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Opportunity Zones and REITs—The Latest Guidance from Treasury and the IRS

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Real estate investment trust ("REIT") investments in opportunity zones may yield tax benefits. This article explains how new opportunity zone provisions apply to REITs, taking into consideration proposed regulations.

By now, many taxpayers have heard about the tax benefits associated with the opportunity zone provisions enacted as part of the 2017 tax act.[1] In short, a taxpayer (including a REIT) may (1) temporarily defer an eligible gain by reinvesting this gain in a qualified opportunity fund ("QOF"), which includes an entity electing to be taxed as a REIT; (2) have a portion of the reinvested gain permanently excluded from gross income if the investment is held for at least five years;[2] and (3) permanently exclude post-acquisition gain from gross income if the investment is held for at least 10 years.[3] However, notwithstanding these tax benefits, some taxpayers were hesitant to enter into opportunity zone transactions due to lack of clarity.

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1 Pub. L. No. 115-97, 131 Stat. 2054 (2017) (the "Tax Act").

2 A taxpayer may be entitled to maximum permanent exclusion of up to 15 percent of its initially invested gains if its investment is held for seven years.

3 Certain capital gain dividends paid by a QOF REIT may be treated as a sale of a qualifying investment under proposed section 1.1400Z2(c)-1(e) as discussed below. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

On October 29, 2018, and May 1, 2019, Treasury and the IRS published two separate sets of proposed regulations. Together, these proposed regulations provide much needed clarity and, in some instances, the flexibility that investors have been waiting for to proceed with opportunity zone investments. However, some unanswered questions remain. This article focuses on the application of the opportunity zone provisions to REITs and provides a high-level summary of what is known based on the proposed regulations.

Eligible Gain and Reinvestment Period

Generally speaking, if a taxpayer recognizes gain from the sale to, or exchange with, an unrelated person of taxpayer's property ("eligible gain"), the taxpayer may defer the recognition of this gain by reinvesting it in a QOF within a 180-day period beginning on the date of the sale or exchange.[4] Eligible taxpayers include individuals, C corporations (including regulated investment companies ("RICs") and REITs), partnerships, certain other pass-through entities, and trust funds.[5]

Under the proposed regulations, an eligible gain includes, among other things:

- The gain that is treated as a capital gain from a sale or exchange with a unrelated person,[6] and
- The capital gain net income determined by taking into account the capital gains and losses for a tax year on all the taxpayer's section 1231 property.[7]

REIT as Eligible Taxpayer

With respect to a REIT, it may reinvest gains on selling or exchanging (1) stock of a subsidiary REIT or a taxable REIT subsidiary ("TRS"), or (2) an investment (e.g., a mortgage loan) treated as a capital asset for U.S. federal income tax purposes even if the gain is considered a short-term capital gain. However, a gain recognized on a transaction between related persons is not eligible.[8] Thus, if a REIT owns a subsidiary REIT through a partnership, and if the partnership recognizes a gain on a complete liquidation of this subsidiary REIT, this gain is not eligible if the same persons own more than 20 percent of the subsidiary REIT (in value) and 20 percent of the partnership (in capital or profits).

It is worth noting that if a REIT is required to treat 20 percent of unrecaptured section 1250 depreciation as "ordinary" at its level (i.e., because it is not distributing a capital gain dividend), a portion of the gain on the section 1250 property is not eligible.[9] Also, it does not appear that a REIT's capital gain net income from all of its section 1231 property needs to be reduced by REIT's capital loss for purposes of determining REIT's eligible gain. For example, if a REIT sells several section 1231 properties at a net

[4] Section 1400Z-2(a).

[5] Proposed section 1.1400Z2(a)-1(b)(1).

[6] Proposed section 1.1400Z2(a)-1(b)(2)(i).

[7] Proposed section 1.1400Z2(a)-1(b)(2)(iii).

[8] For purposes of the opportunity zone rules, persons are related to each other if they are described in section 267(b) or 707(b)(1), determined by substituting "20 percent" for "50 percent" each place it occurs in those sections.

[9] Sections 291(a) and (d).

gain of $100 and disposes of a mortgage loan investment at a loss of ($20) during a tax year, the REIT may reinvest the net gain of $100 into a QOF based on the proposed regulations.

However, to the extent a REIT recognizes gains and losses on sales or exchanges of section 1231 property during a tax year, and one or more of the property is subject to the built-in gain tax,[10] the determination of its eligible gain may require special considerations. First, if the REIT recognizes a loss on a section 1231 property that is not subject to the built-in gain rules, a portion of the built-in gain on another section 1231 property may not be eligible for the deferral due to the netting rule. Also, to the extent a tax is paid on the recognized built-in gain, this tax may further reduce the REIT's capital gain net income in addition to the "ordinary" treatment with respect to the unrecaptured section 1250 depreciation.[11]

For example, assume that a REIT sold two section 1231 properties during the year—Property A, which was acquired from a C corporation at a carryover basis transaction, at a gain of $100 that was entirely a built-in gain, and Property B, which was purchased by the REIT with cash, at a loss of ($30). Thus, the built-in gain cannot be reduced by the non-built-in loss for determining REIT's corporate tax. Assume further that the REIT has significant taxable income from its rental operation for the year so it is not subject to the taxable income limitation.[12] It appears that the loss on Property B would need to be considered for determining the REIT's eligible gain to be deferred, such that the REIT could not fully reinvest the built-in gain in the QOF (of $100) to defer U.S. federal tax. For example, if the REIT reinvests $40 into a QOF, it would have a U.S. federal tax of $12.6 ($60 at 21 percent), which is treated as a loss on section 1231 property, and its eligible gain would be $57.4 ($100 minus $12.6 and minus $30) before considering section 1250 recapture.

At the REIT level, the 180-day period begins on (1) the last day of a REIT's tax year with respect to any capital gain net income from section 1231 property for the tax year; or, (2) for other capital gains, the day on which the gain would be recognized if the REIT did not elect under the opportunity zone rules to defer recognition of that gain.[13]

REIT's Shareholder as Eligible Taxpayer

With respect to a REIT's shareholder, the eligible gain may include a dividend (or a portion of this dividend) designated by the REIT as a capital gain dividend ("Actual CGD"), which for U.S. federal

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[10] Section 1.337(d)-7 states that property owned by a C corporation that becomes property of a REIT in a conversion transaction (including transfer of property owned by a C corporation to a REIT) will be subject to the built-in gain rules under section 1374. Pursuant to section 1374, a corporate level tax will be imposed on built-in gains in transferred property if the REIT disposes of this property during the five-year recognition period.

[11] Section 1.337(d)-7(b)(3)(ii) provides in part "[t]he amount of tax imposed… on net recognized built-in gain for a taxable year is treated as a loss sustained by… the REIT during such taxable year," and "[t]he character of the loss is determined by allocating the tax proportionately (based on recognized built-in gain) among the items of recognized built-in gain included in net recognized built-in gain."

[12] Section 1.1374-2(a)(2).

[13] Proposed sections 1.1400Z2(a)-1(b)(2)(iii) and (b)(4)(i).

income tax purposes is treated as a gain from the sale or exchange of a long-term capital asset.[14] For this purpose, the designation is effective up to REIT's net capital gain for the tax year and must be proportionate among shares.[15] Further, the designation is accomplished via a written notice mailed to REIT's shareholders within 30 days of the close of REIT's tax year (or mailed to REIT's shareholders with REIT's annual report for the tax year).[16] Generally, a widely held REIT notifies its shareholders of an Actual CGD via Form 1099-DIV that is due to shareholders before January 31 of the year following the relevant tax year. However, a REIT must consider circumstances under which its tax year may be cut short (e.g., merging out of existence, liquidation, etc.).

It should be noted that while a REIT is required to identify the portion of its Actual CGD that is treated as unrecaptured section 1250 gain, this portion is nevertheless a capital gain to a non-corporate shareholder for U.S. federal income tax purposes and, thus, should be eligible gain for purposes of the opportunity zone rules. However, to the extent the shareholder is a corporation, a portion of unrecaptured section 1250 gain is re-characterized as "ordinary," and thus, it may not be entirely clear whether it remains an eligible gain for purposes of the opportunity zone provisions.[17]

Furthermore, while a REIT ordinarily distributes all of its earnings to shareholders to avoid a corporate tax at its level, it technically is not required to distribute its net capital gain, which is "the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year."[18] Under the proposed regulations, for REIT's shareholders, the eligible gain may also include the net capital gain that is retained by the REIT, subject to tax at the REIT level, and deemed distributed to shareholders at the close of REIT's tax year ("Deemed CGD") upon a written notice mailed within 60 days of the close of REIT's tax year (or mailed with REIT's annual report for the tax year).[19] For U.S. federal income tax purposes, shareholders at the close of REIT's tax year are deemed to have paid their proportionate share of U.S. federal tax paid by the REIT on the retained net capital gain and allowed credit or refund as the case may be, for the tax so deemed to have been paid.[20] Finally, the eligible gain may include a gain recognized on the sale or exchange of a shareholder's REIT stock, if held as a capital asset, including a complete liquidation of the REIT to which section 331 applies if the shareholder is not considered related to the REIT.

According to the proposed regulations, the 180-day period begins on (1) the day on which the Actual CGD is paid by the REIT;[21] or (2) the last day of the REIT's tax year with respect to the Deemed CGD.[22]

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[14] Section 857(b)(3)(A) and proposed section 1.1400Z2(a)-1(b)(4)(ii) Example 2.

[15] Sections 857(b)(3)(B) and (g)(2).

[16] Section 857(b)(3)(B).

[17] Section 291(d).

[18] Sections 857(a)(1) and 1222(11).

[19] Section 857(b)(3)(C)(i).

[20] Section 857(b)(3)(C)(ii).

[21] Proposed section 1.1400Z2(a)-1(b)(4)(ii), Example 2.

[22] Proposed section 1.1400Z2(a)-1(b)(4)(ii), Example 3.

Many widely held REITs make distributions with respect to their stock on a quarterly basis and will not know the amounts of their E&P (for treating distributions as dividends) and their net capital gains (for designating Actual CGDs) until close to the year-end. Thus, shareholders of widely held REITs may find it challenging to reinvest an Actual CGD within the 180 days of receiving this dividend. For example, assume that a REIT makes the following distributions during 2020 and determines that its E&P and net capital gain for 2020 to be $3,500 and $800, respectively. The REIT's Actual CGDs can be designated as follows:[23]

	31-Jan-20	30-Apr-20	31-Jul-20	31-Oct-20	Total
Amount on Common	1,000.00	1,000.00	1,100.00	1,100.00	4,200.00
Amount on Preferred	200.00	200.00	200.00	200.00	800.00
					5,000.00
Dividend - Common	642.86	642.86	707.14	707.14	2,700.00
Dividend - Preferred	200.00	200.00	200.00	200.00	800.00
					3,500.00
Actual CGD - Common	146.94	146.94	161.63	161.63	617.14
Actual CGD - Preferred	45.71	45.71	45.71	45.71	182.86
					800.00

However, if its E&P and net capital gain for 2020 turn out instead to be $3,900 and $300, respectively, the REIT's Actual CGDs can be designated as follows:

	31-Jan-20	30-Apr-20	31-Jul-20	31-Oct-20	Total
Amount on Common	1,000.00	1,000.00	1,100.00	1,100.00	4,200.00
Amount on Preferred	200.00	200.00	200.00	200.00	800.00
					5,000.00
Dividend - Common	738.10	738.10	811.90	811.90	3,100.00
Dividend - Preferred	200.00	200.00	200.00	200.00	800.00
					3,900.00
Actual CGD - Common	56.78	56.78	62.45	62.45	238.46
Actual CGD - Preferred	15.38	15.38	15.38	15.38	61.54
					300.00

23 Pursuant to section 316, a cash distribution made by a REIT with respect to its stock is treated as a dividend up to REIT's E&P. Revenue Ruling 69-440, 1969-2 C.B. 46, found that for purposes of section 316, E&P is to be regarded as having been distributed in accordance with the provisions of a corporate charter that requires that dividends be distributed to preferred shareholders prior to any other distribution of E&P to the other stockholders. If a REIT has made cash distributions in excess of its E&P (computed as of the close of the year without diminution by reason of any distributions made during the year and without regard to the amount of E&P at the time of the distribution), each cash distribution carries proportionately E&P for the year under section 1.316-2(b). Finally, Revenue Ruling 89-81, 1989-1 C.B. 226, found that, when a regulated investment company had two classes of stock outstanding - common and preferred, the designation of distributions (e.g., capital gain dividends or dividends qualifying for the dividends received deduction) had to be on a proportionate basis between the two classes of stock.

Certainly, the complexity of designating Actual CGDs increases when the REIT's current-year E&P is sufficient to cause the distribution made in January 2021 to be considered being made on December 31, 2020.[24]

Inclusion Event

As discussed above, a taxpayer (referred to as a "QOF owner") can exclude from its gross income an eligible gain by reinvesting the deferred gain in exchange for an interest in a QOF (referred to as "Qualifying Investment"). Pursuant to the opportunity zone rules, the deferred gain is included in gross income in the tax year that includes the earlier of: (1) the date on which the Qualifying Investment is sold or exchanged (referred to as an "Inclusion Event' by the proposed regulations); or (2) December 31, 2026.[25]

Relevant to a REIT as a QOF owner or as a QOF REIT, an Inclusion Event would include, among other things:

- A QOF owner's transfer of a Qualifying Investment that reduces the QOF owner's Qualifying Investment.[26] For example, if a REIT (which is a QOF owner) transfers a portion of its Qualifying Investment to a subsidiary REIT pursuant to section 351, this transfer is an Inclusion Event.[27] However, a QOF owner's contribution of its Qualifying Investment in a QOF partnership to another partnership in a transaction governed all or in part by section 721 is not an Inclusion Event, provided the interest transfer does not terminate the QOF partnership.[28]
- A termination or liquidation of a QOF REIT (e.g., a QOF REIT ceases to exist for U.S. federal income tax purposes).[29] However, if the assets of a QOF REIT are acquired in a qualifying section 381 transaction, and if the acquiring corporation is a QOF immediately after the acquisition, then the transaction is not an Inclusion Event, provided a QOF owner does not receive boot.[30]
- A taxable liquidation of a QOF owner that is treated as if the Qualifying Investment were sold to the distributee at its fair market value.[31] For example, if a REIT is a QOF owner and holds a Qualifying Investment, a taxable liquidation of this REIT to which section 336(a) applies is an Inclusion Event. However, a distribution by the REIT of its Qualifying Investment in a complete liquidation is not an

[24] Pursuant to section 857(b)(9), any "dividend" declared by a REIT in October, November, or December of any calendar year and payable to shareholders of record on a specified date in such a month is deemed paid by the REIT on December 31 of the calendar year if the dividend is paid during January of the following calendar year.

[25] Section 1400Z-2(b)(1).

[26] Proposed section 1.1400Z2(b)-1(c)(1)(i).

[27] Proposed section 1.1400Z2(b)-1(f), Example 2

[28] Proposed section 1.1400Z2(b)-1(c)(6)(ii)(B).

[29] Proposed section 1.1400Z2(b)-1(c)(2)(i).

[30] Proposed section 1.1400Z2(b)-1(c)(10)(i).

[31] Proposed section 1.1400Z2(b)-1(c)(2)(ii)(A).

Inclusion Event to the extent section 337(a) applies to this distribution (i.e., a liquidation to which section 332 applies).[32]

- A QOF owner's receipt of property in a transaction that is treated as a distribution for U.S. federal income tax purposes, whether or not the receipt reduces the QOF owner's ownership of the QOF.[33] However, a distribution of property by a QOF REIT to a QOF owner with respect to the Qualifying Investment is not an Inclusion Event except to the extent section 301(c)(3) applies to the distribution.[34] Thus, a QOF REIT's distribution to a QOF owner treated as a dividend (i.e., up to QOF REIT's E&P) should not give rise to an Inclusion Event. It should be noted that because a QOF owner's initial basis in the Qualifying Investment (i.e., stock of a QOF REIT) is zero, a distribution in excess of the QOF REIT's E&P (including a debt-financed distribution) could give rise to an Inclusion Event. Because a REIT's E&P cannot be accurately determined until the year-end, distributions by a QOF REIT must be carefully monitored. See the example below.

Includible Amount

In the case of an Inclusion Event, the amount of the remaining deferred gain includible in gross income is equal to the excess of:

- The lesser of (1) the fair market value of the Qualifying Investment being disposed of in the Inclusion Event; or (2) the remaining deferred gain multiplied by a fraction, the numerator of which is the fair market value of the Qualifying Investment being disposed of in the Inclusion Event, and the denominator of which is the fair market value of all Qualifying Investments immediately before the Inclusion Event; over

- The taxpayer's basis of the Qualifying Investment being disposed of in the Inclusion Event.[35]

Example

On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A transfers $500 to a QOF REIT in exchange for a Qualifying Investment. On February 29, 2020, A transfers 25 percent of its Qualifying Investment in the QOF REIT to a newly formed corporation, Y, in exchange for 100 percent of Y's stock in a transfer to which section 351 applies (the transfer), at a time when the fair market value of A's Qualifying Investment in the QOF REIT is $800.

In the transfer, A exchanged 25 percent of its Qualifying Investment, which reduced A's direct Qualifying Investment in the QOF REIT. As discussed above, the transfer is an Inclusion Event to the

[32] Proposed section 1.1400Z2(b)-1(c)(2)(ii)(B).

[33] Proposed section 1.1400Z2(b)-1(c)(1)(ii).

[34] Proposed section 1.1400Z2(b)-1(c)(8).

[35] Proposed section 1.1400Z2(b)-1(e)(1).

extent of the reduction in A's direct Qualifying Investment, and, thus, A includes in income an amount equal to the excess of:

— The lesser of (1) $200 (i.e., 25 percent of $800 being disposed of); or (2) $125 (the remaining deferred gain of $500 x ($200 / $800)); over

— The basis of the Qualifying Investment being disposed of, which is zero.

As a result, A must include $125 of the remaining deferred gain in income in 2020.

For a distribution by a QOF REIT to which section 301(c)(3) (i.e., in excess of stock basis) or an "exchange" redemption applies, the amount of the remaining deferred gain includible in gross income is equal to the lesser of (1) the remaining deferred gain; or (2) the amount that gave rise to the Inclusion Event.[36]

Example

On May 31, 2019, A sells a capital asset to an unrelated party and realizes $500 of capital gain. On October 31, 2019, A transfers $500 to a QOF REIT in exchange for a Qualifying Investment. In 2020, when the QOF REIT has $40 of E&P, it distributes $100 to A (the distribution).

Of the $100 distribution, $40 is treated as a dividend and $60 is treated as gain from the sale or exchange of property under section 301(c)(3), because A's basis in its QOF REIT stock is zero. Thus, $60 of A's gain that was deferred is recognized in 2020 (i.e., the lesser of (1) the remaining deferred gain of $500; or (2) the amount that gave rise to the Inclusion Event of $60).

Investment Held for More Than 10 Years

Generally, the opportunity zone provisions exclude from gross income the post-acquisition gain on the Qualifying Investment that is held for at least 10 years. Specifically, the statute allows an election to increase the basis of this Qualifying Investment to equal to the fair market value at the date of the sale or exchange of this Qualifying Investment.[37] To this end, if the QOF is a partnership, the proposed regulation provides that the basis of the QOF owner's interest in the QOF partnership is adjusted to an amount equal to the fair market value of the interest, including debt.[38] Thus, if the QOF owner is a REIT and has held its Qualifying Investment in the QOF partnership for at least 10 years, it seems to have no gross income attributable to the post-acquisition gain to be distributed and arguably have no E&P (i.e., full basis equal to the fair market value for E&P purposes, too).

Special 10-year rule for dispositions of Identified QOF Property

As discussed above, the exclusion is available when the Qualifying Investment is sold or exchanged. Thus, prior to the second set of the proposed regulations, the use of a REIT as the QOF appeared to be

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[36] Proposed section 1.1400Z2(b)-1(e)(2).

[37] Section 1.1400Z-2(c).

[38] Proposed section 1.1400Z2(c)-1(b)(2)(i).

ideal (in comparison with a QOF partnership) because a QOF REIT could sell property and make liquidation distributions that are treated as in full payment in exchange for the stock (i.e., Qualifying Investment).[39] To provide sought flexibilities, the proposed regulations extend the intended benefit to the sale or exchange by the QOF of certain identified opportunity zone property after the 10-year holding period of its QOF owner. Specifically, with respect to a QOF partnership, the proposed regulations allow an election to exclude from gross income some or all of the capital gain arising from the disposition reported on Schedule K-1.[40] Thus, if the QOF owner is a REIT, it likely has no gain to be distributed; however, it may not be entirely clear whether the REIT will have E&P attributable to this excluded gain because generally tax-exempt income may still increase a corporation's E&P, which could cause distributions made by the REIT to be considered dividend.[41]

However, it should be noted that while the proposed regulations attempt to extend the intended tax benefit to a QOF REIT's disposition of opportunity zone property, it merely allows a QOF owner to apply a zero percent U.S. federal tax rate to CGDs designated by the QOF REIT. Specifically, pursuant to the proposed regulations, a QOF REIT may designate a CGD "identified with a date" if it realizes long-term capital gain on any sale or exchange of opportunity property.[42] Then, if a QOF owner has held the Qualifying Investment for at least 10 years as of the "identified" date, it "may apply a zero percent tax rate to that capital gain dividend, or part thereof."[43] Accordingly, if the QOF owner itself is taxed as a REIT, the QOF owner REIT may still have income that needs to be distributed to avoid any state taxes. This result may warrant utilizing a single-property QOF REIT (rather than a multiple-property QOF REIT), so the QOF REIT can be liquidated after the sale of the opportunity zone property once the 10-year holding period is met for the QOF Owner.

It should also be emphasized that the proposed regulations would require that the designation of CGDs identified with a date be "proportional for all dividends paid with respect to the taxable year."[44] Further, the regulations provide that "[g]reater than de minimis violation of proportionality invalidates all of the purported identifications for a taxable year."[45] While Revenue Ruling 89-81 requires a proportionate allocation of designated CGDs between classes (e.g., common vs. preferred), it does not expressly address whether this allocation must be made on a proportionate basis within a class when quarterly dividends are made. Also, it is not clear what would constitute *de minimis* to avoid invalidating the identification for the entire year.

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39 Section 331.

40 Proposed section 1.1400Z2(c)-1(b)(2)(ii).

41 Section 1.312-6(b) provides in part "[a]mong the items entering into the computation of corporate earnings and profits for a particular period are *all income exempted by statute*, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts." [Emphasis added.]

42 Proposed section 1.1400Z2(c)-1(e)(3).

43 Proposed section 1.1400Z2(c)-1(e)(1)(ii).

44 Proposed section 1.1400Z2(c)-1(e)(3)(ii).

45 *Id.*

Inability to Rely on 10-year Proposed Regulation Rules.

Generally speaking, the proposed regulations are proposed to be effective on or after the date final regulations adopting these rules are published in the *Federal Register*, but taxpayers may generally rely on these regulations for periods prior to the finalization. That said, Treasury and the IRS did not provide taxpayers with the ability to rely on the rules relating to investments held for more than 10 years because, as explained in the preamble to the proposed regulations, these rules do not apply until January 1, 2028. Regardless of the likelihood that Treasury and the IRS will or will not significantly change these 10-year rules, the uncertainty may cause a taxpayer interested in the permanent exclusion to select the structure that maintains maximum flexibility.

Summary

Based on the discussion in this article, the tax benefits associated with the opportunity zone provisions can be summarized in the following example if an existing REIT is to reinvest an eligible gain in a QOF that elects to be a REIT.

Assume a group of taxpayers contributed $1,000 to organize REIT A, which used the new capital to acquire a land parcel. The aggregate stock basis of REIT A's shareholders is $1,000, and REIT A's basis in the land is $1,000. On January 1, 2019, REIT A sold the land for a gain of $500 and invested this gain in a QOF REIT (REIT B), which acquired a rental property constructed by a merchant builder in an opportunity zone that has never placed the building in service. REIT A invests the remaining sales proceeds of $1,000 in other qualifying assets.

The initial basis of REIT A (the QOF owner) in REIT B (the QOF REIT) is zero. After five and seven years, its basis in REIT B is increased to $50 and $75, respectively. Assume that the fair market value of REIT A's interest in REIT B is at least $500 as of December 31, 2026, REIT A (the QOF owner) will include $425 in its gross income. Assume further that REIT A (the QOF owner) will liquidate a portion of its other assets and distribute $425 to its shareholders to purge the deferred gain now included in income. REIT A (the QOF owner) will designate the distribution as a capital gain dividend to its shareholders.

On January 1, 2029, REIT B (the QOF REIT) sells the rental property for $700 and distributes the sales proceeds to REIT A (the QOF owner). To address the state tax issue faced by a QOF owner that is a REIT (as discussed above), REIT B could adopt a plan of liquidation before distributing the sales proceeds of $700. This would enable REIT A to treat the distributions as in full payment in exchange for REIT B stock (i.e., disposition of Qualifying Investment) and to increase its basis in REIT B stock to avoid gain recognition. Assume that ultimately REIT A (the QOF owner) liquidates all of its other investment (of $575) for no gain or loss and makes a liquidation distribution (of $1,275) to the group of its original shareholders. Because the stock basis of the original shareholders remains at $1,000, they recognize cumulatively a gain of $700 (i.e., CGDs of $425 in 2026 and stock gain of $275 upon receiving the liquidation distribution of $1,275).

Based on this example, for an existing REIT to fully secure the intended tax benefit (of the opportunity zone provisions) for its shareholders, it may have to (1) distribute the eligible gain of $500 from the land sale to its shareholders and designate it as an Actual CGD; or (2) retain and pay tax on the eligible gain and then elect the deemed distribution treatment as a Deemed CGD.[46] Its shareholders can then reinvest the Actual or Deemed CGD from the land sale into a QOF within the 180-day period as described above.

It should be noted that while a REIT may engage in a like-kind exchange to defer gain, this deferral is limited to a gain on the disposition of real property (i.e., not with respect to gain on sale of stock of a subsidiary REIT or taxable REIT subsidiary or a mortgage loan investment). Further, to enjoy the full deferral pursuant to a like-kind exchange, the REIT needs to reinvest the full value of the relinquished property in comparison with reinvesting the gain amount under the opportunity zone rules. Thus, an opportunity zone investment, if available, may still be more advantageous if the REIT wants to retain more sales proceeds for investments generating greater returns to its shareholders.

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[46] If a Deemed CGD, the shareholders can file returns to claim as a tax refund of their proportionate share of U.S. federal income tax paid by the REIT. However, there does not appear to be any existing rules for REIT's shareholders to claim as credit the amount of state taxes paid by the REIT on the retained gain.