

# Syndication Attorneys PLLC

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## Qualified Opportunity Funds – Coming to a Community Near You

### This Will Change the Way You Think About Exchanging Property!

*NOTE: This information is of a general, educational nature and may not be construed as legal advice pertaining to your specific offering, exemption or situation. Such advice must be sought from your own attorney, pursuant to an attorney-client relationship, after consideration of your specific facts or questions.*

On Oct. 19, 2018, the [U.S. Department of Treasury and the Internal Revenue Service \(IRS\)](#) jointly issued proposed guidance related to a new Opportunity Zone tax incentive to be applied nationwide. The tax benefit was proposed as part of the 2017 Tax Cuts and Jobs Act (TCJA) to spur economic development and job creation within certain designated Opportunity Zones (low-income areas) within certain geographic areas within the United States.<sup>1</sup> The Proposed Regulations must be published in the Federal Register, after which there will be a 60-day public comment period. Thus, the final rules will not be released until 2019, but don't despair – the government wants you to use this program NOW and has made provision for that.

The program offers taxpayers who invest in such zones the opportunity to defer Federal income tax on capital gains in two ways:

1) By excluding from gross income certain gains if the corresponding amount of such gains are subsequently and timely invested in a Qualified Opportunity Fund (QOF); and

2) By excluding from gross income 100% of the "post-acquisition gains" on investments in QOFs if held for 10 years.

a. Note: There is a staggered exclusion in gains for investments held less than 10 years; with a 10% exclusion of gain from taxation after 5 years of investment and an additional 5% exclusion of gain from income after 7 years of investment; with the real payoff coming after the 10-year hold, in which there is a 100% exclusion of gain from income.

b. Gains for which deferral is sought must be recognized no later than Dec. 31, 2026. Qualifying investments must be made by June 29, 2027 (within 180 days of the qualifying gain) and sold or exchanged no later than Jan. 1, 2048, to be eligible for the 10-year gain exclusion.

The onus is on the taxpayer to meet the above requirements in order to take advantage of the deferral.

<sup>1</sup> The 2017 Tax Cuts and Jobs Act (Public Law No. 115-97, 131 Stat. 20154, 2184 (2017) (TCJA) amended the Internal Revenue Code Income Tax Regulations (25 CFR Part 1) to add sections 1400Z-1 and 1400Z-2. Section 1400Z-1 describes the procedures for establishment of qualified opportunity zones (QOZ) by states and municipalities. Section 1400Z-2 allows taxpayers to defer certain capital gains on funds that are subsequently invested in a Qualified Opportunity Fund.

### WHAT IS A QUALIFIED OPPORTUNITY FUND?

Real Estate Investment Funds who wish to qualify as QOFs can self-certify by filing Form 8996 with the IRS and by meeting the following requirements:

1) Unlike IRS' rules for 1031 Exchanges (Internal Revenue Code §1031), a QOF can be a Corporation, Limited Partnership or Limited Liability Company<sup>2</sup> taxed as a corporation or partnership, but it must be a U.S. company.

2) For QOFs that invest in real estate, 90% of the QOF's assets must be within an Opportunity Zone, with penalties for non-compliance. It is anticipated that the IRS will require QOFs to annually (or semi-annually) determine and report their compliance with the 90% asset test.

3) For QOFs that invest in trade or business, versus real estate, 70% of the tangible property owned or leased by a trade or business must be qualified opportunity zone business property (i.e., used in a Qualified Opportunity Zone).

4) Funds that sell properties during the required 10-year holding period will be required to re-invest the return of capital within a reasonable time (the amount of which has not yet been settled) to remain eligible to claim QOF status.

### EXAMPLE EXCERPTED FROM THE PROPOSED REGULATIONS:

For example, consider a QOF with \$10 million in assets that plans to invest 100 percent of its assets in real property. If it held the real property directly, then at least \$9 million (90 percent) of the property must be located within an opportunity zone to satisfy the 90 percent asset test for the QOF. If, instead, it invests in a subsidiary that then holds real property, then only \$7 million (70 percent) of the property must be located within an opportunity zone. In addition, if the QOF only invested \$9 million into the subsidiary, which then held 70 percent of its property within an

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<sup>2</sup> The IRS clarified in its "Opportunity Zones Frequently Asked Questions" that LLCs can be a QOF as long as it is taxed as a partnership or corporation. This would exclude single-member, disregarded LLCs from QOF eligibility.

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opportunity zone, the investors in the QOF could receive the statutory tax benefits while investing only \$6.3 million (63 percent) of its assets within a qualified opportunity zone.

### **SOME OF THE ISSUES THAT REMAIN UNSETTLED IN THE CURRENTLY PROPOSED REGULATIONS ARE:**

- 1) What is the penalty if the fund doesn't maintain 90% of its assets in the Opportunity Zone?
- 2) What are the reporting requirements for determining whether the 90% "asset test" has been met?
- 3) What is a "reasonable time" in which the funds must be invested or reinvested after a sale?

### **WHAT PROPERTIES ARE ELIGIBLE FOR QOF INVESTMENT?**

Eligible properties include vacant land for development and repurposing vacant buildings through substantial improvements or tangible property owned or leased by a trade or business. Certain asset classes and businesses are specifically excluded from eligibility for QOF investment, including private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, race tracks or other facilities used for gambling, or liquor stores.

### **CAN A QOF ACQUIRE A SINGLE ASSET OR DOES IT HAVE TO BE A FUND THAT ACQUIRES MULTIPLE ASSETS?**

As long as the asset being acquired meets the 90% "asset test" described above and is within a designated Opportunity Zone, nothing in the proposed regulations precludes a Syndication formed to acquire a specific property from electing to be a QOF.

### **WHAT GAINS ARE ELIGIBLE FOR DEFERRAL?**

Specifically, Section 1400Z-2(a)(1) states that "gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer" can be deferred, as long as it doesn't exceed the amount invested in a QOF by the taxpayer claiming the deferral within 180 days after the sale. "Gain" is currently being interpreted by the Treasury Department and the IRS to mean only "capital gains." You can only claim the deferral once with respect to a specific gain, although a single gain can be spread across multiple QOFs as long as the reinvestment is made within the 180-day period after the gain was realized for Federal income tax purposes.

### **WHO ARE RELATED PERSONS?**

Generally, this means family members, an individual and a company in which the individual owns 20% of the interests (stock, partnership interests, LLC units, etc.) or two companies in which 20% of the interests in each belong to the same person or entity who is claiming the deferral.

### **WHO IS ELIGIBLE TO CLAIM THE DEFERRAL?**

Any person or entity that recognizes capital gain for Federal income tax purposes, including individuals, C-Corporations, Real Estate Investment Trusts (REITs), partnerships, and certain other pass-through entities. Additionally, only those persons who invest in equity interests in the QOF are eligible to claim the deferral, including those with preferred ownership interests. Investors who purchase debt instruments such as promissory notes, bonds, debentures or certificates evidencing debt are not eligible to claim the deferral.

### **HOW LONG DO YOU HAVE TO MAKE THE INVESTMENT?**

The date on which the gain is considered realized for Federal income tax purposes is the start of a 180-day window in which the gain must be reinvested in a QOF. For QOFs involved in real estate development or that otherwise acquire, construct, or rehabilitate real estate or other tangible business property, there is a safe harbor of

31 months for holding "working capital," provided there is a written plan identifying such as property held for "acquisition, construction, or substantial improvement of opportunity zone property; a written schedule for use of the funds within 31 months; provided to all taxpayers who are claiming the safe harbor.

### **HOW CAN YOU CLAIM THE DEFERRAL?**

The IRS contemplates that each taxpayer claiming the deferral will attach Form 8949 to its Federal income tax return for the year in which the gain would have been realized.

### **HOW LONG MUST YOU HOLD THE QOF INTERESTS BEFORE YOU GET THE DEFERRAL?**

Once a taxpayer holds the QOF investment 10 years or more, it may elect to increase its basis to the fair market value of the investment when the investment is subsequently sold or exchanged.

### **CAN QOFS ACCEPT NON-TAX DEFERRED CONTRIBUTIONS?**

Yes. Only those investments that made the deferral election will be eligible to claim the step-up basis after the 10-year holding period.

### **HOW LONG DO THE QUALIFIED OPPORTUNITY ZONE DESIGNATIONS LAST?**

Through 2028, but the proposed regulations make provisions for taxpayers whose investments in a QOF will achieve its 10-year maturity date after 2028 such that the required 10-year hold time can still be realized for assets in expired zones through Dec. 31, 2047. The last gain subject to the deferral will occur Dec. 31, 2026. Thus, the proposed rule would allow an investor making an election on gain in December 2026 to hold the investment for the required 10-year period plus another 10 years and still defer the gain. This will prevent investors from having to dispose of their investments at what could then be an inopportune time.

### **DO YOU HAVE TO WAIT FOR THE FINAL REGULATIONS TO BE EFFECTIVE TO CLAIM THE BENEFITS?**

No. According to the Proposed Rules: "An eligible taxpayer, however, may rely on the proposed rules in this section with respect to investments, and deemed contributions, before the date of applicability of this section, but only if the taxpayer applies the rules in their entirety and in a consistent manner."

### **THE BOTTOM LINE:**

The Opportunity Zone rules have the ability to change the way real estate investors think about "exchanges," which until now have been restricted to Tenant in Common Ownership or Delaware Statutory Trusts in a group investing context. Further, under this deferral program, there is no longer a need for a like-kind exchange, as is the case with exchanges made under IRC Section 1031. This opens the door for investors who wish to sell their real estate (or other property) and invest the proceeds in QOFs, and still get the benefit of the exchange, but with a twist. In a 1031 exchange, you simply defer taxes on capital gains until such time as the last property you acquired is sold and no replacement property is purchased. With a QOF investment, the tax is forgiven and gone forever as long as the qualifying investment is held for at least 10 years.

Our firm is currently involved in drafting multiple Qualified Opportunity Funds. Though it goes without saying for those of you who follow our articles, QOF interests are securities and must comply with securities laws if you want to set one up so, in addition to finding a qualified accounting firm that can help you with your IRS elections and reporting requirements, you will need qualified securities counsel to help you set up your QOF. What are you waiting for? [Click here to schedule an appointment.](#)