Opportunity Zones Update

November 8, 2018

Background

In December 2017, as part of the Tax Cuts and Jobs Act ("TCJA"), Congress established a new tax incentive program to promote investment in certain low-income communities designated by the IRS as qualified opportunity zones ("QOZs"). Section 1400Z-2 of the Internal Revenue Code (the "Code") provides three compelling tax incentives to encourage investment in qualified opportunity funds ("QOFs").

- Taxpayers can defer paying taxes on capital gain from the sale or exchange of appreciated assets by investing such gain in a QOF within 180 days following such sale or exchange. Such gain may be deferred until the earlier of (i) when the investment is sold or exchanged or (ii) December 31, 2026.

- Investors receive a step-up in the basis equal to 10% of the original deferred gain if the investment in the QOF is held for at least five years, with an additional 5% basis step-up if the investment is held for seven years. These basis step-ups can result in permanent exclusion from taxation of up to 15% of the originally deferred gain.

- If the investor holds the investment in the QOF for at least 10 years, an elective basis adjustment made upon sale of the interest in the QOF provides a permanent exclusion from taxation for any appreciation in excess of the deferred gain.

Treasury recently released Revenue Ruling 2018-29, as well as the first of several rounds of proposed regulations (the "Proposed Regulations"). The Revenue Ruling and Proposed Regulations (collectively, the "Guidance") clarify the operation of these provisions and answer many questions relating to QOZs and QOFs. A number of significant questions still remain to be answered by future guidance.

This update highlights certain key questions that were answered by the Guidance.

What types of gain can be deferred through investment in a QOF?

The TCJA left open the question of what types of "gain" are eligible for deferral by simply stating "gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer." The Proposed Regulations clarify that only capital gain is eligible for deferral.

Can gain from sale of an interest in a QOF be deferred through investing in another QOF?

Under the Proposed Regulations, if a taxpayer sells its *entire* interest in a QOF, gain from the sale of the QOF interest may be deferred if the taxpayer makes a qualifying new investment in a new QOF.

Are only certain types of taxpayers eligible to invest in a QOF?

All taxpayers that recognize eligible capital gain for federal income tax purposes are eligible to defer such gain under Code Section 1400Z-2. Eligible taxpayers include C corporations (including REITs and regulated investment companies), individuals, partnerships, and S corporations.

Is gain eligible for deferral at the partnership or partner level?

A partnership may elect to defer all or part of partnership capital gain at the entity level to the extent that it makes an eligible investment in a QOF within the 180-day period beginning on the date of the sale or exchange giving rise to the gain.

Under the Proposed Regulations, if a partnership does not make the entity level election to defer all or some partnership capital gain, a partner can make its own election to defer the partner's distributive share of the eligible gain.

When does the 180-day period for investing eligible gain in a QOF begin?

In general, the investment in a QOF must be made during the 180-day period beginning on the date of the sale or exchange giving rise to the gain. In the case of eligible gain arising from a deemed sale or exchange, the 180-day period begins on the date on which the gain would otherwise be recognized for U.S. federal income tax purposes.

How does the 180-day rule apply in the case of a partnership?

If a partnership makes an entity level election to defer gain, the 180-day period for the partnership begins on the date of sale or exchange giving rise to the gain. If a partnership does not elect to defer some or all of the gain realized by the partnership, under the Proposed Regulations, a partner's 180-day period with respect to its share of partnership gain generally begins on the last day of the partnership's taxable year. A partner may also choose to use what would have been the partnership's 180-day period.

How are assets valued for purposes of the ninety percent test at the QOF level?

A QOF must hold at least 90% percent of its assets in "qualified opportunity zone property," determined by the average of the percentage of "qualified opportunity zone property" held on the last day of the first six-month period of the taxable year of the QOF, and on the last day of the taxable year of the QOF.

The term “qualified opportunity zone property” means:

- Qualified Opportunity Zone Stock,
- Qualified Opportunity Zone Partnership Interests, or
- Qualified Opportunity Zone Business Property.

The Proposed Regulations provide that if the QOF has an applicable financial statement, as defined in Treasury Regulation 1.475(a)-4(h) (“AFS”), then the assets can be valued based on the AFS. If there is no AFS then the assets are valued at cost.

What does “substantially all” mean with respect to assets of a qualified opportunity zone business (“QOZB”)?

A QOZB is a trade or business in which substantially all of the tangible property owned or leased by the QOZB is qualified opportunity zone business property and which satisfies certain other requirements. For this purpose, the Proposed Regulations clarify that “substantially all” means 70%. Thus, if at least 70% of the tangible property owned or leased by a trade or business is qualified opportunity zone business property, the trade or business is treated as satisfying the “substantially all” requirement.

The term “substantially all” is used in several other contexts relating to QOZs and QOFs, and the Treasury Department and the IRS have requested comments regarding the proposed meaning of that phrase in those other contexts.

What is considered a “substantial improvement”?

Only tangible property acquired by purchase (as defined in Code Section 179(d)(2)) can qualify as qualified opportunity zone business property. In addition, if the original use of the property does not commence with the QOF or QOZB, the QOF or QOZB must “substantially improve” the property.

Property is substantially improved for these purposes if, during any 30-month period beginning after the date of acquisition of such property, additions to basis with respect to the property exceed an amount equal to the adjusted basis of the property at the beginning of that 30-month period. In other words, by the end of such 30-month period, the QOF or QOZB must spend an amount equal to the QOF’s initial cost basis of the property, plus $1, improving the property.

Revenue Ruling 2018-29 states that if a QOF purchases a building on land that is wholly within a QOZ, the basis of the land itself will not be taken into account for purposes of the substantial improvement determination--only the adjusted basis of the building must be increased within the 30-month period in order to “substantially improve” the property.

What is the Reasonable Working Capital Safe Harbor?

In addition to the “substantially all” tangible asset test described above, QOZBs are subject to a number of other requirements, including the following:

- The “Nonqualified Financial Property Test” which requires that less than 5% of the average of the aggregate unadjusted bases of the property of a QOZB be attributable to “nonqualified financial property” such as debt, partnership interests, stock or other financial instruments, and

- The “50% Gross Income Test”, which requires that at least 50% of the gross income of a QOZB be derived from the active conduct of a trade or business in the QOZ.

The Proposed Regulations create a safe harbor under which QOZBs that acquire, construct, and/or substantially improve tangible property (including both real and other tangible property) can hold large amounts of cash as working capital assets without running afoul of the Nonqualified Financial Property Test and the 50% Gross Income Test. The safe harbor applies so long as three requirements are satisfied:

(1) The amounts are designated in writing for the acquisition, construction and/or substantial improvement of tangible property in the QOZ;
(2) There is a written schedule consistent with the ordinary business operation of the business for the expenditure of the working capital assets under which the working capital assets will be used within 31 months of receipt; and
(3) The assets are actually used in a manner substantially consistent with (1) and (2).

Conclusion

It is important to remember that the Proposed Regulations are not final. The IRS and the Treasury Department are soliciting comments on the Proposed Regulations, including aspects relating to "original use" and "substantial improvement." The Treasury Department and the IRS are also working on additional proposed regulations expected to be released in the near future. Nonetheless, taxpayers may rely on the Proposed Regulations prior to the date they become final so long as taxpayers apply the Proposed Regulations consistently and in their entirety.

For assistance with establishing an opportunity zone fund, or for additional information regarding opportunity zone funds or opportunity zones in general, please contact the attorneys listed below.

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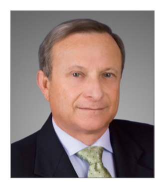

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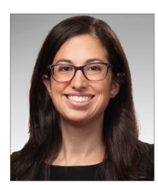

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