10 Things to Know about Qualified Opportunity Zones

By Carol Wright, CPA

Late last year the Treasury Department and IRS issued final regulations and guidance on tax incentives for Qualified Opportunity Zone (QOZ) investments. The QOZ program was created to boost low-income communities with needed investment and provide investors with significant tax incentives.

Without a doubt, the program can be a huge boon, if you know how to capitalize. But there's a lot to understand in the regulations.

Rehmann can help. We do this every day. Here are 10 things you need to know about QOZ investing.

Big Tax Savings

A QOZ allows capital gains to be reinvested, so investors can:

- Defer capital gains taxes until 2026
- Reduce their tax liability by up to 15 percent
- Avoid capital gains taxes from QOZ investments, if held for 10 years

Eligible investors include individuals, C corporations, S corporations, partnerships, trusts and estates.

Capital Gains Only

This incentive only applies to capital gains reinvested in qualified funds within a certain time period. While more can be invested, it won't qualify for tax exclusion after 10 years.

It's important to note only capital gains, not the entire proceeds of a sale, must be reinvested. Also, property contributions to a fund qualify, but subject the fund to special rules.

Taxable Triggers

QOZ investors cashing out before 2026 will trigger the previously deferred capital gains taxes. So-called "inclusion events" force the deferred capital gains taxes to become due.

Here's what the IRS considers cashing out:

- Gifting
- Transferring in a divorce
- Some corporate reorganizations

The IRS doesn't count transfers upon death as inclusion events (beneficiaries pay the tax in 2026). However, partnership distributions larger than the QOZ investment cost basis trigger capital gains taxes.

Capital Requirements

A key test to receive the incentive is 70 percent of a QOZ business' tangible assets must be held in qualified property. Importantly, the test omits working capital and recent capital contributions, making it easier to satisfy.

So, a QOZ business with $500,000 in qualified property and $1,000,000 in cash required for business operations would pass the test (with working capital included, it would not):

$$\frac{\textit{Qualified property}}{\textit{All tangible property except working capital}} = \textit{At least } 70 \textit{ percent}$$

$$\frac{\$500{,}000}{\$500{,}000} = \text{ 100 percent}$$

With working capital (for illustration)

$$\frac{\$500{,}000}{\$1{,}500{,}000} = \text{ 33 percent}$$

Property, Equipment Requirements

What is "qualified property"?

Personal business property like office furniture and computers must be new to the zone, although it can be used equipment. So, a manufacturer could relocate. Or a coffee shop could buy a used machine from outside the zone. Both activities would qualify.

QOZ buildings must be new or substantially rehabilitated, which means one of three things:

- New construction or never used in a business before
- Occupying after three vacant years
- Improvements equal to the portion of the original purchase price allocated to the building:

$50,000 (land)+$250,000 (building)=$300,000 total purchase

Must make at least $250,000 in improvements to qualify

The final regulations are expansive on what qualifies as building rehabilitation. Property enhancements, not just structural changes, qualify. Say you bought a hotel in a QOZ. You could enhance it with new furniture, kitchen equipment, or other improvements, and these qualify as improving the building.

Land used in a QOZ business doesn't need to be rehabilitated. However, special rules prevent land banking and holding unimproved land for future profit.

Leased property qualifies for the incentive, even if unimproved. The value of future lease payments is qualified property and counts towards the 70-percent test. This applies to related-party leases too, provided they're fair market value (FMV).

Must Be "Open for Business"

Assets deployed in a QOZ must be used in a trade or business. That includes start-up businesses (for 31 months generally) and substantial real estate rental activity (i.e., active landlords).

This requirement disqualifies traditional triple net leases from the incentive because they're not considered a trade or business.

In the Zone

A QOZ business must conduct meaningful business activity within the zone to qualify. There are a few ways to meet this test.

One is through wages. A QOZ business qualifies if more than half its wages are earned in the zone. This includes guaranteed payments to partners and independent contractors.

A firm also qualifies if more than half the revenue generated through property and management functions is within the QOZ.

Lastly, hours of service can satisfy the requirement. A QOZ business qualifies if more than half its hours of service are provided in the zone, including services of partners and independent contractors.

Six-Month Turnaround

Investors have 180 days to reinvest capital gains, whether in an active business or a passive QOZ investment fund that invests in QOZ businesses. When the timer starts varies though.

If you have installment gains, they're eligible for reinvestment in the current year. You can choose if the 180-day timer starts the day cash is received or December 31 of the same year.

Investors with gains from flow-through entities have choices for when the 180 days starts:

- Day of sale
- December 31 of sale year
- Entity's tax due date, including extensions (20 months for a January 2020 realized gain)

This reinvestment timeframe gets capital deployed quickly while also giving investors flexibility.

Capital Gains Only, Part 2

Again, only capital gains apply. However, proceeds from each sale of business property (Section 1231 sales) qualifies independently.

That said, ordinary income recaptured from a business property sale isn't eligible. A qualifying gain must flow through an investor's Schedule D (capital gains), regardless of its tax rate.

10 Years for Full Benefit

To receive the full QOZ benefit, qualifying assets or businesses must be held for a decade. Any gains after then are tax-free.

The final regulations clarified that, basically, all assets except inventory are qualifying assets (inventory sales are taxable). When sold, the cost basis is stepped up to FMV, so the gain is zero.

So, say you bought a QOZ building for $1 million, depreciated it to $100,000, then sold it for $2 million a decade later. Your cost basis would be stepped up from $100,000 to $2 million since there is no depreciation recapture, giving you a tax-free $1.9 million gain.

If you're interested in investing in an Opportunity Zone or would like to learn more, Rehmann offers tax and business planning services to help investors evaluate opportunities.

To get started, contact Carol Wright, CPA, at 248.614.6454 or carol.wright@rehmann.com.