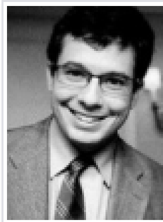
Treasury releases long-awaited QOZ regulations

There are still legitimate reasons to sit on the sidelines. But confusion over the rules is no longer one of them.



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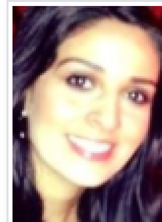

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On Wednesday, the U.S. Department of Treasury released proposed regulations relating to qualified opportunity funds. Until now, investors have been slow to embrace these funds, in part because of lingering questions about their tax treatment. With these latest regulations, the most important tax questions have been resolved, and investors can focus on the economics of the deal.

Congress created QO funds in 2017 to encourage investment in distressed neighborhoods. The idea was to motivate investors to sell their bourgeois assets (stocks, etc.) and reinvest the proceeds into proletarian assets (businesses in "QO zones"). To tie the tax benefit to long-term performance, and to compensate for the historically poor performance of investments in QO zones, the law allows the investor to eventually sell his new investment tax-free, but only if he holds it for at least ten years. In addition, to soften the capital-gain tax bite of the initial sale today (of the bourgeois asset), the taxpayer may defer that tax until as late as 2026. Finally, to encourage investors to adopt funds early, investors can also write off 15 percent of that gain if they invest by the end of 2019, and 10 percent if they invest by the end of 2021. Thus, the new proposed regulations come just in time to release a potential pent-up flood of interest in QO funds in 2019.

The new regulations clarify the rules in several important respects. First, they expand the time limit for investing in a fund, in limited cases. Under the statute, taxpayers have 180 days from the moment they sell their

current investment until the moment they wire cash into the fund. For many taxpayers, this 180-day rule has been a source of hardship. In particular, taxpayers who recognized gains in early 2018, before the fund industry matured, had no realistic opportunity to take advantage of QO funds.

The regulations do not specifically target these taxpayers for relief. However, they create two other grounds for extension, which these taxpayers may be able to take advantage of. First, in October, the Treasury announced an extension for any gains which the taxpayer receives from a pass-through entity (i.e., on a K-1). Second, these proposed regulations now add a similar exception, for gains arising from the sale of "Section 1231 property," which is property used in a trade or business. Where either of these exceptions is met, gains from 2018 can be deferred using a QO fund, even if the investment into the fund is made as late as June 28, 2019. Now is the time to ask your clients whether they had significant amounts of either of these types of gain in 2018.

A second benefit of the new regulations is that they loosen the limits on a fund's ability to hold cash. Of course, there must be some limit on funds' ability to hold cash; otherwise they would horde cash indefinitely. Still, commenters objected that the existing rules encroached on legitimate uses of cash.

To address these concerns, the proposed regulations create a one-year grace period for cash arising from the sale of tangible property, and a six-month grace period for newly contributed cash. In addition, real estate developers chafed at the 31-month window in which to expend their cash. The proposed regulations don't extend that window in all cases, but they do create a further extension of time for delays caused by government agencies. This 31-month rule has also been broadened to apply to non-real-estate start-up ventures.

Third, the new regulations clarify when a fund can hold unimproved land. In general, a fund can't merely buy real property; it must also "substantially improve" that property. In October, the Treasury acknowledged that this rule would apply differently for land (which can't really be improved), but they left open the question of how to apply this rule to unimproved land. As with cash, the concern is that investors might engage in "land-banking," sitting on raw land for no reason except to defer taxes.

With that in mind, the new rule is surprisingly liberal: Unimproved land need not be improved, provided that a genuine business is conducted on the land. In reaching this decision, the Treasury acknowledged that not every business that uses land will improve that land. Still, don't push your luck; the Treasury reserved the right to punish abusive cases. Avoid investments in parking lots, pumpkin patches, and apple farms.

Fourth, the new regulations clarify how excessive distributions from a fund can cause loss of tax benefits. They also include an exception for distributions of partnership debt, to the extent of the partner's outside basis. These types of loans should be in high demand in early 2027, when the tax comes due on the deferred gain. In more extreme cases, the rule suggests a method for bailing investment capital out of a fund.

Fifth, the regulations make funds more palatable to estate planners, by clarifying that the owner's death does not trigger the deferred gain or reset his holding period. Gifts do not receive this favorable treatment.

Sixth, the new regulations define how a fund can make effective use of leased property. These rules are important for people who already own property within QO zones. Under the prior rules, these people could not use these properties in their own funds, due to "related party" restrictions. In the new rules, the related party rules are weakened in the case of leased property.

Finally, the new regulations clarify the logistics for exiting a fund. Previously, it was unclear whether the desired tax benefits would be available if the fund wound up its business by selling its assets. There is little reason for the government to favor one form of exit over another, and the proposed regs help reduce these discrepancies.

Thanks to these proposed regulations, your tax lawyer can now give your proposed QO fund a clean bill of health. Still, that doesn't mean you should invest in it. The tax benefits of QO funds depend directly on their long-term economic performance. Do your diligence.

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