestic partnership or corporation which invests in eligible property that is located within a QOZ; investors can invest gains from a prior transaction in the QOF and receive the preferential tax benefits of the QOZ program.
   - We will focus on evaluating the merits of an individual investor investing in a QOF, and the terms QOZ and QOF may be used interchangeably.
Proposed Regulations Pertaining to the QOZ Program

- **Two sets of proposed regulations** pertaining to the QOZ program have thus far been released

  - **REG-115420-18 (October 19, 2018)**
    - provided guidance to *encourage initial individual investment* in QOFs

  - **REG 1201866-18 (April 17, 2019)**
    - provided more guidance for *businesses operating and investing in QOZs*
Understanding Potential Tax Benefits
Three Potential Tax Benefits

1. The ability to defer the capital gain on the sale or disposition of property to an unrelated person, provided the gain is reinvested into a QOF within 180 days of the sale or disposition. The deferral is available until the earlier of (a) the date on which the subsequently acquired interest in the QOF is sold or exchanged, or (b) December 31, 2026

2. The elimination of up to 15% of the gain reinvested in the QOF, provided certain holding periods are met and

3. The elimination of any gain realized on the QOF interest from the time of initial investment to the sale or exchange of the QOF interest may be eliminated for federal income tax purposes through a step-up in basis of the fund interest to its fair market value on that date, if the QOF interest is held for a minimum of ten years
Reinvestment and Possible Deferral of Gains

• In order to qualify for the federal income tax benefits of the QOZ program, an investor must reinvest gain (long-term or short-term, actual or deemed) from the sale or disposition of property into a QOF **within 180 days of the property’s sale or disposition** to an unrelated party (subject to potential relief in the case of certain pass-through entities)

• The investor must also make an **election to defer the gain**, in whole or in part, by filing **Form 8949** (Sale and Other Dispositions of Capital Assets) with the Federal income tax return for the tax year in which the tax on that gain would otherwise be due if it were not deferred
Reinvestment and Possible Deferral of Gains

• By investing the gain in the QOF and making the appropriate election, the tax due on the gain is deferred until the earlier of the investor’s sale of the subsequently acquired QOF interest or December 31, 2026

• If only a portion of the gain is reinvested into the QOF, then only that part of the gain that was invested in the QOF is eligible for deferral
  • If both capital gains and principal (or cash from other sources) are invested into a QOF, the investment will be treated as two separate investments into the fund
  • Gains incurred within the fund on the portion of the initial investment sourced from non-capital gains are not eligible for either reduction of gain (through a step-up in basis) nor elimination of gain at time of sale of the fund.
Special Considerations

• For **partners, members of LLCs and S-corporation shareholders**, the 180-day period begins to run at the end of the entity’s tax year including the date of sale. REG-115420-18 (October 19, 2018)

• For **1231 gains**, the 180-day period begins to run at the end of the entity’s tax year including the date of sale. REG 1201866-18 (April 17, 2019)
Tax Benefits Beyond Deferral

• While the deferral of tax due in and of itself is a tremendous benefit, the incentives of the QOZ program go well beyond deferral

• While an investor’s basis in a QOF interest is initially zero, the basis is increased by an amount equal to:
  • **10% of the deferred gain** if an investor holds the QOF interest for at least five years
  • **15% of the deferred gain** if an investor holds the QOF interest for at least seven years

• Given that the end date for tax deferral of gains is December 31, 2026, an investor must invest in a fund by:
  • **the end of 2019** to obtain a step-up in basis of **15%**
  • **the end of 2021** to obtain a step-up in basis of **10%**
Possible Elimination of Gain

- Perhaps most significantly from a tax savings point of view, if the QOF interest is held for a minimum of ten years and the taxpayer makes the appropriate optional election, any gain on the QOF interest itself, from the time of initial investment to sale or exchange of the QOF interest will be eliminated for federal income tax purposes through a step-up in basis of the QOF interest to its fair market value on the date of sale or disposition.

- This benefit is important in mitigating concerns around one important unknown: which year’s tax rates will apply when the inclusion of the deferred gain occurs (i.e., the tax rate in the year that the gain was initially deferred or the tax rate in the year that the gain in included and taxable to the investor)?
  - In the absence of this benefit – eliminating gain on the QOF interest in certain circumstances – the risk that tax rates will increase during the period that the gain is deferred may reduce the benefit of the 10-15% reduction in gain as the QOF is held for the 5 to 7 year holding period.
QOZs as an Investment
Threshold Questions for Investors to Ask

• When viewed through a tax planning lens, the benefits of investing in a QOF almost seem too good to be true

• However, it is important to recognize that, in order to reap these tax benefits, an individual investor must have several specific characteristics:

  • As a threshold matter, the investor must have realized gains not yet recognized for federal income tax purposes; and

  • An investor must have a tolerance for illiquidity. The investor must be willing and able to reinvest and lock up such gains for an additional period of time, i.e., the investor must have capital that is not necessary to meet lifestyle needs or other immediate financial goals

  • An investor must have a high tolerance for investment risk
Diversification and Liquidity Considerations

• How does the investment of a QOF fit into an investor’s overall portfolio and affect his or her asset allocation goals?

• How much of the client’s portfolio is illiquid? How diversified are their current illiquid investments?

• Are the QOF’s holdings diversified, such as by location and property type?

• Will the client have sufficient liquid assets to pay the tax liability on December 31, 2026?
Investment Risk

- Redevelopment Real Estate projects historically are among the riskiest investment options

- QOFs are an entirely new category of asset class where no manager has a track record
  - a “backcast” of past real estate development projects that would have qualified is not analogous to an actual history of performance

- One must also consider implementation risk
  - A lot of money is being put to work in a short period of time
  - There are a limited amount of developers
    - Does the team running the development project have experience running this type of investment?
  - A lot of money will be seeking to exit at the same time in 2027 and will be competing with newer projects
State and Local Legal and Tax Considerations

• Projects undertaken in a QOZ are subject to **local laws and restrictions**
  • Is there buy-in at the state and local level with respect to the proposed projects?
  • Is the cost and complexity of small local investments manageable by the QOF?
  • The recent failed endeavor by an internet concern to build a corporate headquarters in New York City’s Long Island City neighborhood (in a QOZ) is a prime example of how the projects underlying these investments may be speculative and by no means are done deals

• Not all states will choose to conform to the QOZ program and offer corresponding tax benefits at the state and local level, i.e., **decoupling from the federal law in this regard**
  • Does the potential investor reside in a “decoupled” state such that only federal income tax benefits are available?
Estate Planning Considerations
IRD and Estate Liquidity Considerations

• After the first round of proposed regulations were issued in October of 2018, comments were submitted to the Treasury Department highlighting that if a person dies holding a QOF interest, Code Section 691 (the IRD Rule) could trigger inclusion of deferred income in the gross income of the decedent’s beneficiaries.

• In the case of a QOF interest, a tax could be triggered without any corresponding liquidity

• The most recent round of Proposed Regulations issued in April 2019 addressed this concern by providing that transfers of QOF interests made pursuant to the death of the owner of the interest are not “inclusion events” (i.e., events that trigger inclusion of deferred gain) for purposes of Code Section 1400Z-2(b)

• However, this clarification does not solve the inherent liquidity issue – what if there is a liquidity need in the decedent’s estate (i.e., estate taxes due), and the QOF interest cannot be liquidated?

• Strategies exist to mitigate this liquidity risk, but potential investors must be aware that such a risk exists in order to appropriately plan
Transfer of an Interest in a QOF

- The recent Proposed Regulations issued in April also clarified that a transfer of a QOF interest to a wholly owned grantor trust is not an inclusion event, meaning that the QOF interest held in the trust will receive the same income tax treatment and benefits as if held in the hands of the grantor.

  - This rule could prevent the beneficiaries of the trust from being burdened with sizable gains.

- However, care should be taken when transferring QOF interests into a grantor trust to ensure that grantor trust status is not “toggled off,” such that an inadvertent inclusion event could be triggered.

- Finally, the Proposed Regulations issued in April also clarified that any other type of gift-transfer is an inclusion event, including a charitable contribution of a QOF interest, because the owner’s qualifying investment is terminated upon the transfer to charity.

  - Potential investors must consider this limitation in evaluating whether a QOF investment comports with their gift and estate planning goals.
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