

When Opportunity Knocks: Qualified Opportunity Zone Proposed Regulations Released

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On Friday, October 19, 2018, the IRS released proposed Treasury Regulations under sections 1400Z-1 and 1400Z-2 and Revenue Ruling 2018-29 to clarify several ambiguities relating to investments in qualified opportunity zones (“QOZs”): designated areas in low income communities. Interested investors in and organizers of qualified opportunity funds (“QOFs”) have anxiously awaited this guidance. Although the guidance clarifies many areas of ambiguity, it leaves many important questions unanswered.

I. Rules for Investors

Sections 1400Z-1 and 1400Z-2 provide tax incentives to taxpayers who reinvest capital gains in QOFs. Specifically, such taxpayers can elect to (i) defer the capital gain reinvested in the QOF; (ii) potentially exclude up to 15 percent of the deferred capital gain; and (iii) eliminate the post-acquisition gain on the investment in the QOF if it is held for at least 10 years.

To seize this opportunity, a taxpayer must realize capital gain income, invest it in a QOF within 180-days of realizing the gain, and elect to defer the gain on his or her tax return. The deferred gain is recognized on the earlier of (i) the date the QOF investment is sold or exchanged; or (ii) December 31, 2026. The deferred gain is reduced by 10 percent if the taxpayer has held the QOF investment for 5 years as of the recognition date and by 15 percent if the taxpayer has held the QOF investment for 7 years. With respect to the QOF investment itself, the taxpayer receives a stepped up basis in the QOF investment equal to its fair market value at the time of the sale if the investment was held for more than 10 years. The proposed regulations clarify many uncertainties impacting the investment decision, including:

- **Eligibility** – Only capital gains from an actual, or deemed, sale or exchange, or any other gain that is required to be included in a taxpayer’s computation of capital gain can be deferred through investment in a QOF. Taxpayers eligible to elect deferral of gain include individuals, C corporations (including RICs and REITs), partnerships and certain other pass-through entities (including S corporations, trusts and estates). Also, although the sale of an original QOF investment before December 31, 2026, would normally require the deferred gain to be recognized, the proposed regulations allow the deferred gain to continue to be deferred after such disposition so long as the taxpayer disposed of the entire initial investment and makes a qualifying new investment in a QOF.
- **Timing** – The 180-day QOF investment period begins on the date on which the gain would be recognized for tax purposes. For certain investments for which only gain is deemed to be recognized, e.g., section 1256 contracts, the 180-day period begins on the last day of the taxable year.
- **Partnerships and Other Pass-Throughs Realizing Capital Gains** – Partnerships that realize capital gain can defer such gain at the partnership level if the partnership makes a QOF investment within 180 days of such realization. If the partnership does not make a QOF investment, a partner can defer recognition of its distributive share of

gain by investing in a QOF within 180 days of the end of the partnership's tax year. Analogous rules apply to S corporations, trusts, and estates, and their respective shareholders or beneficiaries.

- **Electing Deferral** – Treasury anticipates that taxpayers will make an election under section 1400Z-2(a)(1) to defer capital gain recognition on Form 8949, *Sales and Other Dispositions of Capital Assets*, in the year in which the capital gain is realized.
- **Mandatory Basis Step-Up for QOF Investments** – The designation of areas as QOZs expires in 2028. The proposed regulations confirm that taxpayers can nonetheless receive a basis step-up for QOF investments made before June 29, 2027 and held for at least 10 years, so long as the QOF investment is sold before January 1, 2048.

II. Rules for Qualified Opportunity Funds

A QOF is any partnership or corporation formed for the purpose of investing in “qualified opportunity zone property” and that holds at least 90 percent of its assets in qualified opportunity zone property. Qualified opportunity zone property consists of: qualified opportunity zone stock, qualified opportunity zone partnership interest, or qualified opportunity zone business property. The 90-percent asset test is determined by averaging the percentage of qualified assets held on the last day of the first 6-month period of the QOF's taxable year and on the last day of its taxable year. A QOF cannot be formed for the purpose of investing in other QOFs.

Qualified opportunity zone business property (“QOZ Business Property”) is tangible property used in the trade or business of a QOF or a qualified opportunity zone business (“QOZ Business”) if (i) such property was acquired by the QOF or QOZ Business after December 31, 2017, (ii) the original use of such property in the QOZ commences with the QOF or QOZ Business or the QOF or QOZ Business substantially improves the property, and (iii) during substantially all of the QOF or QOZ Business' holding period of such property, substantially all of the use of such property was in an QOZ. To be a QOZ Business, substantially all of the tangible property owned or leased by the business must be QOZ Business Property and at least 50 percent of its gross income must be derived from the active conduct of a trade or business in the QOZ, among other requirements. Qualified opportunity zone stock and a qualified opportunity zone partnership interest must be in a company or partnership that is a QOZ Business. The regulations clarify a number of important statutory ambiguities applicable to these requirements.

- **Eligibility and Certifying Status** – A QOF can be any entity organized in the U.S. or its possessions that is treated for federal tax purposes as a corporation or partnership. A QOF can self-certify its status on Form 8996, *Qualified Opportunity Fund*, attached to its tax return and identify the first month in the year it is treated as such. The selection of the first QOF month will affect the determination of the testing periods for QOF status.
- **Substantially All Means 70 Percent for QOZ Business** – A QOZ Business satisfies the requirement that “substantially all” its property is QOZ Business Property if at least 70 percent of the tangible property owned or leased by the trade or business is QOZ Business Property.

- **Valuation for 90-Percent Asset Test** – A QOF must use the asset values that are reported on its applicable financial statement for the tax year as determined under section 475. If the QOF does not have an applicable financial statement, it must use the cost of its asset.
- **Working Capital Safe Harbor** – A QOZ Business that acquires, constructs, or rehabilitates tangible business property is allowed to treat certain working capital assets as QOZ Business Property for up to 31 months, as long as there is a written plan with a written schedule to disperse such amounts with respect to the acquisition or substantial improvement of property that will qualify as QOZ Business Property, and the business substantially complies with the schedule. Income earned on such working capital will be treated as active income from the active conduct of a QOZ Business. Moreover, the tangible property on which the working capital is to be expended for improvement is not treated as failing to satisfy the substantial improvement test solely because the scheduled consumption of the working capital is not complete.
- **Land Cost Not Included for Improvement** – QOZ Business Property is treated as “substantially improved” only if, within 30 months of acquiring the property, additions to basis with respect to such property exceed its basis at the time of acquisition. For purposes of this rule only the basis of the building itself need be taken into account. Furthermore, even though the land on which a building is located is separate property, the land does not need to be separately substantially improved in order for the land to qualify as QOZ Business Property.

The Proposed Regulations address many of the most pressing issues facing investors, but also request comment on many proposed rules and leave many issues to be addressed in forthcoming regulations. Such issues include (i) the various meanings of “substantially all” for purposes of QOFs, QOZ Businesses and QOZ Business Property; (ii) transactions that may trigger inclusion of deferred gain; (iii) the “reasonable period” for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty; (iv) rules governing when a QOF fails to satisfy the 90-percent asset test; (v) rules governing how to apply the 90-percent test after the date on which QOZ designations expire; and (vi) information reporting requirements.

Attorneys in [Caplin & Drysdale’s Private Client](#) and [Business, Investment & Transactional Tax](#) practice groups have broad experience advising individuals and businesses on organizing and structuring their business investments. For more information regarding these new statutory and regulatory provisions, please contact:

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