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8 Opportunity Zone Gain Rules That May Aid Investors.

The qualified opportunity zone program is arguably the most flexible and most impactful tax program passed by Congress in the last 50 years.[1] In this article we explain eight new rules you should know about gain recognition and reinvestment, and how these benefits may be more attractive in light of the COVID-19 crisis.

Taxpayers can elect to invest either short-term or long-term capital gains from virtually any type of asset into a qualified opportunity fund, or QOF, within 180 days of recognizing their qualified gain. But, knowing exactly when the recognition date occurs and when the 180-day reinvestment period starts requires a deep dive into the proposed and final regulations — as well as into each taxpayer's specific facts.

In light of the unprecedented economic challenges presented by the COVID-19 outbreak, taxpayers with short-term or long-term capital gain income generated in 2019, or in early 2020 can use the opportunity zone program to park the qualified gains in a QOF for a period of time, allowing the investors adequate time to perform due diligence on various investments and make qualified opportunity zone business, or QOZB, or QOZB-property investments.

Once the capital gains have been reinvested into a QOF and then dropped into a QOZB, taxpayers have up to 62 months to reinvest the proceeds into various qualified opportunity zone projects. With the tremendous uncertainty in the current market, taxpayers will generally view this extended reinvestment period as a godsend.

The opportunity zone final regulations issued on Dec. 18, 2019, became effective March 16. The new rules give taxpayers tremendous flexibility and extension of time when it comes to determining when the 180-day capital gain reinvestment countdown begins for purposes of meeting the QOF deadline.

Taxpayers can elect to adopt the much more liberal final regulations earlier than their effective date for filing 2019 tax returns. However, this requires that electing taxpayers adopt all aspects of the final regulations — not just the 180-day rule. In most cases, this strategy should not negatively impact a taxpayer, but we highly recommend doing a full evaluation before making an early adoption election.

Below we discuss eight key aspects of the 180-day deadline rules under the proposed and final opportunity zone regulations. Let's take them one at a time.

1. Direct Capital Gains Generated From the Sale of an Asset Held by an Individual, Grantor Trust or C Corporation

There are no changes here between the final regulations and the proposed regulations. The 180-day period starts on the date of sale. Therefore, a taxpayer effectively has 179 days after the date of a sale to contribute all (or a portion) of their capital gains into a QOF.

For example, if an individual, grantor trust or C Corporation sold stock on June 1, 2019, the 180-day

deadline would fall on Nov. 27, 2019 — exactly 179 days after June 1. The deadline is not six calendar months from the date of sale (i.e. Dec. 1), as is often misunderstood. There is also no extension of the 180-day period if the last day falls on a weekend.

2. Capital Gains Flowing Through on a Schedule K-1 With No Entity-Level Election

Under the proposed regulations, taxpayers generally needed to wait until the pass-through entity's year-end to begin their 180-day period. For example, an owner of a calendar year pass-through entity has 180 days starting on Dec. 31, 2019 and ending on June 27 to contribute their 2019 share of Schedule K-1 capital gains into a QOF.

Under the proposed regulations, if the flow-through entity notified the taxpayer of their share of Schedule K-1 capital gain and the date of the actual sale, then the equity owner was able to choose to start the 180-day period earlier than year end, i.e. on the date of the actual sale. Interestingly, neither the proposed nor final regulations provide a specific time requirement or form for notification.

Remember, this option will help taxpayers that had identified qualified opportunity zone business property before year-end and that wanted to purchase replacement property early. However, to do that, the pass-through entity should not have made an election to defer the capital gains or have made a QOF investment at the entity level — as further discussed below.

Note that if the entity-level reinvestment election is made, the qualified opportunity zone business property must be purchased and titled under a QOZB, via a two-tier parent-subsidiary QOF-QOZ-property structure. It should not be purchased by the QOF directly and then dropped into a qualified opportunity zone business property, as this may disqualify the qualified opportunity zone business property and ultimately the QOF.

The rationale for this ruling is that the U.S. Department of the Treasury and the Internal Revenue Service wanted to give taxpayers the maximum amount of flexibility and time to invest in the opportunity zone program. Regulators also wanted to ensure that taxpayers did not miss a potential deferral election if they ended up receiving their final Schedule K-1s later than the aforementioned deadline laid out in the proposed regulations.

Under the final regulations, taxpayers can elect to start the 180 days on the pass-through entity's year-end, or on the due date of the pass-through's income tax return (not including any extensions — generally March 15 for partnerships and S Corps, and March 31 for trusts).

For example, if a pass-through entity reports on a calendar year-end, the owner can start the 180-day countdown on either Dec. 31, 2019, or on March 16, for their share of 2019 pass-through capital gains.

If owners choose to start their 180 days on March 15, 2020, then they have until Sept. 10, to contribute their share of 2019 Schedule K-1 capital gains into a QOF. If owners choose Dec. 31, 2019 then they have until June 27, to contribute 2019 capital gains into a QOF. NOTE: Taxpayers with a 2019 gain need to elect to apply the final regulations early if they prefer to extend the reinvestment period to Sept. 10.

The same rules apply if the pass-through entity is on a fiscal year-end basis. For example, if a pass-through entity's year-end is Nov. 30, 2019, then the 180 days would start on Nov. 30, 2019 or Feb. 15, at the election of the equity holder.

Note that limited liability company and partnership managers, and S Corp management should

adopt clear guidelines about the process required to make an entity-level reinvestment and the procedure needed for notifying equity holders about capital gains and Internal Revenue Code Section 1231 gain details during the year. This is an area that may generate future litigation for entities that do not take proactive steps.

3. Capital Gains Flowing Through on a Schedule K-1 With Entity-Level Election

Alternatively, the pass-through entity can elect to defer the capital gains at the entity level, which means the 180-days would start on the date of the actual sale.

Under the proposed and final regulations, pass-through entities that make a deferral election are required to notify all of their owners of that deferral election in writing, including the amount of the eligible gain deferral (again — no specific reporting timing is mentioned).

4. IRC Section 1231 Gross vs. Net Gains

One of the most controversial provisions in the proposed regulations pertains to the somewhat complex IRC Section 1231 rules. In general, the Section 1231 rules are as follows:

- Gains from the sale of trade or business property that's held for more than one year — excluding inventory, or IRC Section 1245 or 1250 amounts claimed — are treated as capital gains (federal capital gains are taxed at 0%, 15%, 20% or 23.8% tax rates depending on the individual taxpayer's taxable income and filing status),
- Losses from the sale of trade or business property can be used to offset ordinary income (federal ordinary marginal tax rates range from 10% to 37% depending on the individual taxpayer's taxable income and filing status), and
- Section 1231(c) generally requires taxpayers that had Section 1231 losses claimed during the preceding five years to track those losses and treat them as unrecaptured to the extent that those losses have not yet been applied against any current year Section 1231 gains. The amount of recaptured Section 1231 losses applied to current year Section 1231 gains is treated as ordinary income.

Under the proposed regulations, taxpayers were required to net all of their Section 1231 losses and Section 1231 gains. Further, only the net Section 1231 gains were allowed to be contributed into a QOF under the proposed regulation — after the net amount of gains and losses was determined. Calendar year taxpayers were also required to wait until Dec. 31 to begin the 180-day period under the proposed regulations and were precluded from investing their 1231 gains prior to year-end.

However, as a result of extensive written and public comments to Treasury, the final regulations allow taxpayers to defer their gross 1231 gains via QOF investments. Treasury also changed the beginning of the investment period from the end of the taxpayer's year to the date on which each asset was sold. Or, taxpayers can apply the rules mentioned above for pass-through K-1 capital gains, including Section 1231 gains.

The opportunity zone final regulations do not explicitly suspend Section 1231(c) losses. Therefore, electing opportunity zone treatment for current year Section 1231 gains is even more valuable for taxpayer's with Section 1231(c) losses since the recapture amount is treated as ordinary income.

5. Regulated Investment Company and Real Estate Investment Trust Dividends

Taxpayers who receive dividend distributions from a regulated investment company, or RIC, or from a real estate investment trust, or REIT, can start their 180-day period at the end of their tax year. The final regulations added that taxpayers can elect to start the 180-day period on the date their

dividends are actually received. The 180-day period for undistributed dividends starts on the taxpayer's year-end or the RIC/ REIT's year-end, at the election of the taxpayer.

6. Capital Gains From Installment Sales

The proposed regulations required taxpayers that had capital gains from installment sales to start their 180-day countdown period on the date of sale, provided the assets were owned directly, or to apply the pass-through rules (starting at year-end) if the gains were coming from a K-1. However, this method proved unfair to taxpayers that had to start their 180-day countdown before they actually had the cash in hand to invest into a QOF. Under the final regulations, taxpayers can delay starting their 180-day countdown until the date on which they receive their installment money.

Somewhat surprisingly, the final regulations also clarified that capital gains resulting from pre-2018 installment sales that involve post-2018 payouts now qualify for opportunity zone participation. This ruling allows taxpayers to start a new 180-day period each time an installment payment is received. The 180-day period for pass-through capital gains and Section 1231 installment gains is now treated as though it starts either on the date that the installment money is received, or on the date of the pass-through's year-end, or on the original due date of the pass-through entity's tax.

7. No 180-Day Safe Harbor

Unfortunately, neither Treasury nor the IRS has provided any relief for a missed 180-day deadline, but they may do so in the future.

8. Further Election Issues

A taxpayer can elect to use either the proposed regulations, or the final regulations. However, once a method is chosen, taxpayers must apply the rules consistently throughout. For example, under the proposed regulations, net Section 1231 gains that were recognized in early 2019 by an individual taxpayer could be invested into a qualified opportunity fund on or after Dec. 31, 2019, and by no later than June 27.

If a taxpayer invested gross Section 1231 gains prior to Dec. 31, they would want to elect early application of the final regulations. Otherwise, they would have an ineligible qualified opportunity fund investment. Making this election means that all final opportunity zone regulation rules apply to them. Individual investors and the qualified opportunity fund and QOZB can make independent elections on the regulatory effective dates. Therefore, careful analysis is required for the initial filings.

Note that each taxpayer's facts and circumstances need to be analyzed carefully in order to identify the 180-day deadline. Missing the deadline could be detrimental. As noted above there is currently no extension or safe-harbor available if you miss the 180-day qualified opportunity fund funding deadline. Therefore, all tax advisers need to be aware of these rules and discuss them with their clients as soon as possible. However, the final regulations are generally much more taxpayer-friendly than the proposed regulations, and they can serve as very helpful tax-savings or tax planning tools.

By Alejandra Lopez · April 21, 2020, 6:24 PM EDT

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[1] See our comprehensive overview of the opportunity zone program here:
<https://www.hcvt.com/services-Federal-Qualified-Opportunity-Zone.html>.

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