



September 2018

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## *QOZs (Qualified Opportunity Zones) for Real Estate Developers and Investors<sup>1</sup>*

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Summary: This article summarizes key facts regarding Qualified Opportunity Zones (“QOZs”) pertinent to real estate developers and investors, including items that should be clarified by the IRS and examples (found at the end of this article) of how QOZs work.

### **I. Key Benefits**

By investing in QOZs, you can reduce (by up to 15%) and defer (until 12/31/2026) taxes on capital gains earned on investments made in non-QOZ Property and reduce capital gains taxes on investments made through qualified investment funds (“QOFs”) in QOZ Property to 0% (if held for 10 years or more). Timing requirements are discussed in more detail below.

### **II. Overview**

The Tax Cuts and Jobs Act of December 2017 added new Subchapter Z to Chapter 1 of the Tax Code. Subchapter Z provides tax incentives for investing in designated economically distressed qualified opportunity zones. The list of QOZs can be found [here](#), California specific information can be found [here](#), and additional program information can be found [here](#) and [here](#).<sup>2</sup>

### **III. What Qualifies as QOZ Property, Who Can Buy It, How Do You Buy It?**

- QOZ Property: includes (i) QOZ business property (i.e., real and tangible personal property), (ii) QOZ stock and (iii) QOZ partnership interests.
- QOZ Business Property: (i) must be acquired after 12/31/2017, (ii) must commence with the QOF or when the QOF “substantially improves” the property and (iii) during “substantially all” of the QOF’s holding period for such property, “substantially all” of the use of such property was in a QOZ.
  - Cannot buy and hold unimproved or performing real property, you must improve the property: QOZ Property must be “substantially improved” within the 30-month period after acquisition. “Substantial Improvement”: The improvements are worth at least as much as the tax basis of the QOZ property at the time of its acquisition.
  - Land vs. Improvements: For tax purposes, land is typically treated separately from any buildings on the land. Funds spent on constructing improvements on land arguably may not cause such land to be treated as “substantially improved.”



- QOF: means any investment vehicle organized as a corporation (including REITs) or a partnership for the purpose of investing in QOZ Property (other than another QOF) that holds at least 90% of its assets in QOZ Property. The 90% rule is determined at six-month intervals by averaging the percentage of QOZ Property held in the QOF (A) on the last day of the first 6-month period of the taxable year of the fund and (B) on the last day of the taxable year of the fund.
  - Do LLCs Qualify? We are waiting on IRS confirmation, but it is expected that they will qualify.
- QOZ stock and partnership interests must satisfy these criteria:
  - The interest is acquired after 12/31/2017 for cash;
  - At the time of acquisition, the company/partnership must be organized as a QOZ business; and
  - During “substantially all” of the QOF’s holding period of such interest, such company/partnership qualified as a QOZ Business.
- QOZ Business (only relevant to investments in QOZ stock/partnership interests, not investments in QOZ Business Property): means a business in which “substantially all” of the property owned/leased thereby is QOZ Property.
  - Specific Exclusions: Any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.
  - Specific Restriction: Less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property (i.e., financial instruments other than working capital). As such, a QOZ Business cannot hold cash reserves in excess of working capital potentially making it difficult to reserve for long-term capital improvement programs. It is unclear how much working capital will be considered acceptable for this program.
- How to Organize and Fund a QOF
  - It is a self-certification process, no IRS approval/action is required. The IRS has indicated that it will make a form available to be attached to tax returns.
  - There are no restrictions on funding acquisitions with mortgage, mezzanine or other financing.
  - Securities Restrictions: Investments in QOFs are considered securities. Private placement rules (i.e., accredited investors) and exemptions apply.

#### **IV. Timing Is Crucial**

- Deferring Capital Gains: To defer capital gains on an appreciated asset, you must reinvest the gain in a QOF within 180 days of realizing the gains. Note, the 1031 “like kind”



requirements do not apply. This program provides far more flexibility in this regard so long as you invest in QOZ Property.

- Best to Invest by December 31, 2019 to maximize benefits
  - Hold a QOF investment for  $\geq 5$  years: 10% of the deferred gain is forgiven, permanently (i.e., the tax basis is increased by 10% of the amount of the deferred gain).
  - Hold a QOF investment for  $\geq 7$  years: 15% of the deferred gain is forgiven, permanently (10% plus an additional 5%, not an additional 15%; i.e., the tax basis is increased by 15% of the amount of the deferred gain).
  - Deferred gains are taxable on the earlier of (i) sale and (ii) 12/31/2026. Therefore, (i) if you want to maximize your benefit, invest no later than 12/31/2019 and (ii) at 12/31/2026, you will have a liquidity issue (i.e., taxable income with no corresponding cash flow) unless the QOF makes a distribution to its investors to cover the tax liability or another funding mechanism is employed.
- Hold for 10 Years → No capital gains tax on the appreciation in the investment (i.e., the basis is deemed to equal the fair market value on the sale date).

## V. State Income Tax

States have released explanations of how the federal provisions will work under state law. The New York Department of Taxation and Finance stated that deferral or exclusion of gains will flow through to New York (with a caveat that New York could consider decoupling from the federal provision) but the California Franchise Tax Board stated that California will not conform to the deferral and exclusion of capital gains reinvested or invested in QOFs. Georgia has adopted the provisions of all federal tax acts that were enacted on or before February 9, 2018, except for provisions they specifically did not adopt. The QOZ code provisions were not excluded, so Georgia law should follow the same gain deferral treatment.

## VI. Additional IRS Guidance Required

Treasury is expected to issue interim regulations addressing some QOZ program gating issues within the next two weeks. Additional IRS guidance on discrete issues is expected to be issued over the next few months before the regulations are finalized sometime next year. Below are some of the critical questions that need to be answered in order for the program to be effective:

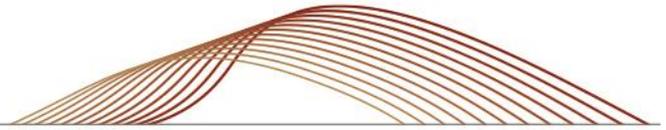
- Can the QOF be an LLC / Is it required that the QOF investors be considered partners for tax purposes? LLCs are not specifically discussed, but arguably LLCs with multiple members that are treated as a partnership for tax purposes are “organized” as a partnership.
- How long does the QOF have to deploy the investors’ funds? QOFs must hold at least 90% of the fund’s assets in QOZ Property beginning on the sixth month of the QOFs first tax year. In a typical real estate deal this would be insufficient time in order to complete the improvements. Even under the substantial improvement rule, it is unclear whether property under construction or rehabilitation will be considered QOZ Property during the improvement period. Guidance is needed from the IRS that a reasonable period will be provided to deploy the initial capital.



- Land vs. Improvements: Clarification that constructing buildings on land shall be deemed as “substantially improving” such land (instead of treating the land separately).
- What happens if a QOF sells an investment in a QOZ and replaces it with another investment in a QOZ during the 10-year period (i.e., does the 10-year period reset)? We expect further guidance regarding reinvestment timing for return of capital from QOZ investments.
- Whether distributions of debt can be used to help investors fund 12/31/26 tax obligations.
- Whether QOFs have reporting requirements, both investor reporting and fund reporting.
- Whether there will be any restrictions on twinning other tax credit projects with QOZ funds.
- How to deal with sale of investor interests in a QOF with multiple properties that need to be liquidated over time.
- Clarification on how tiered partnerships work in QOZ funds.
- Coordination of the partnership tax rules and QOZ program rules. For instance, in the partnership context, if the QOF sells the property that it holds, the gain from the sale will be allocated to the investors which negates the tax benefits of the deferrals and exclusions at the investor level.
- It is also unclear in a levered transaction whether the portion of the project financed with leverage will qualify for the appreciation gain exclusion.
- Clarification on how QOZ Businesses qualify for the QOZ program benefits, including rules regarding the determination of what is considered “substantially all.”

## VII. Tax Calculation Examples

1. Jack Fiditch sells a (non-QOF) building on September 1, 2018 and realizes a gain of \$1,000. Jack invests the proceeds attributable to the \$1,000 gain in a QOF on March 1, 2019. Jack invested the proceeds attributable to the gain outside of the 180-day period (it expired on February 28, 2019) so the entire \$1,000 gain is subject to tax in 2018. Although it is not entirely clear, if he holds the investment in the QOF for 10 years, then any gain on such QOF acquisition may not be subject to tax (but, Jack is clearly not entitled to any 5-year or 7-year step-up in basis on his initial \$1,000 investment).
2. Jack sells a building on September 1, 2018 and realizes a gain of \$1,000. Jack invests the proceeds attributable to the gain in a QOF on February 1, 2019. Jack invested the proceeds attributable to the gain within the 180-day period, no tax is owed in 2018 on such gain. If:
  - a. Jack sells his QOF investment on March 30, 2023, then Jack owes tax on the \$1,000 gain (he held for less than 5 years), but such tax is deferred until 2023.
  - b. Jack sells his QOF investment on February 2, 2024, then Jack owes tax on \$900 since he gets the 10% benefit ( $\$1,000 \times 10\% = \$100$ ) in 2024.
  - c. Jack sells his QOF investment on February 2, 2026, then Jack owes tax on \$850 since he gets the 15% benefit ( $\$1,000 \times 15\% = \$150$ ) in 2026.



- d. Jack sells his QOF investment on February 2, 2029, then (1) Jack owes tax in 2026 on \$850 (phantom income due to 12/31/2026 deadline) and (2) Jack owes no tax on any gains on his QOF investment since he satisfies the 10-year hold rule.
3. Jack sells a building on September 1, 2023 and realizes a gain of \$1,000. Jack invests the proceeds attributable to the gain in a QOF on February 1, 2024. Jack invested the proceeds attributable to the gain within the 180-day period, no tax is owed in 2024 on such gain. If:
    - a. Jack sells his QOF investment on February 2, 2034 for \$1,900 (i.e., a \$900 gain), then (1) Jack owes tax in 2026 on \$1,000 because he cannot satisfy the 5-year hold rule in 2026 (there is no 10% reduction benefit, but he still benefits from a deferral) and (2) Jack owes no tax in 2034 on any gains on his QOF investment since he satisfies the 10-year hold rule (and he already paid tax in 2026 on his non-QOF deferred gain).
    - b. Jack sells his QOF investment on February 2, 2033 for \$1,900 (i.e., a \$900 gain), then (1) Jack owes tax in 2026 on \$1,000 because he cannot satisfy the 5-year hold rule in 2026 (benefitting only from a deferral) and (2) Jack owes tax in 2033 because he does not satisfy the 10-year hold rule; however, in 2029 and in 2031, Jack is most likely entitled to a 10% and a 5% step-up in his tax basis, respectively, because he satisfies the 5- and 7-year hold rules (i.e., his tax basis is \$1,150 [ $\$1,000 + (\$1,000 * 15\%) = \$1,150$ ]) which may allow additional depreciation deductions through the partnership prior to the sale in 2033.

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*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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<sup>1</sup> Note: This article is intended to be a summary only, please seek further professional tax guidance before investing in a QOZ. See Sections 1400Z-1 and -2, Subchapter Z of Chapter 1, of the Internal Revenue Code of 1986, as amended, for the subject code provisions.

<sup>2</sup> [https://www.cdfifund.gov/Documents/Copy\\_of\\_Designated\\_QOZs.6.14.18.xlsx](https://www.cdfifund.gov/Documents/Copy_of_Designated_QOZs.6.14.18.xlsx);  
[http://dof.ca.gov/Forecasting/Demographics/opportunity\\_zones/](http://dof.ca.gov/Forecasting/Demographics/opportunity_zones/);  
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