Proposed Regulations Clarify Certain Open Issues on the Opportunity Zone Tax Incentive Program

On October 19, 2018, the Treasury Department released the first set of proposed regulations ("Proposed Regulations") and a revenue ruling (the "Revenue Ruling") that clarify certain open issues with respect to the new "Opportunity Zone" tax incentive program introduced in the 2017 Tax Cuts and Jobs Act (the "TCJA"). The Opportunity Zone program was designed to encourage investments in certain distressed communities throughout the country and have garnered a considerable amount of discussion since the summer. However, potential investors and fund managers have been in a holding pattern on actually launching funds created to take advantage of this legislation waiting for IRS guidance to answer open questions and uncertainties concerning the program. The Proposed Regulations address many, but not all, of these open issues, and taxpayers may rely on the Proposed Regulations until the final regulations are released. The IRS indicated that it expects to release additional guidance on the program before the end of the year.

Qualified Opportunity Zone ("QOZ") investments have multiple tax benefits. Anyone with realized gains from any source - real estate, publicly traded stock or most other sources of taxable gain - can defer paying taxes on the gains until as late as 2026 if they invest the gains into QOZ investments. Investors can also eliminate up to 15% of the tax on the deferred gain and potentially exclude from tax all of the subsequent gain generated from the appreciation of investments in QOZs.

Treasury Secretary Steven Mnuchin predicted the zones will attract over $100 billion in private capital.[1] Much of the focus is currently on the establishment of "qualified opportunity funds" ("QOFs"), the vehicles through which investments in QOZs are expected to most commonly be made. This article will explain the QOZ program set forth in the TCJA, how the Proposed Regulations and Revenue Ruling clarify some open questions surrounding the program and the issues that remain to be answered.

Summary of the QOZ Program

Gain that can be Deferred and Reinvested in QOZs

The deferral of gain under the QOZ program applies to gain derived by a taxpayer from the sale or exchange of any existing property held by the taxpayer, including sales of stock and real property, to an unrelated party if the taxpayer invests such gain in a QOF within 180 days of the sale or exchange of such property. The Proposed Regulations clarify that only "gain" that is characterized as capital gain is entitled to the deferral tax benefits under the QOZ program. This would preclude ordinary income from the sale of inventory and possibly gain recharacterized as ordinary income under the depreciation recapture rules from qualifying for the program. However, carried interest treated as short-term capital gain under the TCJA would qualify as eligible gain as the Proposed Regulations are currently written.

The Proposed Regulations also provide special rules for the deferral of gains from the sale of Section 1256 contracts into a QOF and for

[1] See "Big Stock Windfall? New Rule Defers Taxes With Real Estate Investment" WSJ, October 2, 2018.

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offsetting-positions transactions. The only gain arising from Section 1256 contracts that is eligible for deferral is “capital gain net income” for a taxable year. However, no deferral of gain from a Section 1256 contract is allowed in a taxable year if, at any time during the taxable year, one of the taxpayer’s Section 1256 contracts was part of an offsetting positions transaction in which any of the other positions was not also a Section 1256 contract. Capital gain from a position that is or has been part of an offsetting-positions transaction (except where all positions are section 1256 contracts) is not eligible. Offsetting-positions transactions are specifically defined under the Proposed Regulations and include most straddles.

Finally, the Proposed Regulations provide that taxpayers can roll over deferred gains on the sale of QOF investments by reinvesting those gains in other QOFs within 180 days of the transaction date.

There is no minimum investment required into a QOF. If an investor makes an investment in a QOF in excess of the gain realized from recent sales or exchanges, such investment will be treated as two separate investments: one including only amounts covered by the QOZ program and one consisting of other amounts. The benefits of the QOZ program will apply only to eligible investments for which a taxpayer makes an election to be covered by the QOZ program.

Unlike tax deferred like-kind exchanges under Section 1031 of the Internal Revenue Code of 1986, as amended (the “Code”), which (i) require re-investment of the total sale proceeds (not just the gain, as with the QOF) to achieve deferral treatment and (ii) are now limited to exchanges of real property due to changes under the TCJA, the QOZ program allows investors to defer tax on a broader array of assets and potentially eliminate entirely a portion of the gain subject to tax and serves as an alternative for investors whose assets do not qualify for 1031 treatment.

Types of Taxpayers Eligible to Elect Gain Deferral

The Proposed Regulations clarify that individuals, C corporations (including regulated investment companies (RICs) and real estate investment trusts (REITs)), partnerships and certain other pass-through entities are eligible to elect to defer gain under the QOZ program. The Proposed Regulations provide that if the taxpayer is a partnership and elects not to reinvest and defer gain, the gain will flow through to the individual partners of the entity, and the partners can make the election individually to reinvest their share of the gain into QOFs. In the event that partners elect to defer the gain, the Proposed Regulations give the partners an increased period during which to reinvest the gain into a QOF. If the gain flows through to the partners, the Proposed Regulations provide that the 180-day period to invest in a QOF generally begins on the last day of the applicable partnership’s taxable year (rather than the date on which the partnership sold the applicable assets).

Designated QOZs

More than 8,700 census tracts have currently been approved as QOZs in all 50 states and the District of Columbia, as well as five U.S. territories (including all of Puerto Rico). The QOZs are generally in low-income areas that lawmakers see as benefiting from an influx of private funds.

Holding Period Requirements for Deferral and Elimination of Gain

A taxpayer’s initial basis in an investment in a QOF which is funded with deferred gain is zero. If the investment is held for five years, the taxpayer’s basis is increased to 10% of the deferred gain (thereby eliminating 10% of the taxable gain on the investment). After seven years, the taxpayer’s basis is increased an additional 5%, resulting in a total 15% permanent reduction in taxable deferred gain.

The investor must recognize the remaining deferred gain (or the fair market value of the

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investment if lower) on the earlier of the date on which the investment is sold or December 31, 2026. Accordingly, because the deferred gain must be recognized by December 31, 2026, the last date to make a QOF investment that is eligible for a basis bonus is December 31, 2021 (for the five-year holding period) or December 31, 2019 (for the seven-year holding period). If the taxpayer has not sold the QOF investment by December 31, 2026, the inclusion of the deferred gain in income may result in phantom income for the taxpayer.

If an investment in a QOF is held for at least ten years, the post-acquisition capital gains attained by the investment will be permanently excluded from a taxpayer's gross income. Specifically, in the case of a sale or exchange of such investment, the taxpayer can elect to have the basis of the investment equal the fair market value of the investment as of the date of sale or exchange, such that, effectively, no gain is realized on the appreciation of the investment. Taxpayers can continue to recognize losses associated with investments in QOFs under current law.

The Proposed Regulations also provide additional guidance with respect to investments in QOFs held beyond December 31, 2028, the date on which the QOZ designations currently in effect will expire. The regulations allow an investor to hold its investment in a QOF past the ten-year period described above for an additional period of up to twenty years until December 31, 2047 and still receive the step-up in basis to exclude from income all post-acquisition appreciation through the sale date.

Structure of QOFs

A QOF is any investment vehicle "organized" as a corporation or partnership for the purpose of investing in "qualified opportunity zone property" or QOZ property, as defined below. In order to qualify as a QOF, at least 90% of the fund's assets must be QOZ property, as determined by the average of the percentage of QOZ property held in the fund as measured (i) on the last day of the first six-month period of the taxable year of the fund and (ii) on the last day of the taxable year of the fund. The IRS has issued guidance that eligibility to be a QOF will be through a self-certification process in which the taxpayer will complete and attach a form to its timely filed federal tax return (including extensions).

The Proposed Regulations provide that QOFs may include entities treated as partnership for federal income tax purposes, which would allow for the use of limited liability companies.

There had been uncertainty as to whether funds must be deployed by a QOF into QOZ property within 180 days of the sale by all of the QOF's investors of their respective properties in which they are seeking deferral of gain. The Proposed Regulations give businesses an additional period of up to 31 months to hold the capital it receives from investors as working capital, as long as they have a plan for a qualifying project in a QOZ with a schedule for the use of the proceeds within the 31-month period. Those plans are not required to be filed with the government but must be retained by taxpayers in their records.

QOZ property

QOZ property is defined as property which is: (1) QOZ stock, (2) a QOZ partnership interest or (3) QOZ business property.

QOZ stock or partnership interest

A QOZ stock or partnership interest is defined as any stock or partnership interest in a domestic corporation or partnership if: (1) the stock/interest is acquired by the QOF after December 31, 2017 at its original issue (directly or through an underwriter) from the corporation or from the partnership *solely in exchange for cash*; (2) as of the time the stock was issued or partnership interest was acquired, the corporation/partnership was a QOZ business, as described below (or, in the case of a new corporation/partnership, the entity was formed for the purpose of being a QOZ business); and (3) during substantially all of the QOF's holding period for such stock or interest, the

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corporation/partnership qualified as a QOZ business.

Note that the QOF cannot contribute an existing QOZ business into a corporation or a partnership in exchange for stock or a partnership interest as the interest must be acquired solely for cash.

QOZ Business

Both the QOZ stock and QOZ partnership interest require that the acquired or newly created entity be a "QOZ business". The term means a trade or business in which:

1. "substantially all" of the tangible property owned or leased by the taxpayer is QOZ business property (as described below);
2. at least 50% of the gross income of the QOZ business is derived from the active conduct of a trade or business;
3. a substantial portion of any intangible property is used in the active conduct of a trade or business;
4. less than 5% of the average of the aggregate unadjusted bases of the property of the entity is attributable to "nonqualified financial property" (i.e., debt, stock, partnership interests, options, futures contracts, annuities and other similar property, excluding cash, cash equivalents, accounts receivable or debt instruments with a term of less than 18 months); and
5. the QOZ business is not a specifically excluded business (i.e., golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facilities used for gambling, or any store where the principal business is the sale of alcoholic beverages for consumption off premises).

The Proposed Regulations provide that, for purposes of determining whether a given business counts as having "substantially all" of its assets in QOZ business property, the business must have at least 70% of its tangible property in QOZ business property. Accordingly, because 10% of a QOF's assets can already be invested outside of QOZ property, under the Proposed Regulations, applying a 70% to the remaining 90% of assets means that as little as 63% of the capital of a QOF could be invested in QOZ property. This will allow additional flexibility as to the timing of investments of gains into a QOF and the use of the capital invested in the QOF.

QOZ business property

QOZ business property generally includes tangible property used in a trade or business of the QOF if:

(i) the property was acquired by purchase after December 31, 2017 from an unrelated person;

(ii) the "original use" of the property in the QOZ commenced with the QOF or the QOF "substantially improves" the property; and

(iii) during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a QOZ.

The TCJA provided that property is treated as substantially improved by the QOF only if, during any 30-month period beginning after the date of acquisition of the property, additions to basis with respect to the property by the QOF exceed the adjusted basis of the property at the beginning of that 30-month period. Given the uncertainty of the application of this test to real estate, the Revenue Ruling provides guidance in cases where a QOF purchases a building located on land within a QOZ. The Revenue Ruling provides that the QOF need only substantially improve the building on a parcel of acquired land (*i.e.*, it can ignore the cost allocated to land and invest an amount at least equal to the cost allocated to the existing improvements to meet the test). For example, if a QOF purchases for $10 million a building and the land upon which the building is located within a QOZ, with 60% of the purchase price allocated to the land and 40% allocated to the building, the QOF would need to improve the building by an amount in excess of $4 million

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within the 30-month period beginning on the date of purchase for the property to be considered to be "substantially improved." Accordingly, real estate developers and investors are able to purchase existing property and to renovate and otherwise improve the property without having to meet the original use requirement, and, by excluding land value from the improvement calculation, the Revenue Ruling will enable more projects to be developed under the QOZ program in high-cost urban QOZs.

The Revenue Ruling clarifies further that, given the permanence of land, the original use of land can never commence with the QOF. However, the Revenue Ruling indicates that land may qualify as QOZ business property if the improvements thereon qualify under the substantial improvement test, even if the land is not improved. Accordingly, a QOF need only substantially improve the building on a plot of acquired land in order for the entire value of the building and the land purchased to qualify for the 90% asset test.

Outstanding Issues

The Proposed Regulations and the Revenue Ruling addressed many of the issues that were limiting the launch of opportunity fund investments and may spur the formation of funds hoping to close deals before year-end. However, additional guidance is needed to address certain operation issues of the QOFs, including whether QOFs can buy and sell assets within a QOZ without the triggering of the recognition of deferred gain, and further details regarding the definitions of "original use" and "substantial improvement." The Treasury said it is working on additional guidance and expects to release additional proposed regulations in the near future to address these issues. We will continue to keep you posted as additional regulations and further guidance is forthcoming.

For more information on the topic discussed, contact **Michele Itri** at **itri@thsh.com** or **David Schulder** at **schulder@thsh.com**.

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