VORYS

Publications

Federal Tax Bulletin: Key Timing Issues for Qualified Opportunity Fund Investments

Related Attorneys

Joseph B. Mann

Lauren N. Fromme

Related Services

Federal Taxation

Real Estate

Tax and Economic Development Incentives

Taxation

CLIENT ALERT | 11.13.2019

Time is running out to clearly maximize the tax benefits available under the qualified opportunity zone (QOZ) program. Under current guidance, it seems that you must invest in a "qualified opportunity fund" (QOF) by **December 31, 2019** to be eligible for all possible QOZ tax benefits (though most QOZ tax benefits will still be available for QOF investments made after 2019). Additionally, if your capital gain this year is from the sale of property used in a trade or business, you must wait to make the related QOF investment until the last day of the taxable year (which for most taxpayers is December 31, 2019). These two critical timing requirements are woven into the QOZ rules, which are discussed in more detail below.

Basic QOZ Rules and Benefits

Under QOZ program, QOZ tax benefits are available to a taxpayer who recognizes capital gain on the sale of property to an unrelated buyer, makes a qualifying equity investment in a QOF up to the amount of that capital gain, and holds the QOF equity interest for a certain specified period of time. Such a taxpayer has the ability to defer and partially eliminate federal tax on that capital gain, as well as to avoid all federal tax on the taxpayer's eventual sale of their QOF equity interest.

A QOF is an investment vehicle created to invest in QOZs. Any corporation or partnership (including an LLC treated as a corporation or partnership for tax purposes) can be a QOF, so long as it follows the applicable QOZ rules and self-certifies by filing a Form 8996 with its federal income tax return. The QOZ requirements (which are beyond the scope of this Bulletin) primarily are designed to ensure that QOF investments result in new or significantly refurbished assets deployed and used in QOZs.

There are 3 potential tax benefits available to taxpayers who make qualifying QOF investments. A taxpayer's eligibility for 1 or more of these benefits depends on **when** the taxpayer invests in a QOF, and **how long** the taxpayer holds their QOF equity interest. These 3 tax benefits include:

1. **Deferral of Capital Gain Recognition**. A taxpayer who invests capital gain into a QOF in compliance with the QOZ rules is not subject to immediate tax on that capital gain. Rather, taxation of that capital gain is **deferred**, and no federal income tax is required to be paid on the gain until the end of 2026 (or upon the investor's disposition of the QOF equity interest, if earlier).
2. **Reduction of the Deferred Capital Gain**. When a taxpayer is required to pay federal tax on their deferred capital gain, if they have held their QOF equity interest long enough by that point, a portion of the deferred tax will be eliminated. Specifically, if the QOF interest has been held at least 5 years, then 10% of the deferred tax liability will be eliminated, and if the interest has been held at least 7 years, an additional 5% of the deferred tax liability will be eliminated. Thus, the maximum reduction of the deferred federal tax liability is 15%.
3. **No Federal Tax on Ultimate Sale of QOF Equity Interest**. Any increase in value of a QOF equity interest that a taxpayer holds for **at least 10 years** prior to disposition is not subject to federal tax upon the sale of that QOF equity interest.

180-Day QOF Investment Window: When Does it Begin?

When a taxpayer recognizes capital gain in a qualifying sale, the taxpayer has a 180-day window in which to make a corresponding equity investment in a QOF. Generally, that 180-day window begins on the day of the sale; however, there are exceptions to this rule.

1. **Sale of Business Property**. If the capital gain that you wish to invest in a QOF resulted from the sale of property used in a trade or business, special rules apply. Firstly, only your **net** capital gain for the year from sales of business property is eligible for QOF investment. Secondly, because that net gain amount cannot be determined until the end of the year, the 180-day QOF investment window for this gain does not begin until the last day of the year. Although this delay in the start of the 180-day window can be a benefit to many taxpayers by providing a later deadline for investment in a QOF, it can also be a potential trap. If a taxpayer were to recognize gain from the sale of business property and unwittingly make a QOF investment **before** year-end, that investment would not be eligible for any QOZ tax benefits.
2. **Flow-Through Entities**. When capital gain is recognized by a flow-through entity (e.g., an entity taxed as a partnership or an S corporation), either the entity itself may invest that capital gain in a QOF, or (in the event that the entity elects not to so invest) the entity's owners may directly invest their respective shares of the capital gain in QOFs. Where a flow-through entity invests in a QOF, normal rules relating to the 180-day window apply. Where an owner invests, however, their 180-day window begins on the last day of the flow-through entity's taxable year (though an owner may make an election to use the 180-day window of the flow-through entity).

The Significance of December 31, 2019

As stated above, in order to obtain the maximum 15% elimination of federal tax on deferred capital gain, a taxpayer must have held their QOF interest for 7 years by the time they are required to pay federal tax on that gain. The latest date that any taxpayer can defer tax on capital gain is December 31, 2026. Only QOF interests acquired on or before December 31, 2019 will satisfy the 7-year holding period on December 31, 2026. Therefore, under current guidance, it seems that taxpayers must invest in a QOF no later than

December 31, 2019 to be eligible for the total maximum 15% federal tax elimination.

Taxpayers making QOF investments on or before December 31, 2021 would still be eligible for the 10% federal tax exclusion. Additionally, QOF investments made on or before December 31, 2028 will be eligible for the permanent exclusion from tax on the sale of those QOF interests, described above.

The foregoing rules create a tight timetable for most taxpayers hoping to maximize their QOZ benefits from the sale of business property this year. Those taxpayers have just one day—December 31, 2019—to achieve their desired tax results. Happy New Year's Eve!

Note that the above discussion is based upon QOZ rules currently described in proposed regulations, which may be modified when released in final form. Until such time, the Treasury Department has indicated that taxpayers may rely on these proposed regulations. If you have any questions about these QOZ rules or the QOZ program generally, please contact your Vorys tax attorney.