

# OPPORTUNITY ZONES

## *Treasury Releases Proposed Regulations on Tax Incentives for Investment in Designated Zones*

On Friday, October 19, 2018, Treasury issued much-anticipated guidance in the form of Proposed Regulations and related Revenue Ruling 2018-29 to allow investors to move forward with Qualified Opportunity Zone (QOZ) projects. The QOZ tax incentive was established as Internal Revenue Code Section 1400Z-2 in the 2017 Tax Cuts and Jobs Act to encourage long-term capital investment and job creation in distressed communities. Treasury has designated 8,761 QOZs across the country.

The Proposed Regulations provide clarity to taxpayers on the type and timing of transactions that will qualify for the beneficial tax treatment associated with investments in Qualified Opportunity Funds. While the Proposed Regulations do not answer all of the questions raised in the investor and tax community, the rules are generally taxpayer-friendly and should encourage investment to flow into QOZs via both real estate deals and business creation or expansion.

These Regulations are only proposed, and are therefore subject to further revisions based on comments received by Treasury over the next sixty days. However, as with all Proposed Regulations, taxpayers may rely on these proposed rules, provided that the taxpayer applies the rule in its entirety and in a consistent manner. Additional Regulations and Revenue Rulings are anticipated to be released before year-end.

### **QOZ Overview**

Taxpayers may elect to defer the recognition of capital gain to the extent such gains are invested in a Qualified Opportunity Fund (QOF). The gain must be invested during the 180-day period beginning on the date such capital gain would have been recognized by the taxpayer. Tax on the deferred gain will be recognized on the date the investment in the QOF is sold or exchanged, or on December 31, 2026, whichever comes first.

For investments in a QOF held longer than five years, taxpayers may exclude 10 percent of the deferred gain from inclusion in income, and for investments held longer than seven years, taxpayers may exclude a total of 15 percent of the deferred gain from inclusion in income. In addition, and most importantly, for investments held longer than 10 years, the post-acquisition appreciation on the qualifying investment in the QOF may be excluded from income tax.

### ***Key elements of the transaction:***

- 1. Investor has proceeds from a capital gain*
- 2. Investor contributes capital gain dollars in exchange for an equity interest in a QOF within 180 days of the realized gain*
- 3. The QOF holds 90% of its assets in QOZ Property*

### **3 Key tax benefits:**

1. *Deferral of capital gains*
2. *Step-up in basis on original gain of up to 15%*
3. *Exclusion of gain on appreciation while held in a QOF for 10 years or more*

A QOF may be any entity taxed as a corporation or partnership for federal income tax purposes. A QOF must hold at least 90 percent of its assets in QOZ property, as measured by the average percentage held at the last day of the first 6-month period of the taxable year of the fund and the last day of the taxable year. The statute requires a QOF that fails this 90 percent test to pay a penalty for each month it fails to maintain the 90-percent asset requirement.

A Fund may be closely-held and invested in a single qualified asset, like a real estate project, or it may be widely-held and invested in multiple categories of assets across multiple Zones.

## **Clarity provided from the Proposed Regulations**

### **Eligible Gains**

- An investment in a QOF must be an equity interest – corporate stock, a partnership interest, a membership interest in a limited liability company. The investment cannot be any form of debt instrument.
- Only gains that are capital in nature may be deferred into QOF projects. Capital gains from straddles or any transaction that is part of an offsetting-position transaction are not eligible for deferral. Those gains on futures treated as capital in nature under Internal Revenue Code section 1256 are eligible.
- The character of the eligible capital gain will carry through the investment period. For example, if an investor has short-term capital gains that are invested in a QOF, the gain will be taxed as short-term capital gain at the end of the deferral period.
- Any taxpayer that recognizes capital gains is eligible to defer those gains (i.e. an individual, a corporation, partnership, trust, estate, etc.). Eligible gains may not arise from a transaction with a related party.
- Partnerships may defer gain by making an eligible investment in a QOF. Or, if the partnership chooses not to defer the gain, one or more of the individual partners in the partnership may elect to defer his/her share of the gain into a QOF. S-corporations, trusts and estates that are taxed as passthrough entities are treated the same way -- an election at the entity or individual level may be made.
- An individual partner or shareholder in a passthrough entity may begin the 180-day period on the last day of the partnership's (or S-corporation's) tax year, or may elect to begin his/her own 180-day period on the date of the gain transaction within the passthrough entity. This provides significant flexibility for an individual investor.



## Qualified Opportunity Fund Issues

- A QOF may make an election to choose the month in which the entity becomes a QOF. IRS will release guidance regarding the form and content for this election. Making the election allows fund managers to create a legal entity and conduct start-up activities while deferring the receipt of investor dollars and deferring the measurement timeline for the 90% Asset Test. Investors may only defer gains into a QOF and qualify for the tax benefits if the investment is made in or after the month that the QOF has chosen. If no month is chosen, then the month of the entity's inception will be deemed to be the first month that it is a QOF.
- A QOF will use the asset values that are reported on the QOF's applicable financial statements for the year to calculate the 90% Asset Test. If a QOF has no applicable financial statement, the QOF will use the cost basis of the assets for the Test.
- QOFs may accept non-capital gain rollover funds from investors. However, only investments of rollover gains will be eligible for the tax incentives of the QOF. So, separate accounting will be necessary to track the tax treatment for each category of investment.
- Partial dispositions of QOF investments will generally be determined using the First-In, First-Out method, though other methods are possible.
- Preexisting entities may qualify as QOFs or as QOZ Businesses, providing that they otherwise satisfy the necessary requirements.
- QOZs are set to expire as of December 31, 2028, which causes investors to question whether the gain exclusion provision will endure beyond the 10-year hold window. The gain exclusion is technically facilitated by a basis step-up at the time of sale. The Proposed Regulations permit taxpayers to make the basis step-up election under section 1400Z-2(c) after a QOZ designation expires. The ability to make this election is preserved under these Proposed Regulations until December 31, 2047, 20½ years after the latest date that an eligible taxpayer may properly make a QOZ investment.

## Qualified Opportunity Zone Businesses

- A QOZ Business must have "substantially all" of its tangible property owned or leased within a Zone. The Proposed Regulations define "substantially all" in this particular context of the law as 70 percent of business property.
- For each taxable year, at least 50 percent of the gross income of a QOZ business must be derived from the active conduct of a trade or business in the QOZ. Further, a substantial portion of the intangible property of a QOZ business must be used in the active conduct of a trade or business in QOZ.
- Given that many QOZ projects will involve construction and/or significant renovation and rehabilitation work, a safe harbor has been provided for a QOF to hold liquid assets as working capital and to qualify those assets for purposes of the 90% Asset Test. This safe harbor provides that a reasonable amount of working capital may be held by a QOZ Business for a period of up to 31 months, if three requirements are met:
  - The intended use of the working capital is in writing,
  - There is a reasonable written schedule that outlines the planned deployment of the working capital, and
  - The working capital is used in a manner substantially consistent with the written use plan and the schedule.



## Revenue Ruling 2018-29

- The law requires that an existing building may qualify as a QOZ property if it is substantially improved. “Substantial improvement” in this context requires new investment in the property that is equal to or greater than the original cost basis, and that the investment be completed within 30 months from acquisition.
- This Revenue Ruling provides a significant enhancement to the law. If a QOF purchases an existing building, the original use of the building is not considered to begin with the QOF’s acquisition date. Further, the measurement of “substantial improvement” to the building includes only the building’s basis, not the land on which the building is located. The QOF is not required to substantially improve the land. This reduces the adjusted basis threshold and makes it easier to qualify a rehab project in a QOZ.

## Administrative Details

- Taxpayers who are contributing capital gain dollars into QOFs will report the deferral election on Form 8949, which will be filed with the tax return for the year in which the gain was recognized. This form and instructions are forthcoming from the IRS.
- QOF managers will certify compliance with the 90% asset test using Form 8996, which will be filed with the Fund’s tax return annually.

## Outstanding issues

There are several outstanding issues remaining to be resolved by future Treasury Regulations or Revenue Rulings, which are expected within the next 60 days:

- The QOZ law authorizes regulations that provide a QOF have “a reasonable period of time to reinvest the return of capital from investments in QOZ stock and QOZ partnership interests, and to reinvest proceeds received from the sale or disposition of QOZ business property.” If a QOF were to sell assets prior to a 90% Asset Test Period, it would perhaps fail the test. Additional guidance is needed to define the reinvestment period.
  - Investors and fund managers requested that Treasury consider a safe harbor time period for a QOF to invest cash received from investors. No guidance on this point has been issued, which means that cash must be invested in qualified property by the first semi-annual measurement of the 90% Asset Test. However, this may be mitigated using the guidance provided in the Proposed Regulations to elect the start date of a QOF, as outlined above.
  - There are multiple uses of the term “substantially all” in the QOZ legislation, including reference to “substantially all” of a QOZ Business’ holding period for certain assets, “substantially all” of the usage of tangible property by the Business in the QOZ, and “substantially all” of the intangible property used in the business. The Proposed Regulations defined that term only for the definition of QOZ Business Property (at 70%), but left the remainder undefined at that time.
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## More Information

GBQ believes that this is one of the most significant tax incentives ever established to encourage investment in distressed areas. The program is flexible and scalable. We are encouraged by the conversations we have had to-date with real estate developers, business owners and individual investors, and we are excited to help our clients implement these rules.

For further information about taking advantage of the Opportunity Zone tax incentives, [here](#) to our previous communication, or [here](#) to the Proposed Regulations and [here](#) for Revenue Ruling 2018-29. To determine where the Zones are located, use this online mapping tool: <https://www.enterprisecommunity.org/opportunity360/opportunity-zone-eligibility-tool>.

For more information, or to discuss how these rules apply to your situation, please contact a member of the GBQ tax team:

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