



# The Return to OZ – Updates on Tax Benefits of Investing in a Qualified Opportunity Zone Fund

By: **Sean Sawey** – Alternative Investments Tax Lead

*May 2019*

After a very long wait, the Internal Revenue Service issued a highly anticipated update of the proposed regulations on the Opportunity Zone tax incentives. This program allows investors to take proceeds from capital gains, (short-term, long -term, Section 1231, Section 1256, etc.) and reinvest them in Qualified Opportunity Zone Funds. If you meet the 5, 7 and 10 year holding period requirements, a portion (up to 15%) of the initial deferred gain may be exempt from tax and post-investment appreciation may be entirely exempt from taxation by the federal government.

The recently released 169-page proposed regulations provide additional guidance on many topics that have caused concern from investors. The topics that we felt were most applicable to our clients are listed below, but there are many other areas that have received additional clarification that we can help you navigate. Many investors have been sitting on the sidelines waiting to invest and, hopefully with this additional guidance, more people will be ready to jump in with both feet.

---

## Recent Updates/Clarification Items

### Tax Rates on Deferred Gain

There were originally many questions related to the tax rate at which the deferred gains would be taxed when they were finally recognized after the deferral period. Under the newly issued proposed regulations, taxpayers are required to include the gain in taxable income in the year in which the deferral period ends. A safe assumption would be that the taxpayer pays tax based on the prevailing tax rates in that year. The character of these gains does not change (short-term gains that were deferred will be short-term gains when recognized).

### Raw/Unimproved Land

The proposed regulations provide that unimproved land within a Qualified Opportunity Zone (“QOZ”) that is acquired by purchase is not required to be substantially improved. Land can be treated as Qualified Opportunity Zone business property for purposes of section 1400Z-2 only if it is used in a trade or business of a QOF or Qualified Opportunity Zone business. Holding of land for investment does not give rise to a trade or business and such land could not be qualified opportunity zone business property. Moreover, land is a crucial business asset for numerous types of operating trades or businesses aside from real estate development, and the degree to which it is necessary or useful for taxpayers seeking to grow their businesses to improve the land that their businesses depend on will vary greatly by region, industry, and particular business.

### Section 1231 Gains

To become a Qualified Opportunity Fund and invest in eligible property/businesses located in an Opportunity Zone, the taxpayer would need to self-certify. In other words, no approval or action by the IRS is required. To self-certify, the taxpayer must complete Form 8996 (currently only in draft form) and attach this form to the taxpayer’s federal income tax return for the taxable year. Investments are not limited only to real estate; they can also be made into Opportunity Zone Businesses, but the transaction needs to be made with an unrelated party to qualify. An Opportunity Zone Business is a business that owns or leases substantially all (defined as 70% or more) of its tangible property in Qualified Opportunity Zone Business Property.

### Defining Original Use

The proposed regulations generally provide that the “original use” of tangible property acquired by purchase by any person commences on the date when that person or a prior person first places the property in service in the Qualified Opportunity Zone for purposes of depreciation or amortization (or first uses the property in the Qualified Opportunity Zone in a manner that would allow depreciation or amortization if that person were the property’s owner). Thus, tangible property located in the Qualified Opportunity Zone that is depreciated or amortized by a taxpayer other than the QOF or Qualified Opportunity Zone business would not satisfy the original use requirement of the section. The Treasury Department and the IRS are proposing that when a building or other structure has been vacant for at least five years prior to being purchased by a Qualified Opportunity Zone Fund or Qualified Opportunity Zone business, the purchased building or structure will satisfy the original use requirement.

### Treatment of Carried/Profits Interests

QOZ benefits are only available for those partners that contribute capital gains and get their return from that capital gain investment. If a taxpayer earns carried interest or a profits interest as the manager/general partner of the investment vehicle, then these gains do not qualify for the special tax treatment and are taxed as they would be from any other typical investment.

### Working Capital Safe Harbor

The proposed regulations make two changes to the safe harbor for working capital. First, the written designation for planned use of working capital now includes the development of a trade or business in the Qualified Opportunity Zone as well as acquisition, construction, and/or substantial improvement of tangible property. Second and seemingly more important for investors in states with slower permitting and local governmental approval processes, exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action, the application for which is completed during the 31-month period.

### Debt-financed Distributions

The proposed regulations seem to clarify that a debt-financed distribution is allowed and creates no issues for the investors (subject to the disguised sale rules), provided that the amount distributed does not exceed the partner’s basis in its partnership interest.

- A Qualified Opportunity Zone Fund may distribute cash and other property to a partner, and as long as the fair market value of the distribution does not exceed the partner’s basis, there will be no inclusion event.
- A Qualified Opportunity Zone Fund may sell Qualified Opportunity Zone property and reinvest the proceeds in other Qualified Opportunity Zone property within a year. In this situation, if the proceeds from the sale are maintained as cash or certain short-term investments, they will be considered Qualified Opportunity Zone property during the 12-month period.

### Events That Cause Inclusion of Deferred Gains

By using the terms “sold or exchanged” in Section 1400Z-2(b)(1), the regulations did not directly address non-sale or exchange dispositions, such as gifts, bequests, devises, charitable contributions, and abandonments of qualifying investments. There have been 11 clarifying items that could trigger an inclusion of previously deferred gains. Each of these are inclusion event, because each would reduce or terminate the QOF investor’s direct (or, in the case of partnerships, indirect) qualifying investment for federal income tax purposes or (in the case of distributions) would constitute a “cashing out” of the QOF investor’s qualifying investment. As a result, the QOF investor would recognize all, or a corresponding portion, of its deferred gain under Section 1400Z-2(a)(1)(B) and (b).

The regulations note, however, that the contribution of property to a QOF is generally not an inclusion event.

The recently updated proposed regulations have provided much needed guidance that should allow fund managers to become more comfortable with establishing and making investments into Qualified Opportunity Funds. Many fund managers have been sitting on the sidelines waiting for additional clarity, and now that numerous areas of concern have been clarified, we feel that there will be a tremendous influx of capital into these Opportunity Zones (which some estimate to be between \$15 and \$30 billion). For a full copy of the newly released proposed regulations, visit <https://www.irs.gov/pub/irs-drop/reg-120186-18-nprm.pdf>.

If you have questions about fair value measurements of real estate assets, or questions about Opportunity Zones or Qualified Opportunity Funds, Richey May's professionals are available to help. Please contact [Stephen Vlasak](#) for any questions regarding this white paper, or regarding the public accounting services Richey May provides to the Alternative Investments industry.

To access our additional resources regarding Qualified Opportunity Zones, visit our [website](#).

---

***Notice to Reader:***

The information contained herein is of a general nature and based on authoritative guidance that is subject to change. The descriptive and summary statements in this document are not intended to be a substitute for IRS guidance or requirements, or any other applicable accounting literature. The applicability of the tax information to specific situations should be determined through consultation with tax advisors.