

INSIGHTS

IRS and Treasury Department Release Proposed Regulations on Opportunity Zones

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On October 19, 2018, the IRS and Treasury Department released highly-anticipated [proposed regulations](#) (the Proposed Regulations) under Section 1400Z-2 of the Internal Revenue Code of 1986, as amended (the OZ Statute). The OZ Statute, which was enacted pursuant to the Tax Cuts and Jobs Act, offers tax incentives to encourage private investment in qualified opportunity zones (QOZs), which are certain [low-income communities](#) designated by the Treasury Department.

The OZ Statute initially was met with great enthusiasm from taxpayers that saw opportunities to recognize gains without current tax liability, reinvest such gains, and potentially be subject to a reduced effective rate of income tax on such gains when they ultimately are recognized. The OZ Statute, however, was long on promise and short on details. The Proposed Regulations, which provide clear and practical guidance on the scope and application of the OZ Statute, have been well received by taxpayers, practitioners and commentators alike. Although many questions remain, the Proposed Regulations should provide most taxpayers with sufficient guidance to obtain the benefits of the OZ Statute. Additional regulations with respect to the OZ Statute are anticipated by year end.

Primary Tax Benefits under the OZ Statute

The OZ Statute provides three primary tax incentives to encourage taxpayers to reinvest capital gains in qualified opportunity funds (QOFs). First, a taxpayer may elect to defer U.S. federal income tax on capital gains, to the extent such capital gains are reinvested in a QOF, until the earlier of the taxpayer's disposition of the QOF investment or December 31, 2026.

Second, a taxpayer that elects to defer such capital gains may receive an increase in its tax basis in the QOF investment equal to 10% of the gain initially deferred if the QOF investment is held for 5 years prior to December 31, 2026, and an additional increase in tax basis equal to 5% of such deferred gain if the QOF investment is held for 7 years prior to December 31, 2026. A taxpayer therefore could eliminate up to 15% of the capital gain that was deferred in connection with the initial QOF investment. Because the deferral period ends on December 31, 2026, however, taxpayers must make investments in QOFs no later than December 31, 2019 to

be eligible for the full 15% exclusion.

Third, if a taxpayer holds the QOF investment for at least 10 years, the taxpayer may elect to increase the tax basis in the QOF investment to its fair market value. As a result, any appreciation in the QOF investment (that is, gain in excess of the initial deferred gain) generally would never be subject to U.S. federal income tax.

Qualified Opportunity Funds

A QOF must be classified as a corporation or a partnership for U.S. federal income tax purposes. It also must be organized in one of the 50 U.S. states, the District of Columbia or one of the U.S. possessions. If an entity is organized in a U.S. possession, it will qualify as a QOF only if it is organized for the purpose of investing in qualified opportunity zone property (QOZ Property) that relates to a trade or business operated in the U.S. possession in which such entity is organized.

In addition, at least 90% of a QOF's assets must be comprised of QOZ Property (the "90% Test"). For purposes of the 90% Test, the QOF must determine the fair market value of its assets based upon financial statements filed with the SEC, or any federal agency other than the IRS, or certified audited financial statements under certain circumstances. Otherwise, the QOF must use the cost basis of its assets for purposes of the 90% Test.

The OZ Statute provides that QOZ Property includes three asset classes: qualified opportunity zone business property (QOZ Business Property), qualified opportunity zone stock (QOZ Stock), and qualified opportunity zone partnership interests (QOZ Partnership Interests). The Proposed Regulations clarify and refine the scope of the three asset classes, as follows:

- **QOZ Business Property:** tangible property used in a trade or business of a QOF if (1) the QOF purchases the property after December 31, 2017, from an unrelated person, (2) the original use of the property in the QOZ commences with the QOF, or the QOF substantially improves the property, and (3) during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a QOZ. For this purpose, property is treated as substantially improved only if, during any 30-month period beginning after the date of acquisition, the new basis of the property attributable to improvements made by the QOF, on the one hand, exceeds the initial adjusted basis of the property in the hands of the QOF at the beginning of the 30-month period, on the other hand. The Proposed Regulations add that basis attributable to land is disregarded in the calculation of substantial improvement.
- **QOZ Stock:** stock acquired by a QOF, solely for cash, from an entity classified as a corporation for U.S. federal income tax purposes. The exchange must occur after December 31, 2017 and, at the time of issuance, the corporation must conduct a QOZ Business (as described below) or, in the case of a new corporation, be organized for purposes of conducting a QOZ Business. During substantially all of the QOF's holding

period for such stock, such corporation must qualify as a QOF Business.

- **QOZ Partnership Interests:** partnership interests acquired by a QOF, solely for cash, by an entity classified as a partnership for U.S. federal income tax purposes. The exchange must occur after December 31, 2017 and, at the time of issuance, the partnership must conduct a QOZ Business or, in the case of a new partnership, be organized for purposes of conducting a QOZ Business. During substantially all of the QOF's holding period for such partnership interest, such partnership must qualify as a QOF Business.

To be treated as conducting a QOF Business, substantially all of the tangible property owned or leased by a corporate or partnership subsidiary of a QOF must be QOZ Business Property. For this purpose, the Proposed Regulations provide that "substantially all" means 70%. Accordingly, to the extent a QOF invests in a corporate or partnership subsidiary, it would have more flexibility in its direct and indirect asset ownership than if it held all of its assets in the form of QOZ Business Property. For purposes of this 70% test, valuation rules similar to the 90% Test apply.

In addition, to be treated as conducting a QOF business, such a corporate or partnership subsidiary must (1) derive at least 50% of its total gross income from the active conduct of a trade or business in a QOZ, (2) use a substantial portion of its intangible assets in the active conduct of a trade or business in a QOZ, and (3) hold less than 5% of its property as nonqualified financial property, which includes debt, stock, partnership interest, warrants, notional principal contracts and other similar property. For purposes of the requirement regarding nonqualified financial property, the Proposed Regulations include a safe harbor for reasonable working capital held in cash, cash equivalents or debt instruments with a term of 18 months or less. Under the safe harbor, such working capital assets are not treated as nonqualified financial property if (1) there is a written plan that identifies such working capital assets as held for the acquisition, construction, or substantial improvement of tangible property in a QOZ, (2) there is written schedule consistent with the ordinary start-up of a trade or business for the expenditure of such working capital assets within 31 months of the receipt by the business of the assets, and (3) the trade or business substantially complies with such written schedule.

Finally, the Proposed Regulations provide that a corporation or partnership must self-certify its status as a QOF on an IRS Form 8996, a draft of which was released with the Proposed Regulations, and this form must be attached to the corporation or partnership's U.S. federal income tax return for each year that the QOF determination is made.

Qualifying for QOZ Tax Benefits under the Proposed Regulations

The OZ Statute, together with the Proposed Regulations, provide that, to qualify for QOZ tax benefits, an Eligible Taxpayer must reinvest Eligible Gains from the sale or exchange of an asset into an Eligible Investment within the Statutory Period, and file a Deferral Election (each as described below). The Proposed Regulations clarify the meaning of such terms, as follows:

- **Eligible Taxpayer:** any taxpayer that recognizes capital gain for U.S. federal income tax purposes, including individuals, corporations (including RICS and REITs), and partnerships. The Proposed Regulations clarify that, if a partnership does not elect to invest eligible gains in a QOZ, a partner may invest its share of such gains in a QOF, and provide procedures for such partner to make the Deferral Election (as defined below).
- **Eligible Gain:** capital gain realized from an unrelated person that would be recognized no later than December 31, 2016. The OZ Statute was unclear whether ordinary income, including, for example, depreciation recapture, would be eligible for reinvestment into a QOZ. The Proposed Regulations confirm that only capital gains, either short term or long term, are so eligible.
- **Eligible Investment:** any equity interest in a QOF, including preferred stock or a partnership interest. An equity interest in a QOF will not fail to qualify as an Eligible Investment if the interest is used as collateral for a loan, as long as the Eligible Taxpayer is treated as owning the interest under U.S. federal income tax principles. The Proposed Regulations clarify that neither a debt investment in a QOF nor a deemed capital contribution under Code Section 752(a) will constitute an Eligible Investment for this purpose.
- **Statutory Period:** 180 days after the date when the Eligible Taxpayer would have recognized the Eligible Gain, without regard to the Deferral Election.
- **Deferral Election:** an election filed on IRS Form 8949 and attached to the taxpayer's U.S. federal income tax return for the taxable year when the Eligible Gain would have been recognized, without regard to the application of any QOZ tax benefits.

Looking ahead

While the Proposed Regulations answer many questions raised by the OZ Statute, additional guidance will be needed. Notably, further clarification is needed with respect to the application of the OZ Statute to Eligible Investors and QOFs that are classified as partnerships for U.S. federal income tax purposes, particularly pooled investment vehicles, such as private equity funds, that seek to reinvest capital gains in QOFs. The IRS and Treasury Department have promised additional guidance, including in the form of further proposed regulations, in the near future.

Effective Date

The OZ Statute became effective on January 1, 2018. If finalized, the Proposed Regulations would apply to transactions that occur on or after the date the Proposed Regulations are finalized. Taxpayers may rely on the Proposed Regulations prior to the date they are finalized, so long as taxpayers apply the Proposed Regulations in their entirety and in a consistent manner.