THE TAX CUTS AND JOBS ACT OFFERS NEW TAX BREAK FOR REAL ESTATE: A LOOK AT QUALIFIED OPPORTUNITY FUND

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On December 22, 2017, Congress enacted the Tax Cuts and Jobs Act (the Act) which made numerous changes to the Internal Revenue Code (the Code) and incentivized certain investments in qualified opportunity zones. The Act created § 1400Z of the Code, which provides for significant deferral, reduction, and elimination of capital gains that are timely and properly reinvested by taxpayers in a qualified opportunity zone. More than 8,000 low income census tracts located in all fifty states, the District of Columbia, and five U.S. territories are designated as qualified opportunity zones.

Until recently, many questions about the Act discouraged taxpayers from attempting to invest in qualified opportunity zones. However, Proposed Treasury Regulations 1.1400-Z-2 and Revenue Ruling 2018-29 were issued on October 19, 2018, which clarify many important details regarding the requirements. This IRS guidance will likely result in many taxpayers considering the advantage of qualified opportunity zones.

Real estate developers and investors may be especially interested in investing in qualified opportunity funds. A qualified opportunity fund is a corporation or partnership (including a limited liability company taxed as a partnership) organized for the purpose of investing in qualifying property that holds at least 90% of its assets in qualified business property (as more particularly described below). Although the tax benefits may apply to a variety of other assets and businesses in qualified opportunity zones, the benefit to real estate developers and investors is readily apparent because the investment of capital gains into a qualified opportunity fund typically entails the acquisition of land and/or improvement of real property within a qualified opportunity zone at some level. Developers and investors who have been frustrated by many of the rigid restrictions and certain time periods associated with Code § 1031 transactions may find investments in qualified opportunity zones to be a more liberal and valuable alternative. Taxpayers interested in diversifying from nonreal estate assets to real estate assets may also find qualified opportunity zone investments attractive.

The tax benefits associated with qualified opportunity zones include a possible 15% gain exclusion and a deferral of the entire tax on capital gains reinvested in a qualified opportunity fund until the earlier of the date the fund is sold or December 31, 2026. If the investment is held for more than ten years and disposed of timely, the post-acquisition gain on the qualifying investment in the qualified opportunity zone may also be permanently excluded from income. Key distinctions between § 1031 exchanges and qualified opportunity zone investments are described in the following table:

Key Differences between 1031 Exchange and QOZ Investment

	1031 Exchange	QOZ Investment
May personal property (including securities) be sold and proceeds used for an exchange?	No.	Yes.
May personal property be replacement property in an exchange?	No.	Yes, as long as the personal property is a business asset in a QOZ.
Must replacement property be identified within forty-five days?	Yes.	No.
Must the taxpayer close on replacement property within 180 days?	Yes.	Generally, yes.
Will less taxable gain result from the first exchange?	No, 1031 only provides deferral, not reduction, of tax.	Yes, a taxpayer may step up tax basis in the original investment up to 15%.
Will less tax result from the eventual sale of the replacement property?	No, 1031 only provides deferral, not reduction, of tax.	Yes, a taxpayer may step up 100% of the gain from the reinvested proceeds.

There are a number of key timing requirements related to acquisition, disposition, and holding of the asset that must be satisfied to take full advantage of investments in qualified opportunity zones. First, to obtain any tax benefits, a taxpayer must reinvest capital gains (which may be from almost any source other than certain hedging transactions or transactions with related parties) within 180 days into a qualified opportunity fund. Qualified business property must be purchased after December 31, 2017, and prior to June 29, 2027. The exclusion of gain requires that the investment be held for at least five years, in which case 10% of the deferred gain may be excluded from income. To obtain the full 15% gain exclusion, the investment must be made prior to December 31, 2019, and must be held for at least seven years. To exclude post-acquisition gain from income, a taxpayer must dispose of the investment in the qualified opportunity fund prior to January 1, 2048.

The magnitude of tax benefits from qualified opportunity funds is illustrated by the following example. Suppose a taxpayer bought common stock in 2013 for $500,000 and sold the stock in 2018 for $1,500,000, resulting in a capital gain of $1,000,000. The investor then timely invests $1,000,000 in a qualified opportunity fund for ten years, at which time the investment is sold for an amount which results in another $1,000,000 gain for the taxpayer. By investing the initial gain in the qualified opportunity fund, the taxpayer will save nearly $200,000 in aggregate taxes (assuming tax rates do not change), and will also defer paying $170,000 in taxes for seven years.

	Without QOF	**With QOF**	
Initial Investment (Sold in 2018)	2018	2018	2026 *(Calculation of Tax Due from 2018 Sale)*
Amount Realized	$1,500,000	$1,500,000	$1,500,000
Adjusted Basis (Original Investment)	($500,000)	($500,000)	($650,000) [1]
Gain from Original Investment	$1,000,000	$1,000,000	$850,000
Taxes Paid (20%)	($200,000) [2]	*N/A - Deferred*	($170,000) [3]
After Tax Gain Available to Reinvest in 2018	$800,000	$1,000,000	*N/A*
Second Investment (Purchased with gain from 2018 sale, hold for ten years, sell in 2028 for 100% increase of amount reinvested)			
Amount Reinvested	$800,000	$1,000,000	
Amount Realized	$1,600,000	$2,000,000	
Adjusted Basis	($800,000)	($2,000,000) [4]	
Taxable Gain from Reinvestment	$800,000	$0	
Taxes Paid (20%)	($160,000)	$0	
Total Gain from Both Investments	**$1,800,000**	**$2,000,000**	
Total Taxes Paid	($360,000)	($170,000)	
Total After Tax Gain	**$1,440,000**	**$1,830,000**	

[1] Basis increased after seven-year deferral period by 15% of the original gain amount of $1,000,000.

[2] Paid in 2018, the year of sale of the capital asset.

[3] Paid in 2026, after seven-year deferral period. The present value of $170,000 in taxes that do not have to be paid for seven years is $99,193.37 using a discount rate of 8%.

[4] Basis in QOF investment is increased to FMV if investment is held for ten years.

Given the considerable potential tax savings involved and the federal government's desire to encourage economic growth and investment in distressed communities, a qualifying opportunity fund must satisfy numerous technical requirements to ensure that the investment reaches the intended beneficiaries. A qualified opportunity fund must have at least 90% of its assets in qualified business property. To be classified as qualified business property, the property must be tangible property used in a trade or business, purchased after December 31, 2017, and purchased by or substantially improved by the qualified opportunity fund. The property must also be located within a qualified opportunity zone during substantially all of the qualified opportunity fund's holding period for such property.

Qualifying property may include stock or a partnership interest if such stock or interest is acquired for cash at a time when the corporation or partnership is a qualified opportunity zone business or when it is being organized for the purpose of investing in qualified business property and if the corporation or partnership constitutes a "Zone Business." A trade or business is a Zone Business if (i) at least 70% of its tangible property owned or leased is qualifying property; (ii) at least 50% of its gross income is derived from the active conduct of a trade or business in a qualifying opportunity zone; and (iii) the trade or business is not a private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other gambling facility, or liquor store. Working capital used to improve real property will not cause the qualifying opportunity fund to fail the 90% qualifying property test (as a result of the fund having large amounts of cash on hand) so long as the fund (i) designates working capital requirements in writing for the acquisition, construction, and/or substantial improvement of the property; (ii) has a written schedule consistent with the ordinary start-up of a trade or business to spend the working capital within thirty-one months of receipt; and (iii) uses the working capital consistent with the foregoing requirements.

The new IRS guidance addresses a number of important details. First, the recent regulations specify that any deferred gain retains its original character. Thus, short-term capital gain that is deferred for five or seven years would be taxed at short term capital gain rates in year seven (or December 31, 2026, whichever occurs first). Second, the guidance clarifies the start date for the 180-day rollover period to invest in a qualified opportunity fund. Generally, the period starts on the date of the sale giving rise to the capital gain. If that date is unclear, the period begins with the date upon which the gain would otherwise be recognized for tax purposes. If a partnership has an eligible capital gain that it does not reinvest in a qualified opportunity fund, its partners may reinvest their allocable shares of that capital gain. The rollover period for the partners begins on the last day of the partnership's tax year, although any partner may elect to treat the partnership's 180-day period as the partner's own 180-day period.

The IRS guidance also defines "substantial improvement" of a property. Substantial improvement occurs if, over a period of thirty months, a qualified opportunity fund increases the basis of real property by an amount at least equal to the initial basis of the property. For purposes of this calculation, any basis allocated to land is ignored. So, if a qualified opportunity fund acquires land and improvements in a qualified opportunity zone for $1,000,000, with $400,000 of the purchase price allocable to the land and $600,000 allocable to a building, the fund must make at least $600,000 of improvements to the building within thirty months to satisfy the substantial improvement test. Importantly, the acquisition of raw land without improvement cannot result in "substantial improvement." In that case, new improvements must be constructed on the raw land.

The proposed regulations and IRS guidance are far from a complete explanation of qualified opportunity funds. Future guidance from the IRS is expected to address additional questions such as the inclusion of deferred gains, administrative penalties, and reporting requirements. However, the recent

IRS guidance provides a sufficient framework for real estate developers and investors to more seriously assess the benefits of qualified opportunity funds and to compare investment in a qualified opportunity fund with a more traditional Code § 1031 exchange. The guidance permits taxpayers with unrealized appreciation in nonreal estate assets to consider whether an investment in a qualified opportunity fund is an appropriate vehicle to diversify investment portfolios. Ultimately, the additional information concerning qualified opportunity funds indicates that they may offer greater flexibility and significant benefits to taxpayers who are willing to explore the parameters of the new legislation.