Insights

INSIGHT: Qualified Opportunity Zones: Death, Taxes, and Other Uncertainties

BY LIBIN ZHANG

The 2017 tax act (Pub. L. No. 115-97) created the new concept of qualified opportunity zones (QOZ), which are low-income census tracts in which certain investments are provided tax benefits. On Oct. 19, 2018, the Treasury Department and the Internal Revenue Service released the initial set of proposed regulations. The regulations resolved some fundamental questions but left others unanswered, such as what happens upon an investor's death and the interaction of the QOZ rules with other tax provisions.

The QOZ provisions have generated substantial interest among investors, developers, and start-up entrepreneurs, who have already deployed capital to revitalize the low-income areas. As second generation qualified opportunity funds become effective in early 2019 with new types of QOZ investments and greater pools of institutional and retail investors, the need for additional Treasury and IRS guidance becomes more pressing.

Introduction

The QOZ provisions generally provide three tax benefits for a taxpayer who has capital gain from the sale or exchange of any property (with an unrelated person) in late 2017 through 2026. If the taxpayer invests an amount equal to its gain in a qualified opportunity fund (QO Fund) equity interest during the 180-day period beginning on the sale or exchange date, the taxpayer may benefit from:

- permanent exclusion of up to 15 percent of the gain (i.e., 10 percent of the gain is excluded after the QO Fund interest is held for five years, and an additional 5 percent of the gain is excluded after seven years);
- recognition of the remaining 85 percent of the gain is deferred until Dec. 31, 2026; and
- permanent exclusion of gain from any post-investment appreciation in the QO Fund, if the QO Fund interest is sold or exchanged after being held for 10 years or more,(through 2047).

A QO Fund is a corporation or partnership (including an LLC taxed as a corporation or partnership) that has at least 90 percent of its assets (measured approximately every six months) consist of three types of properties acquired in 2018 and later:

1. ''qualified opportunity zone business property'' (QOZ business property),
2. ''qualified opportunity zone stock'' in a lower-tier domestic corporation, and
3. ''qualified opportunity zone partnership interest'' in a lower-tier domestic partnership.

QOZ business property is generally tangible property that the QO Fund purchased from an unrelated person in 2018 or later, is used in a trade or business in a QOZ, and is substantially improved by the QO Fund over a 30-month period (or the property's original use in the QOZ commences with the QO Fund). For example, a residential rental property located in a QOZ is generally QOZ business property if the QO Fund purchases the property in January 2019 and doubles the building's adjusted tax basis by July 2021.

The lower-tier corporation or partnership must meet various requirements to be a QOZ business. For example, at least 70 percent of a QOZ business's owned or leased tangible property must consist of QOZ business property. At least 50 percent of the entity's total gross income must be derived from the active conduct of a trade or business in the QOZ. Furthermore, less than 5 percent of the QOZ business's total assets can be stocks, debt, and similar ''nonqualified financial property,'' but nonqualified financial property does not include cash and other working capital generally held for up to 31 months of planned acquisition, construction, and/or substantial improvement of QOZ business property.

Example: An individual, Earl, recognizes $20 million of capital gain in late 2017 and early 2018, from the sale of some bitcoins, Crytokitties, and rare Neopets accessories, as well as the sale of stock in his closely held company to his sister-in-law. (Note, for QOZ purposes, the only family members considered ''related'' are an individual's siblings, spouse, ancestors, and lineal descendants.) Earl invests $20 million of cash into his own QO Fund on June 1, 2018, with the knowledge that the QO Fund has six months to deploy that cash. In late November 2018, following the QOZ proposed regulations, the QO Fund contributes $18 million of cash to a lower-tier partnership, which holds the cash as working capital to acquire and develop certain QOZ business property over the next 31 months.

In early 2020, the lower-tier partnership buys $4 million of land in a NoHobo (north of Hoboken NJ) QOZ. A $14 million commercial rental building is constructed on the QOZ land within the required timetable, i.e., by June 2021. In the interim, Earl's affiliated companies borrow some of the cash under loans that have a term of 18 months or less. The commercial rental building is used in the active conduct of a trade or business once it is placed in service. The QO Fund uses its remaining $2 million of cash to make seed investments in various QOZ start-ups that are tenants of the commercial rental building.

If all goes according to plan, Earl will exclude $2 million of his original gain after five years of QO Fund investment, i.e., on June 1, 2023, and another $1 million

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of the original gain is excluded on June 1, 2025. Earl will recognize only up to $17 million (85 percent) of the deferred gain on Dec. 31, 2026. Earl does not have any taxable capital gain when he sells his QO Fund investment on or after June 1, 2028 for $100 million, of which the $80 million tax-free profit is attributable mostly to a successful QO Fund investment in a QOZ podcasting start-up.

Death

Despite Earl's careful attention to tax details, he is less cautious in his personal life and suffers an unfortunate demise in December 2021 in a lettuce-related incident. His QO Fund interest is inherited by his son, Earl Jr., on Dec. 15, 2021. The effect of Earl's death on the QO Fund tax benefits is unclear.

The only death-related guidance in the QOZ statute is tax code Section 1400Z-2(e)(3), which provides that ''[i]n the case of a decedent, amounts recognized under this section shall, if not properly includible in the gross income of the decedent, be included in gross income as provided by section 691.''

Section 691 provides rules for so-called ''income in respect of a decedent'' (IRD); for example, if a taxpayer defers gain on the sale of property by receiving an installment note, the heir who acquires the installment note generally recognizes the deferred gain when the note is paid. When an heir normally inherits property from a decedent, Section 1014(a) provides that the property may obtain a tax basis step-up (or step-down) to its fair market value as of the decedent's death, but the tax basis step-up does not apply to property which constitutes a right to receive an item of IRD.

Although a detailed discussion of the IRD rules is beyond the scope of this article, it appears that there is no recognized gain for Earl or his estate upon his death in December 2021. Instead, Earl Jr. inherits the QO Fund interest and the deferred gain, which Earl Jr. recognizes in 2026.

The amount of Earl Jr.'s 2026 recognized gain is not certain. For a person who owns property with tax basis determined by reference to the tax basis in the hands of another person (a carryover basis), Section 1223(2) generally provides a tacked holding period in determining the period for which the person has held the property, however acquired. Earl Jr. may therefore figuratively step into the shoes of Earl. Like his father, Earl Jr. excludes $2 million of gain on June 1, 2023, excludes another $1 million of gain on June 1, 2025, recognizes up to $17 million of gain on Dec. 31, 2026, and can sell his QO Fund investment tax-free on or after June 1, 2028.

Earl Jr.'s 2026 gain recognition may be problematic if he does not have sufficient cash at hand to pay the tax on the gain. The QO Fund may possibly make a cash distribution to Earl Jr. after 2026, which is a tax-free distribution generally under Section 731 to the extent of Earl Jr.'s $20 million tax basis in his QO Fund interest.

Alternatively, a stricter interpretation may require Earl Jr. to have his own holding period for purposes of the five-year, seven-year, and 10-year rules, in which case Earl Jr. excludes $2 million of gain on Dec. 15, 2026, recognizes up to $18 million of gain on Dec. 31, 2026, and can sell his QO Fund investment tax-free only after Dec. 15, 2031. A third school of thought is that Earl Jr. never qualifies for any QOZ gain exclusion, because he was not the original investor in the QO Fund with the initial deferred gain.

If Earl's QO Fund interest is worth more than the initial $20 million investment in December 2021, such as $35 million, the QO Fund interest may be bifurcated between the $20 million IRD portion and the $15 million excess portion. The $15 million excess portion of the QO Fund interest may be allowed a basis step-up to $15 million, while the IRD portion continues to have a low tax basis. The limited basis step-up can reduce Earl Jr.'s recognized taxable gain if he were to sell the QO Fund interest before the required 10-year holding period, however measured.

The Section 1223(2) tacked holding period rule does not apply to property with a basis step-up at death. Section 1223(9) instead provides that if Earl Jr. sells or otherwise disposes of the stepped-up basis portion of inherited property within a year, Earl Jr. is considered to have held the inherited property for more than one year. A lack of a tacked holding period may require Earl Jr. to hold the stepped-up basis portion of the QO Fund for another 10 years, to December 2031, in order to obtain the full QOZ gain exclusion after 10 years. On the other hand, Section 1223(2) applies to any property with a carryover basis in whole or in part, which may treat the entire QO Fund interest (with its partially stepped-up basis) as a single asset with a single tacked holding period.

Taxes

It is possible for a QO Fund to claim federal income tax credits and other federal tax benefits, though guidance is minimal on the interaction between the QOZ rules and other federal provisions.

The Section 45D new markets tax credit (NMTC) is a tax incentive to encourage investments in low-income communities. Since QOZs are defined as a subset of low-income communities plus certain adjacent tracts, substantially all QOZs are low-income communities that can generate NMTCs. There is a national limit of $3.5 billion NMTCs per year (through 2019), which is allocated by the Treasury's Community Development Financial Institutions Fund among various ''qualified community development entities'' (QCDEs).

With the proper structuring and certifications, a QO Fund can also be a QCDE and generate NMTCs equal to 39 percent of the investor's initial investment, allowed in seven installments over six years. The more popular NMTC structures involve QCDEs making loans, which QO Funds generally cannot do. Instead, the QCDE can make equity investments in qualified active low-income community businesses, which are corporations and partnerships subject to certain tax requirements substantially similar to that of QOZ businesses. For instance, at least 50 percent of the qualified active low-income community business's gross income must be derived from the active conduct of a business within a low-income community.

There is generally a minimum NMTC investment period of seven years, which can run concurrently with the QO Fund holding periods of five to 10 years. The NMTC regime has some other requirements that do not apply to QO Funds, such as the qualified active low-income community business cannot be the rental of residential real property or predominantly consist of the development or holding of intangibles for sale or li-

cense. In the above example, Earl's QO Fund may be allowed the NMTC for the commercial rental building and other investments, which can provide Earl and Earl Jr. with up to $7.8 million of total federal income tax credits in 2018 through 2024.

There are some areas of uncertainty in the interaction between the QOZ provisions and NMTC provisions. For example, Section 45D(h) requires the investor to reduce the basis of his QCDE interest by the amount of any allowed NMTC. Since Earl starts out with a tax basis of $0 in his QCDE / QO Fund interest under the QOZ rules, any allowed NMTC may result in a negative tax basis, which is generally disfavored under the tax rules. It is possible that the NMTC gives rise to taxable gain for Earl or is suspended until Earl has a positive tax basis, such as by contributing non-gain cash to the QO Fund, waiting five to 10 years, or having the QO Fund incur debt.

Other areas of uncertainty relate to NMTC requirements that may differ from the QOZ requirements. For example, a lower-tier partnership, which is operating the QOZ business and qualified active low-income community business, generally cannot have more than 5 percent of its assets consist of debt, stocks, and similar nonqualified financial property. The QOZ proposed regulations provide that the lower-tier partnership may hold a reasonable amount of working capital for up to 31 months if it will be used for the acquisition, construction, or substantial improvement of QOZ business property, while a similar working capital safe harbor for NMTC purposes applies only to 12 months of construction of real property.

The NMTC regulations indicate that the NMTC investment may also give rise to other tax benefits, such as the Section 47 rehabilitation tax credit for the rehabilitation of certain old and/or certified historic buildings. The TCJA amended the rehabilitation tax credit to generally provide a 20 percent federal tax credit (allowed at 4 percent per year for five years) for the rehabilitation expenditures spent on a certified historic building that is substantially rehabilitated (generally by doubling the building's adjusted tax basis over either two years or five years). The substantial rehabilitation requirement is similar to the QOZ substantial improvement requirement, which requires the building's adjusted tax basis to be doubled over 30 months. The rehabilitated building is subject to a five-year holding period after it is placed in service, to avoid credit recapture. While the rehabilitation tax credit's five-year holding period is shorter than the 10-year hold for QOZ purposes, the time gap is reduced when the rehabilitation takes a few years to finish.

The TCJA provides a grandfathering rule that allows the 20 percent historic rehabilitation tax credit all in one year for a rehabilitated certified historic building, or a 10 percent federal tax credit for a rehabilitated pre-1936 non-certified-historic building, as long as the building is owned or leased by ''the taxpayer'' during the entirety of the period after Dec. 31, 2017, and the taxpayer begins the two-year or five-year rehabilitation period by June 20, 2018. For a building owned by a partnership, there is some Congressional legislative history that the relevant taxpayer is the partnership. A QO Fund may possibly acquire an interest in a grandfathered rehabilitation project owned by an existing partnership, particularly if proper structuring was completed in late 2017 in anticipation. The QO Fund must still comply with all the QOZ rules including the requirement that at least 70 percent of its lower-tier partnership's tangible property must be acquired by purchase from an unrelated party in 2018 or later, e.g., through the construction of the rehabilitation improvements.

Section 50(c) requires the QO Fund to reduce the tax basis of the rehabilitated building by the amount of the rehabilitation tax credit. There is no required tax basis reduction for the QO Fund if the QO Fund elects to pass through the rehabilitation tax credit to certain lessees of the rehabilitated building, under the complex rules in former Section 48(d), which were technically repealed by the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) but confusingly are still in effect under Section 50(d)(5). The QO Fund should be engaged in a trade or business as the lessor.

Another popular tax credit for QOZs is the Section 42 low-income housing tax credit (LIHTC), given that QOZs are low-income communities with demand for low-income housing. The LIHTC is allocated by state housing agencies to each low-income housing project, which is allowed the credit annually over a period of 10 years, in an amount that cumulatively would result in the investors recovering generally either 30 percent or 70 percent of the adjusted tax basis of the low-income housing (based on certain present value factors and whether the project is federally subsidized or unsubsidized). A low-income non-federally-subsidized building placed in service in December 2018 would be allowed a 7.74 percent LIHTC per year, or 77.4 percent of total tax credits over 10 years. In exchange, the building must generally remain low income housing for around 15 to 30 years. The low-income housing must meet various requirements, such as minimum rehabilitation expenditures over 24 months generally equal to either 20 percent of the building's adjusted basis or around $7,000 per housing unit; LIHTC projects with relatively light rehabilitation would not be eligible for QOZ benefits, but more substantial low income housing rehabilitation would be eligible.

LIHTC projects generally have low or negative cash flow due to the low rents and the fact that much of the investors' economic return is derived from the LIHTCs. Since an investor in a QO Fund recognizes his deferred capital gain in 2026 generally only up to the value of his QO Fund interest at that time, a LIHTC project of low value in 2026 can significantly reduce the deferred gain recognized in 2026.

The LIHTC computation is based on the adjusted tax basis of the low-income housing, as of the close of the first year of the 10-year credit period. One QOZ-related uncertainty is whether the QO Fund actually has a full cost basis in its low-income housing, or whether the investors' initial tax basis of $0 in their QO Fund interests also results in a corresponding basis step-down in the QO Fund's assets. A lower tax basis in the low-income housing means less LIHTCs and also affects the tax losses for the LIHTC investors.

Other useful tax credits for QO Funds include the Section 41 credit for research activities, the Section 45 or Section 48 credits for solar, wind, geothermal, and other renewable energy properties, the Section 48A credit for high tech coal projects, and the foreign tax credit for QOZs in Puerto Rico and other U.S. possessions.

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Example: A QO Fund invests in a QOZ business, CalZone Low-Cal Calzone Zone, which is a restaurant in a California QOZ that serves fast, casual Italian food made with low calorie ingredients. The restaurant hires some certified local teenagers as additional wait staff over the summer, which results in a $1,200 Section 51 work opportunity credit for each such employee. The restaurant also purchases several Tesla delivery vehicles in 2018, each of which generates a $7,500 Section 30D qualified plug-in electric drive motor vehicle tax credit. The restaurant allocates the tax credits and its net income to the QO Fund and its investors, who can also claim the 20 percent Section 199A pass-through business income deduction for the restaurant's net business income.

Some credits expired at the end of 2017 but are the subject of anticipated tax extender legislation, including the Section 30D credit for electric motorcycles.

In all cases, the tax credits and other tax benefits must comply with other applicable tax requirements, such as the Section 49 at risk rules, the Section 465 passive activity rules, the alternative minimum tax (AMT) limitations on the use of some credits by non-corporate taxpayers, the Section 41(g) limitations on an individual's research credit, and the rules in former Section 46(e) that limit some tax credits for REITs and other entities, which were technically repealed by the Omnibus Budget Reconciliation Act of 1990 but are still in effect under Section 50(d)(1).

A QO Fund may also claim state income tax incentives that may be available for property rehabilitation, employment creation, and other encouraged activities. New York, for example, has its own tax credits for low-income housing and for the rehabilitation of historic properties and old agricultural barns. The New York rehabilitation credit for historic properties effectively doubles the federal rehabilitation credit, for up to $5 million of additional tax credits through 2024.

Conclusion

Despite Benjamin Franklin's quip that ''[t]wo things in life are certain, death and taxes,'' there is less certainty about death and taxes in the QOZ context. The estate planning issues and interaction with other state and federal tax benefits can be added to list of issues for QO Funds that have been discussed by various commentators, such as the treatment of leases, the definition of original use, all the QOZ business requirements, the effects of QO Fund debt, eligible gains and their reinvestment periods, interactions with FIRPTA and UBIT, state tax conformity, working capital for non-real-estate activities, and the centralized partnership audit rules as enacted by the Bipartisan Budget Act of 2015.

If a QO Fund rehabilitates an old or certified historic building in a QOZ, the same investors may be able to benefit from the QOZ provisions, the rehabilitation tax credits, and either the NMTC or the LIHTC. Such a structure may be called either a tax trifecta or a tax turducken, depending on one's side of the QOZ generational divide. Like a real turducken, the traditional Thanksgiving meal of a chicken stuffed inside a duck stuffed inside a turkey, a tax turducken may seem to be more frequently discussed in Internet publications than used in real life, until one is served up and prompts everyone to dig in.

Libin Zhang is a partner at Roberts & Holland LLP in New York.