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Overview

1. What is a QOZ? What is a QOF?
2. Overview of Tax Benefits
3. Existing Guidance
4. 2024 QOZ Update: Where are we now?

A Basic Guide to QOF Acronyms

- QOZ: Qualified Opportunity Zone

Economically distressed census tracts designated by State and local government officials.

- QOF: Qualified Opportunity Fund

Business entity that invests in qualifying property in a QOZ and meets various requirements to qualify eligible owners for tax treatment.

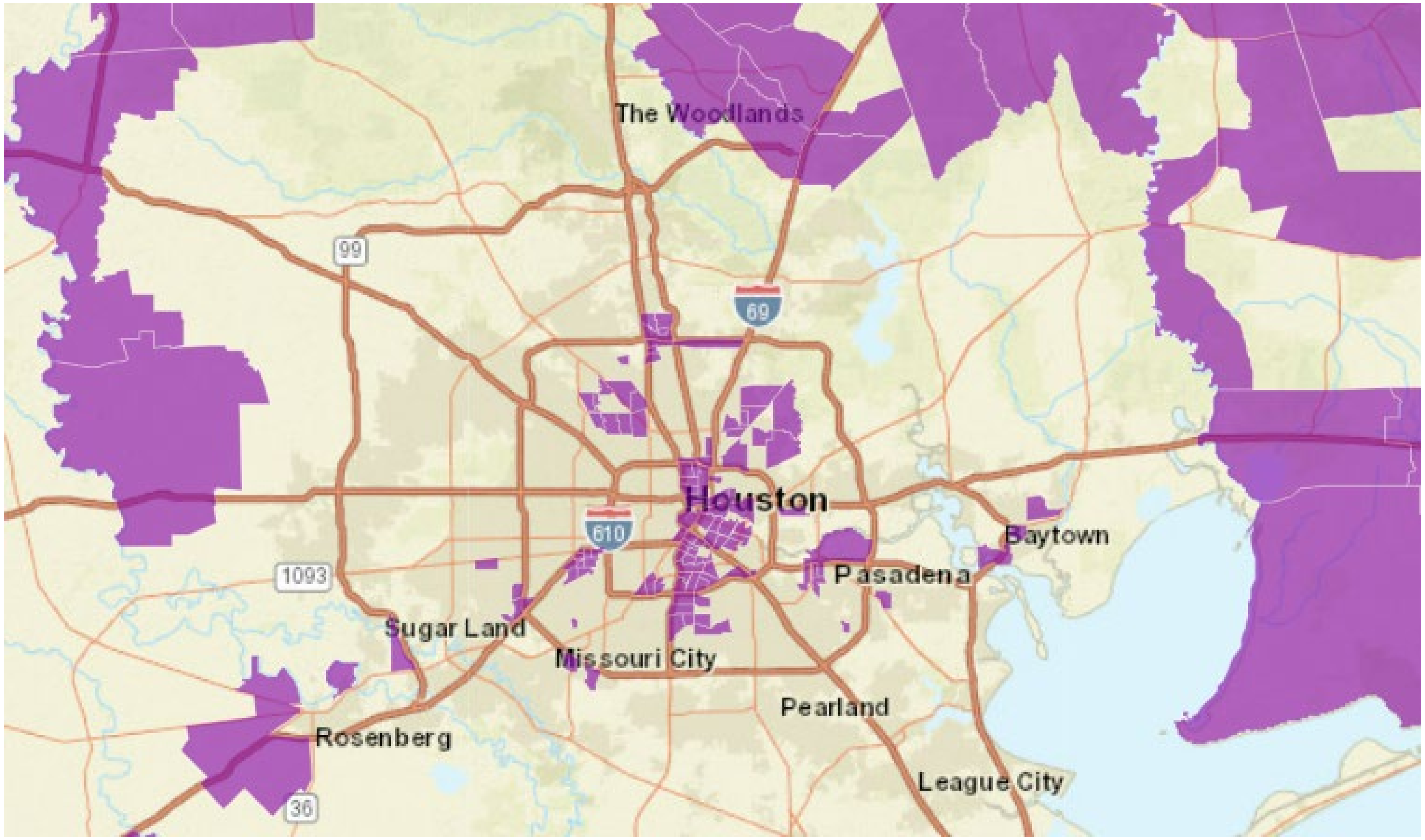
TCJA Created New IRC § 1400Z

- Enacted on December 22, 2017 as part of the Tax Cuts and Jobs Act.
- Established ***Qualified Opportunity Zones*** (QOZs).
- QOZs are intended to promote economic development and growth in low-income communities.
- Provides federal tax benefits to investors who invest in ***QOZ property*** through ***Qualified Opportunity Funds*** (QOFs).

QOZ Designation Process

- **Eligible Census Tracts**: Poverty rate of at least 20 percent or a median family income (MFI) of less than 80 percent of its surrounding region.
- Governors in U.S. states and territories nominate up to 25% of eligible census tracts. Up to 5% of those nominated census tracts could be in areas that were contiguous with low-income community census tracts. Opportunity Zones have been designated in all 50 states, Washington, D.C., Guam, American Samoa, Puerto Rico, the U.S. Virgin Islands and the Northern Mariana Islands.
- The average Opportunity Zone (excluding U.S. territories) has a *29 percent* poverty rate according to the latest available data — nearly twice the national rate — and an MFI only *59 percent* of the respective benchmark at the time of nomination.
- QOZ Map Resource: https://www.enterprisecommunity.org/resources/opportunity-zone-eligibility-map-tool

Houston Area QOZ Map



QOF/QOZ Tax Incentives

If you have **capital gain** (not ordinary income and not cash laying around) recognized on or after January 1, 2018, you can receive:

1) Capital Gain Deferral

~~2) Capital Gain Reduction~~

3) Capital Gain Exclusion

Capital Gain Deferral

- Temporary deferral of tax on 100% of capital gain (the "***original gain***") reinvested into QOFs.
- Reinvestment must generally be within 180 days of the sale resulting in the original gain, subject to certain exceptions.
- The period of deferral of the original gain ends upon the earlier of
  a) the date of sale or exchange of the reinvestment in the QOF, or
  b) December 31, 2026.

Capital Gain Reduction

- Provides investors a step-up in basis in their original investment based on the length of time the investment is owned by the QOF.
- After December 31, year 7 15% step up is not available for new investments.

YEARS QOF INVESTMENT MAINTAINED	PERCENT OF ORIGINAL GAIN ELIMINATED VIA STEP-UP
5	10%
7	15%[1]

[1] Basis is increased an additional 5% for a total basis step-up of 15%

Capital Gain Exclusion

- The taxpayer's basis in the QOF is initially deemed zero.
- The basis in the QOF increases as the holding period of the investment reaches certain milestones. These increases mirror the basis step-ups for the Capital Gain Reduction.

  - QOF investment held for 10 years: basis will be increased to 100% of the original gain amount.
  - **Final Regulations clarify that gain exclusion includes depreciation recapture (but does not include inventory gain).**

Key Differences between 1031 Exchanges and use of QOZs

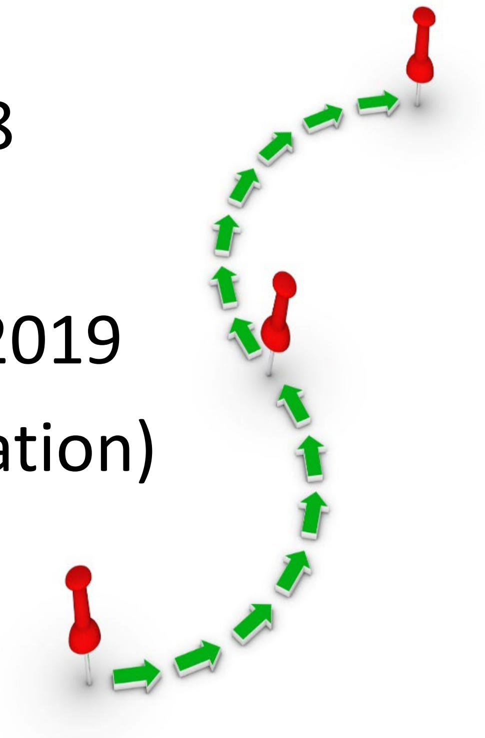
	1031 Exchanges	Qualified Opportunity Zones
May personal property be sold and proceeds used for an exchange?	No.	Yes.
May personal property be replacement property in an exchange?	No.	Yes, as long as the personal property is business assets in a QOZ
May securities be sold and proceeds used in an exchange?	No.	Yes.
Must replacement property be identified within 45 days?	Yes.	No.
Must the taxpayer close on replacement property within 180 days?	Yes.	Yes.
Does less taxable gain result from the first exchange?	No, 1031 only provides deferral not reduction in tax.	Yes, taxpayer may step up their basis in the original investment up to 15%.
Does less tax result on the eventual sale of the replacement property?	No, 1031 only provides deferral not reduction in tax.	Yes, taxpayer may get a 100% step up on the gain from the reinvested proceeds.
May a partner of a partnership defer gain?	No, only the partnership may defer the original gain.	Yes, if the partnership does not elect to.

When is 1031 still superior?

- Many real estate investors that are deferring gain on the sale of real estate will still prefer 1031.
- In conjunction with a step up in basis on death of property holder, 1031 can provide complete exclusion of the original and subsequent gains.

Existing Guidance

- IRC § 1400Z
- First Proposed Regulations – Oct. 2018
- Revenue Ruling 2018-29
- Second Proposed Regulations – April 2019
- Proposed IRS Form 8996 (Self-Certification)
- Final Regulations – Dec. 2019



Proposed and Final Regulations

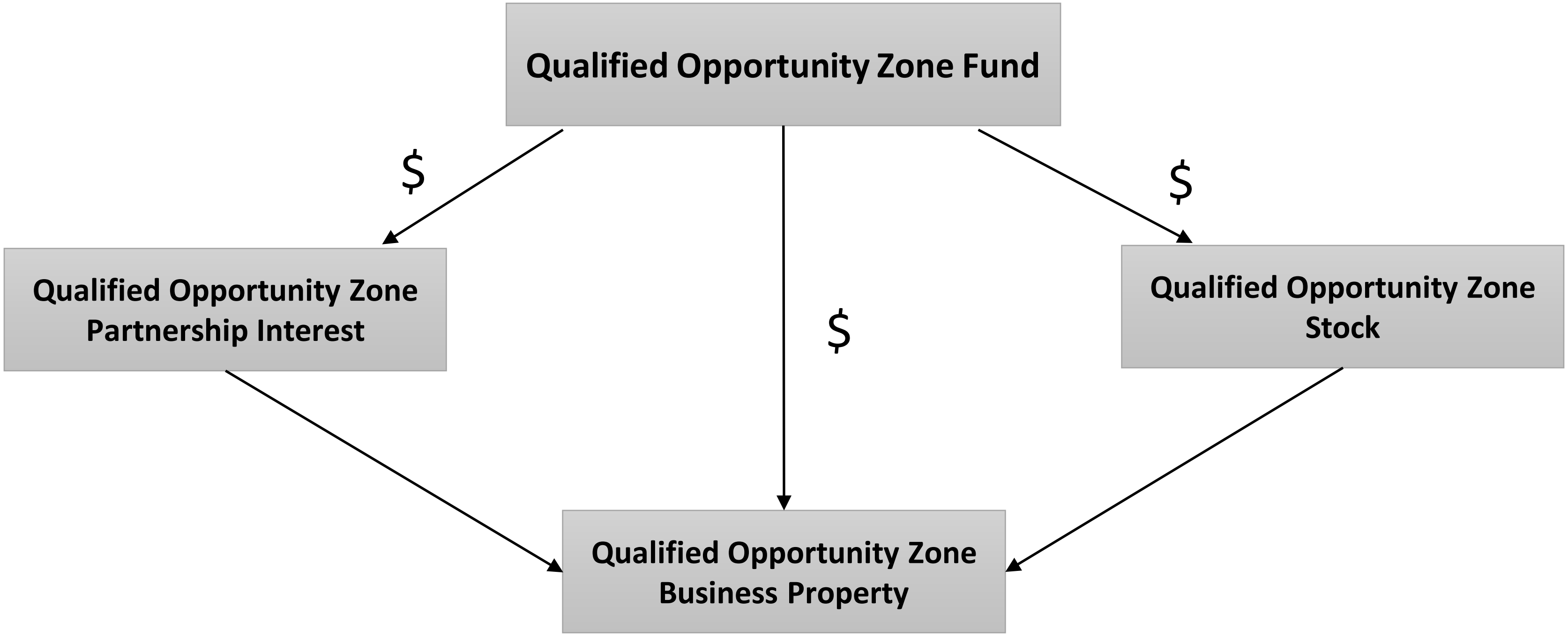
- On October 19, 2018, Treasury released its first round of guidance on the QOF program.
- On April 17, 2019, Treasury issued an extensive set of additional regulations that answered many additional questions.
- On December 19, 2019, Treasury issued final regulations which made several clarifications and changes to the proposed regulations as well as additional guidance.
- Regulations make it clear that Treasury intends for QOFs to be an effective incentive program and to make it easy for the program to achieve its aims of facilitating capital flow into low income regions.

Qualified Opportunity Funds

- Must be corporations or partnerships.
- Organized for the sole purpose of investing directly into QOZ property.
- ***Investment Standard*** – Must hold at least 90% of its assets in QOZ property.

QOZ Property

- ***Stock***: Any stock in a domestic corporation if:
  1) acquired by the QOF after December 31, 2017, at original issue from the corporation solely in exchange for cash;
  2) the corporation was a QOZ Business at the time such stock was issued; and
  3) such corporation qualified as a QOZB for substantially all of the QOF's holding period for such stock.
- ***Partnership Interests***: Any capital or profits interest in a domestic partnership if:
  1) acquired by the QOF after December 31, 2017, solely in exchange for cash;
  2) at the time the interest is acquired, the partnership is a QOZ business (or being organized for the purpose of being a QOZ business); and
  3) during substantially all of the QOF's holding period for such interest, such partnership qualified as a QOZ business.
- ***Business Property***: Any tangible property used in a trade or business of the QOF if:
  1) the property was acquired by the QOF for purchase after December 31, 2017;
  2) the original use of the property in the QOZ commences with the QOF or the QOF substantially improves the property; and
  3) substantially all of the use of the property was in a QOZ during substantially all of the QOF's holding period of the property.


Qualified Opportunity Zone Fund
$
$
$
Qualified Opportunity Zone Partnership Interest
Qualified Opportunity Zone Stock
Qualified Opportunity Zone Business Property

QOZ Businesses

- QOFs may invest in a newly formed or already existing entity so long as the investment is in the property of a ***QOZ Business.***
- A QOZ Business is a trade or business in which:
  - Substantially all (70%) of its tangible property, owned or leased is QOZ Business property
  - At least 50% of its gross total income is derived from the active conduct of its business
  - A substantial portion of its intangible property is used in the active conduct of its business
  - Less than 5% of the average of its aggregate unadjusted bases of the property is attributable to non-qualified financial property
  - None of the property is: a golf course, county club, massage parlor, hot tub facility, suntan facility, racetrack, facility used for gambling, or any liquor store. Final regulations clarify that a QOF can directly own these "sin" businesses but not through a multi-tier structure.

QOZ Business Guidance

- 50% Sourcing of Income Rules
  - Safe Harbor One: Number of hours for services provided in the QOZ
  - Safe Harbor Two: Amount paid by QOF for services provided in the QOZ (i.e. payroll within and without QOZ)
  - Safe Harbor Three: Tangible personal property and management present in QOZ are necessary to produce 50% of revenue. (Example: Landscaper with management office in QOZ and stores tangible personal property in QOZ)
  - Additionally, can qualify under facts and circumstances test

QOZ Business Guidance

- Intangibles
  - “Substantial portion” means 40% of intangible property is used in a QOZ

QOZ Business Property – Substantially Improved

- In order to qualify:
  - The original use of the tangible property must commence with the QOF

  OR

  - The QOF must substantially improve the tangible property
- Substantially improved
  - **Only if, during any 30-month period beginning after the date of acquisition of the property, the QOF adds to the basis of the property such that the basis doubles. EXTENDED BY FINAL REGULATIONS TO BE UP TO 62 MONTHS.**

Revenue Ruling 2018-29
Original Use

- Issue 1: Can the original use of an existing building or land be considered to have commenced with the QOF?
- Holding: No
- Land: Due to the permanence of land, land can never have its original use in a QOZ commence with a QOF
- Building: If it is an existing building, it cannot be considered to have its original use commence with the QOF

Original Use

- Tangible personal property must not have been used (depreciation/amortization test) in the QOF to qualify.
- Final regulations are more generous than proposed regulations and state that land/building is vacant if vacant for more than a year (if before QOF designation date) or if becomes vacant after QOF designation date, three years. Vacant if 80% or more vacancy in property.
- Original use test does not apply to land.
- Leased property does not need to meet original use test.

Revenue Ruling 2018-29 Substantially Improved

- Issue 2: Is a substantial improvement to the building measured by additions to the adjusted basis in the building or is it measured by additions to the adjusted basis in the building and the land?
- Holding: A substantial improvement to the building is measured by the QOF's additions to the adjusted basis of the building and not the adjusted basis of the building and the land combined

Revenue Ruling 2018-29 Substantially Improved

- Example:
  - QOF purchased land with a factory building located within a QOZ for $800,000.
  - Sixty percent of the purchase price ($480,000) was attributable to the value of the land.
  - Forty percent of the purchase price ($320,000) was allocable to the building.
  - Within 24 months of acquisition of the Property, QOF invests an additional $400,000 to convert the building to residential rental property.
  - Section 1400Z- 2(d)(2)(D)(ii) does not apply to the land on which the factory building is located, but does apply to the building.
- Result:
  - QOF ***did*** substantially improve the Property because during the 30-month period beginning with the acquisition, QOF's additions to the basis of the factory building ($400,000) exceed the amount of the QOF's adjusted basis in the building at the beginning of the 30-month period ($320,000).

Revenue Ruling 2018-29 Substantially Improved

- Issue 3: Do the regulations require the QOF to separately substantially improve the land?
- Holding: No, the regulations do not require the QOF to separately substantially improve the land upon which the building is located. The value of the land is disregarded for the improvements calculation.

Substantially Improved

- Concerns about unimproved land.
  - Example: Farmland in QOZ
- Proposed Regulations: Tangible personal property substantial improvement made on an asset by asset basis.
- **Final Regulations provide aggregation rules that replace the asset-by-asset approach for purposes of determining whether a property or group of properties has been sufficiently improved. Generally, property can count toward the substantial improvement requirement if it is in the same QOZ, used in the same trade or business, and improves the functionality of the non-original use property.**

Eligible Capital Gains

- Capital Gains that may be reinvested and deferred: [1]
  - LTCG and STCG
  - Section 1231 Gains – **Final regulations clarify that 1231 gains do not have to be netted at year end**.
  - 25% unrecaptured § 1250 gain
  - *May not* include recapture gain treated as ordinary income
- Gains at the partnership level can be rolled over by the partnership or any partner. [2]

[1] Prop. Reg. § 1.1400Z-2(a)-1(a)(2)

[2] Prop. Reg. § 1.1400Z-2(a)-1(c)(2)(ii)(B)

Gain Allocated from Partnerships

- Partners can choose to rollover gain starting from the later of the date the partnership recognizes gain or December 31. **Final regulations allow K-1 recipients to elect to start 180 day window on pass through entity return date (without extensions). Does not apply to grantor trusts**
- Partnerships need to break out gain and loss. A partner with no net gain allocation (from gain and loss netting) can still rollover the gain allocation from the partnership.
- If gain from a partnership, deferral from December of Year 1 to January of Year 2 would allow partner to roll gain as late as June of Year 3.

Cash/Working Capital Exclusions

- Capital received in the prior six months is not included on a QOF testing date for purposes of 90% QOZP asset test
- Contribution must be cash, cash equivalent, or debt instrument
- Preamble to final regulations indicate that if all the assets are excluded cash (and thus the ratio is undefined) QOZB should pass.

QOZ 2024 Update

Notes From the Field

2023 Proposed Legislation

When do QOZs end?

Under current law, last eligible capital gains will be those recognized in **<u>2026</u>**.

All QOZ investments must be sold by **<u>December 31, 2047</u>** to recognize 10 year benefit.

QOF Data from U.S. Treasury

Table 4. Form 8996, Qualified Opportunity Fund (QOF), selected items for tax years 2018-2020*

	2018	2019	2020
Number of QOFs	1,300	5,800	7,800
Qualified Opportunity Zone Property ($ billions)	4	28	44
Total Assets ($ billions)	4	30	48

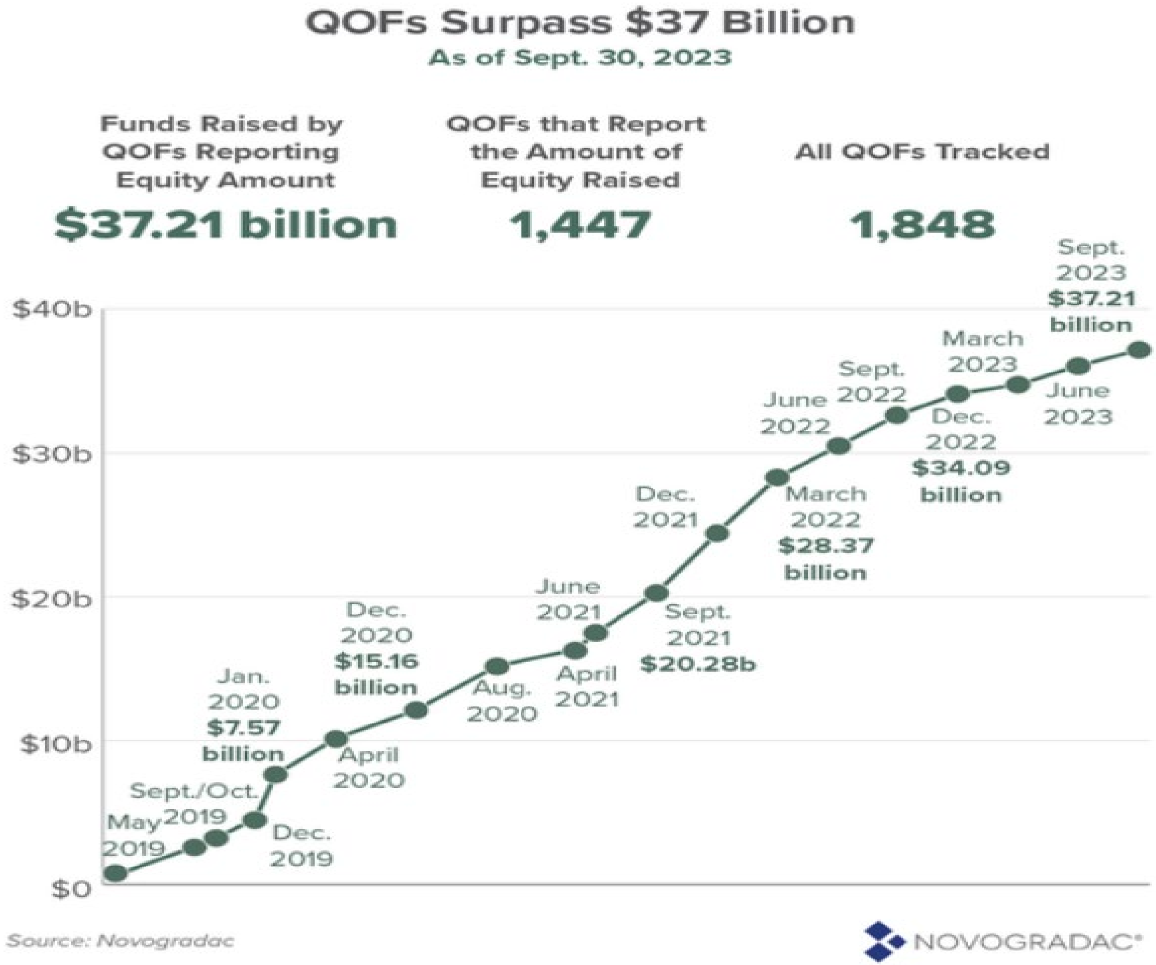
*Counts and amounts are rounded totals for tax returns available as 11/1/2022. Paper returns that have not yet been transcribed are not included in these totals.

Table 5. Form 8996, Share of Qualified Opportunity Fund (QOF) Returns and Assets by Entity Type, Tax Years 2018-2020 (Percent)

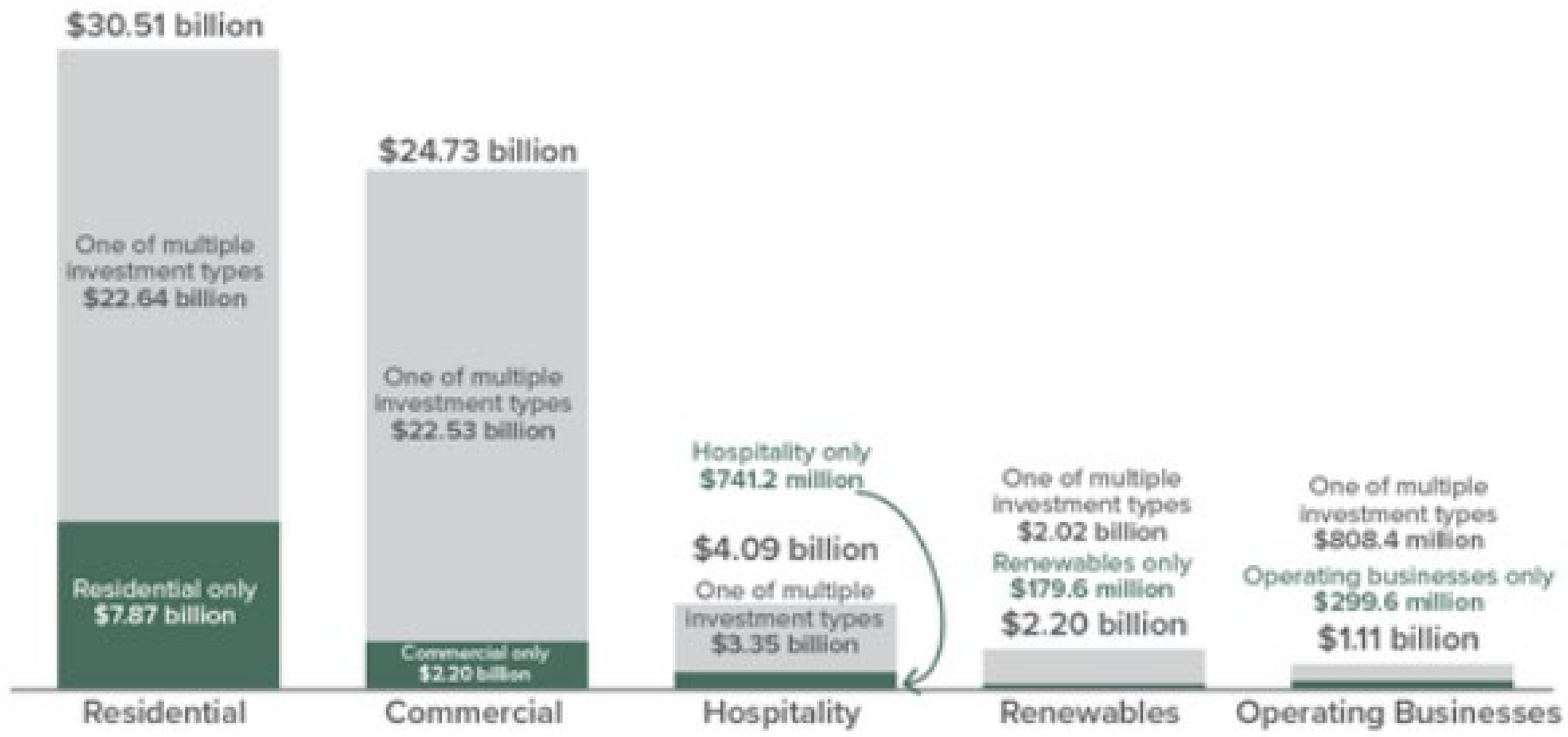
Return type	Share of QOFs	Share of Qualified Opportunity Zone Property	Share of Total Assets
	2018		
Form 1065 Partnerships	93	90	90
Form 1120 Corporations*	3	8	9
Form 1120S S-Corporations	4	2	2
	2019		
Form 1065 Partnerships	95	87	87
Form 1120 Corporations*	2	12	12
Form 1120S S-Corporations	4	1	1
	2020		
Form 1065 Partnerships	94	89	89
Form 1120 Corporations*	2	10	10
Form 1120S S-Corporations	4	1	1

*This includes all 1120 form types including 1120-F and 1120-REIT, except 1120S

QOF Investments as of 9/30/2023 *(Tracked by Novogradac)*



Residential, Commercial Still Dominate



Source: Novogradac

Legislative Update

H.R. 5761, the Opportunity Zones Transparency, Extension, and Improvement Act

- Extension of Deferral Period to December 31, 2028 (implication on 5%/10% basis step up)

- Elimination of Certain QOZs.

- Ability for QOFs to Invest in QOFs.

- Changes to Reporting Requirements.

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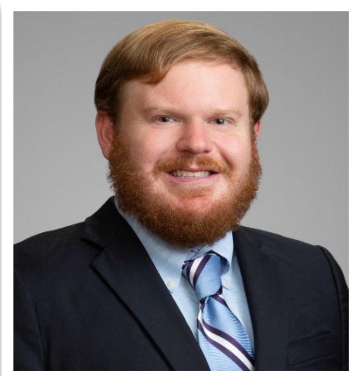

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Tax Planning

Austin Carlson helps companies (domestic and international) and individuals structure corporations, LLCs, partnerships and nonprofit entities, achieve their transactional tax and corporate planning goals, and successfully resolve tax controversies with the IRS and state taxing authorities. He also has substantial experience with all types of foreign account and income disclosure issues including the Streamlined Filing Compliance Procedures and Delinquent International Information Return Submission Procedures.

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Austin has previously served as a board member of TXCPA Houston and is currently a member of the Leadership Council of the TXCPA. He is a regular speaker on tax issues at events sponsored by organizations across the nation, including various state and local societies of CPAs and State Bar associations.

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