INSIGHT: Making Sense of the Timetables and Grace Periods in Opportunity Zone Investing

BY FORREST MILDEN

Much has been made of the deadline for taxpayers with capital gains to make their investments in qualified opportunity funds (or “QOFs”). Most frequently mentioned is Dec. 31, 2019 (perhaps Jan. 1, 2020) in order to maximize their tax benefits. That’s because the opportunity zone (OZ) rules provide the maximum tax savings for investments that are held for a full seven years on Dec. 31, 2026. Investments held for the full seven years qualify for a 15% basis step-up, and, therefore, generally a 15% reduction in the resulting tax liability. Investments made after that date will qualify at most for a 10% basis step-up. While this difference between these two reductions is not enormous, it is still important to have a good understanding of the numerous time periods and tests that apply to opportunity zone investing.

Here’s a summary of the important timing rules related to investing in a qualified opportunity fund.

The 180-day rule at the Investor level

The general timing rule for investing in a qualified opportunity fund requires the investor to get his, her, or its money into the fund within 180 days of the capital gain in order to qualify for the favorable OZ tax benefits. However, in its current form, the rule is more complicated than that.

While many capital gains arise from the sale of stock and similar assets (we might call these “portfolio gains”), capital gains can also arise from the sale of “assets used in a trade or
business,” like the sale of rental real estate, or a company’s corporate headquarters, or intangibles, like trademarks and copyrights (we’ll call these “1231 gains” (for tax code Section 1231)).

The Internal Revenue Service’s proposed regulations have two potentially unhelpful rules with respect to 1231 gains:

1. only the “net gains” are eligible for OZ treatment, so if the taxpayer has a 1231 gain from one sale of assets used in a trade or business and a 1231 loss from the sale of another such asset, then only the excess of the first over the second is eligible for OZ benefits, and

2. the 180-day period for investing does NOT start on the date of the sale of the 1231 sale; it is delayed until Dec. 31 of the year of the 1231 gain (for a calendar year taxpayer).

Of course, the first point may occasionally significantly reduce the amount of gain eligible to be invested, and the second point makes tax planning amazingly complicated because a single transaction might give rise to both portfolio and 1231 gains, with different 180-day periods.

Plainly, the delay in the start of the 180-day period to the end of the year for investing 1231 gains is at odds with encouraging rapid investment in OZs. For example, suppose a stockholder sells both (i) her corporate stock of a business, and (ii) her direct ownership of the building that she leases to the business. On these facts, the 180-day period for the portfolio gain will run from the date the stock is sold, while the 1231 gain will run from Dec. 31 of the year of sale, even if both stock and real estate are sold in the same transaction at the same time.

There has been a lot of criticism of the IRS’s treatment of 1231 gains. Indeed, some have contended that the IRS’s position is so wrong that the regulations would not be upheld by a court. For the time being, unless and until the IRS changes its rules (and final regulations may come out by the end of 2019), it may not pay to act inconsistently with the timetables I’ve described above.

The 6-month rule and the 90% test at the fund level

Once an investor makes an investment into a fund, we get to the next question of how soon the fund must actually spend the money. Here are the tests and timetables relevant to that investment.

A. The 6-month test.

A QOF is subject to a 90% test six months after it elects to start the fund, or at the end of its taxable year, if sooner. Thereafter, the 90% test is done at the six-month and year-end points for every year after that. For a calendar year entity, that means June 30 and Dec. 31 each year.

The IRS also has a somewhat surprising way of measuring six months for this purpose. Under the IRS rule, the first test date is the end of the six-month period that includes the start date (presuming that the end of the tax year doesn’t come first). In general, that will be less than a full six months.

Thus, for a calendar year entity which elects to become a QOF in the second half of any year, the first test date will be Dec. 31, while for an entity which elects to become a QOF in the
first half of any year, the first six-month test is actually done after five months and some number of days later.

For example, if a calendar-year fund elects to start being a fund on Sept. 10, the first test date will be Dec. 31. On the other hand, if a fund elects to start on March 12, then the first testing date will be August 31, which is actually five months and 19 days later. In either case, for a calendar year fund, the testing dates in subsequent years will be June 30 and Dec. 31.

Note that I use the phrase “elects to start” because the rules allow a fund to be formed on one date, but elect to start being a QOF on a later date, presumably the first date that it actually gets a capital contribution. This facilitates getting the paperwork done in advance if the parties find that useful.

B. The 90% test.

When it comes to passing the 90% test, the “good assets” (which count towards the “90%”) consist of three possibilities: (i) direct investments in QOZ business property (e.g., direct ownership of a building by the fund), (ii) ownership of a partnership interest in a partnership/LLC entity that qualifies as a QOZ business, and (iii) ownership of stock in a corporation that qualifies as a QOZ business. I’ll call these three baskets the “direct ownership basket,” the “partnership interest basket” and the “corporate stock basket.” Anything else, such as mere cash, or direct ownership of real estate or other assets that are not in an opportunity zone count against passing the 90% test. I’ll call them “bad assets.” Of course, there are many additional tests that apply here: in general, qualified opportunity zone business property must be acquired after 2017 from an unrelated person, used property must be substantially rehabilitated, and several others. I’ll leave the analysis of all those requirements for another discussion.

But, returning to the timing requirements that we are considering here, the bottom line is that each time a six-month testing date comes around, the QOF wants to make sure that at least 90% of its assets are in one of the three good baskets.

There is an important exception in the regulations, as follows:

Treasury Regulations Section 1.1400Z2(d)-1(b)(4): Option to disregard recently contributed property. A QOF may choose to determine compliance with the 90-percent asset test by excluding from both the numerator and denominator of the test any property that satisfies all the criteria in paragraph (b)(4)(A) through (C) of this section. A QOF need not be consistent from one semi-annual test to another in whether it avails itself of this option.

(A) As the case may be, the amount of the property was received by the QOF partnership as a contribution or by the QOF corporation solely in exchange for stock of the corporation;

(B) This contribution or exchange occurred not more than 6 months before the test from which it is being excluded; and
Between the date of that contribution or exchange and the date of the asset test, the amount was held continuously in cash, cash equivalents, or debt instruments with a term of 18 months or less.

Put into plainer English, this section of the regulations provides a fund a six-month “grace period” for it to not count recent capital contributions.

For example, suppose that we start a fund on Sept. 30, and on that date, we get $5 million from investors. We take all that money and invest it in “cash, cash equivalents, or debt instruments with a term of 18 months or less,” and when we get to Dec. 31, the $5 million is still sitting there. Before you knew about the grace period, you might have thought that our fund had 100% bad assets on Dec. 31, because none of the assets are in the three good baskets; instead, everything is in cash, cash equivalents, or debt instruments with a term of 18 months or less; none of those is direct ownership of an OZ asset, or a partnership, LLC, or stock interest in an OZ business.

But, that’s where the grace period kicks in. It says that as long as

(i) the capital contribution was received within the past six months, and

(ii) the capital contribution is held in cash, cash equivalents, or debt instruments with a term of 18 months or less (I’ll call these “grace period investments”)

then it doesn’t count. Accordingly, the fund in our example has no assets (everything was received in the past six months) and it doesn’t fail the 90% test. (Some tax advisors have worried about the mathematics of dividing zero by zero; I learned at MIT the answer to this computation is considered to be “infinity.” Still, I’ll note that infinity is more than 90%!).

Note that the grace period doesn’t go on forever. Fast forward to June 30 of next year, and now, the capital contribution was received more than six months ago (Sept. 30 to June 30 is nine months). So, the capital contribution received on Sept. 30 of the prior year no longer gets excluded. In other words, by June 30 of the following year, we do have to have 90% of our assets in one of the three baskets, and cash received more than six months ago is no longer excluded from the computation of the 90% test. Instead, they are part of the bad assets. So, we must invest that money in one of the good baskets, or our fund will not qualify as a QOF. More on this in the next section.

Of course, new contributions to the QOF can start the computations all over again. For example, assume a QOF got $3 million in September of 2019 and $5 million in March of 2020. On those facts, on the Dec. 31, 2019, test date, the $3 million must be invested in either (A) one of the three good baskets, or (B) grace period investments, and the fund will still qualify. But, on the June 30, 2020, test date, the $3 million has to be invested in one of the three baskets (with a little flexibility provided by the 90% test), because that investment is now more than six months old. On the other hand, the more recent $5 million that was received in March 2020 can still take advantage of investing in grace period investments.

Note that the “debt instruments with a term of 18 months or less” offers some short-term lending possibilities for a fund while it is searching for investments. So, this may make it possible for the QOF to provide short term debt financing for projects in the first several months after contributions are made to the fund, and still qualify as a QOF.
The 70% Test at the Qualified Opportunity Zone Business Level

As noted above, a QOF can pass the 90% test, in part, by investing in the “partnership interest basket” or the “corporate stock basket.” Each of these contemplates that the QOF has acquired an interest in an entity (a partnership, corporation, or LLC) that meets the requirements to be a “qualified opportunity zone business.” We’ll call this entity a “subsidiary entity.” Of course, making a capital contribution to a subsidiary entity that qualifies as a qualified opportunity business is often the optimal place to put the QOF’s cash in order to pass the 90% test.

A subsidiary entity must meet several requirements of the tax code and regulations in order to be a qualified opportunity zone business.

The most notable requirements are that this entity must be engaged in an active trade or business in the zone, and that it have at least 70% of its tangible assets be qualified opportunity business property. There are other requirements as well, which I will briefly and generally summarize as a 5% limit on “nonqualified financial property” that the entity can have, a requirement that 40% of its intangible property be “used in the zone,” and that 50% of its workers’ and independent contractors’ hours or compensation be in the zone. Of course, each of these percentages has exceptions, alternatives, and pages of rules explaining their computation.

I’m not going to provide a detailed discussion on all of these tests in this article. Here, I only wanted to discuss a rule that permits a subsidiary entity to generally pass both (A) the active trade or business requirement, and (B) the cap on nonqualified financial property limitations even while it is sitting on cash, and constructing or rehabilitating a building or developing a business, provided it has a 31-month written plan to do the constructing, rehabilitating, or developing, and it reasonably complies with that plan. Indeed, it may be possible to do more than one 31-month plan as the subsidiary entity gets additional funds.

Putting it all together

In general, combined with the 90% test I described in the preceding section, this means that a fund can get capital from an investor, put that money into cash, cash equivalents, or debt instruments with a term of 18 months or less that are held by the fund until it gets to the next 90% testing date that is more than six months later. Then, the fund can contribute that money to a subsidiary entity that has another 31 months (and possibly more) to build the project that it has described in its written plan. Note that the fund has to actually move the money from the QOF’s bank account into the subsidiary entity in order to not fail the 90% test at the fund level.

The bottom line: There can be a pretty extended period from the date of the investor’s capital gain to the actual expenditure of funds on a physical project or a business by a qualified opportunity zone business. Of course, with all of these timing and percentage tests, there are a lot of potential traps for the unwary, as well as exceptions that can save a particular factual situation. Be sure to analyze the issues thoroughly before assuming that your particular structure passes or fails the requirements.

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