Client Alert

October 2018

Opportunity Zone Update - IRS Issues Proposed Regulations, Revenue Ruling 2018-29 and Form 8996

On October 19, 2018, the Internal Revenue Service (the Service) issued (a) highly-anticipated proposed regulations (REG-115420-18) providing guidance on investing in Qualified Opportunity Funds (QOF), (b) Revenue Ruling 2018-29 providing guidance on the "original use" and "substantial improvement" requirements for buildings located on land that are purchased after 2017 and (c) Form 8996 and instructions to self-certify as a QOF.

The Tax Cuts and Jobs Act, P.L. 115-97, added new Section 1400Z-2 of the Internal Revenue Code (the Code) which created QOFs. An overview of the Opportunity Zone program was provided in our prior client alert. In summary, an investment in a QOF allows investors to: (1) defer recognition of capital gains that are reinvested in a QOF, (2) reduce the amount of deferred gain recognized through an increase in basis if the QOF investment is held for more than five or seven years, and (3) enjoy an exemption from taxation on any appreciation in the QOF investment if the investment is held for at least ten years.

Summary of the Proposed Regulations

The proposed regulations answer many questions that have arisen since the Opportunity Zones program was enacted, but many questions still remain. In fact, the current set of proposed regulations note that the Department of the Treasury (Treasury) and the Service are working on additional proposed regulations that are expected to be released in the near future. Those regulations are expected to address other issues that are not addressed in these proposed regulations including (1) the meaning of "substantially all" in each of the various places where it appears in Section 1400Z-2 of the Code, (2) transactions that may trigger inclusion of the deferred gain, (3) the "reasonable period" for a QOF to reinvest proceeds from the sale of qualifying assets without penalty, (4) administrative rules applicable when a QOF fails to maintain compliance with the 90 percent asset test, and (5) information reporting requirements. In addition, Treasury and the Service are soliciting comments on the proposed regulations, all aspects of the definitions of "original use" and "substantial improvement," and any other issues that should be addressed in future proposed regulations or guidance.

Taxpayers Eligible for Gain Deferral – All taxpayers that recognize capital gain for Federal income tax purposes are eligible to elect deferral, including individuals, C corporations, Regulated Investment Companies (RICs), Real Estate Investment Trusts (REITs), partnerships, and certain other pass-through entities. Special rules are provided for partnerships and other pass-through entities as described below.

Gain Eligible for Deferral – Although the statute refers to "gains" from the sale of property, the proposed regulations clarify that only *capital gains* are eligible for deferral. In addition, the proposed regulations also address two additional requirements for the deferral of gain: (1) the gain must be gain that would be recognized by no later than December 31, 2026, if the opportunity zone provisions did not apply to defer recognition of the gain, and (2) the gain must arise from a sale or exchange with an "unrelated person." In general, in order to be unrelated persons, the two parties must have no more than 20 percent common ownership.

- Partnerships and Other Pass-Through Entities – Either a partnership or a partner may elect deferral of capital gains. If a partnership elects to defer all or part of a capital gain by making an investment in a QOF, no part of the deferred gain will be included in the distributive share of the partners and the gain will not be included in the partners' basis. However, if the partnership does not elect to defer such gain, it will be included in the partners' distributive shares and basis and each individual partner may elect its own deferral with respect to such gain (see the 180-day period discussion below).

- Gains under Section 1256 Contracts – The proposed regulations provide that only the "capital gain net income" from Section 1256 contracts that are "marked to market" (e.g., regulated futures contracts, foreign currency contracts, certain options, etc.) is eligible for deferral—that is, the amount determined by taking into account the capital gain and losses for a taxable year on all of a taxpayer's Section 1256 contracts.

- Offsetting Positions (including Straddles) – Due to the administrative challenges associated with straddles, Section 1256 contracts and other "offsetting-positions" transactions, gain from such transactions is not eligible for deferral. An "offsetting-positions transaction is a transaction in which a taxpayer has substantially diminished its risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (unless all such positions are Section 1256 contracts (see above)).

Investment in a QOF – The investment in a QOF must be an *equity* investment which includes preferred stock or a partnership interest with special allocations. The investment cannot be a debt instrument or a deemed contribution of money under Section 752(a) of the Code (i.e., an increase in a partner's share of or assumption of partnership liabilities by a partner). However, the proposed regulations clarify that a taxpayer may use its equity investment in a QOF as collateral for a loan.

180-Day Rule – The proposed regulations provide that the investment in a QOF must be made within the 180-day period beginning on the day on which the gain would be recognized for Federal income tax purposes if the taxpayer did not elect under Section 1400Z-2 of the Code to defer recognition of the gain. However, the proposed regulations provide certain exceptions with respect to the start of the 180-day period. For example:

- Section 1256 Contracts - Because the amount of the "capital gain net income" with respect to such contracts is not determinable until the last day of the taxable year, the 180-day period begins on the last day of such taxable year.

- Partners in a Partnership (or other pass-through entities) – A partner's 180-day period generally begins on the last day of the partnership's taxable year (i.e., the day on which the partner would otherwise be required to recognize the gain if the gain was not deferred). However, if a partner knows the date of the partnership gain and that the partnership will not elect deferral of such gain, the partner may choose to start the 180-day period on the same date as the beginning of the partnership's 180-day period. Analogous rules apply for other pass-through entities.

Tax Attributes of Gain Maintained – A taxpayer is required to include deferred gain in income in the taxable year which includes the earlier of (a) the date on which the QOF investment is sold, or (b) December 31, 2026. The proposed regulations generally provide that all of the deferred gain's attributes (e.g., holding periods, short-term gain, long-term gain, collectibles gain) are preserved through the deferral period. The proposed regulations also provide certain special rules and examples.

- First-In, First-Out (FIFO) Method – If a taxpayer holds investments with identical rights in a QOF that were acquired on different days and if the taxpayer disposes of less than all of its interest, then the FIFO method must be used to identify the interest that was sold.

- Pro-Rata Method – If after the application of the FIFO method, a taxpayer is treated as having disposed of less than all of the investments that the taxpayer acquired on one day, and if the interests have different tax attributes, then a pro-rata allocation must be made to determine which interests were disposed of.

Election for Investments Held for 10 Years – A taxpayer that holds a QOF investment for at least ten years may elect to increase its basis of the investment to the fair market value of the investment on the date that the investment is sold or exchanged provided that a proper deferral election was made at the time of the QOF investment and regardless of whether the qualified opportunity zone designation for the property has expired. The proposed regulations provide that the ability to make this basis step-up election is preserved until December 31, 2047.

Certification as a Qualified Opportunity Fund – Any taxpayer that is a corporation or a partnership for Federal income tax purposes may self-certify as a QOF using Form 8996. The proposed regulations allow a QOF to both identify the taxable year in which the entity becomes a QOF and to choose the first month in that year to be treated as a QOF. Note that a gain deferral election will not be effective for an investment that is made before an eligible entity certifies as a QOF.

- Pre-Existing Entities – The proposed regulations clarify that a pre-existing entity may self-certify as a QOF after 2017 as long as it meets the QOF requirements under Section 1400Z-2(d) of the Code, including that its Qualified Opportunity Zone Property must be acquired after December 31, 2017.

90% Asset Test - A QOF must hold at least 90% of its assets in "Qualified Opportunity Zone Property." Section 1400Z-2(d)(1) of the Code provides that property holdings of the QOF are measured "on the last day of the first 6-month period of the taxable year of the fund" and on the last day of the taxable year of the fund. However, the proposed regulations provide a special rule that allows a QOF to choose to become a QOF in a month other than the first month of the taxable year. In addition, regardless of when an entity becomes a QOF, the last day of the taxable year is a "testing date". Thus, if an entity becomes a QOF in the seventh or later month of a 12-month taxable year, the 90% test is applied on only the QOF's assets on the last day of the taxable year. The Service also notes that additional "soon-to-be-released" proposed regulations will provide additional guidance on the 90% test and the reinvestment of the return of capital from investments in QOF stock and partnership interests.

- Valuation Method for 90% Asset Test – The proposed regulations require the QOF to use the asset values reported on the QOF's applicable financial statement for the taxable year. If the QOF does not have an applicable financial statement, the QOF must use the QOF's cost basis. In general, a taxpayer's applicable financial statement is a financial statement prepared in accordance with US GAAP that (1) is required to be filed with the SEC, (2) is required to be provided to the Federal government or any of its agencies (other than the Service), or (3) (i) is given to creditors for purposes of making lending decisions, (ii) is given to equity holders for purposes of evaluating their investment in the taxpayer, or (iii) is provided for other substantial non-tax purposes and, in each case, the taxpayer reasonably anticipates will be directly relied on for the purposes for which it was given or provided.

Qualified Opportunity Zone Property – Qualified Opportunity Zone Property is: (i) qualified opportunity zone stock, (ii) qualified opportunity zone partnership interest, and (iii) qualified opportunity zone business property.

- Qualified Opportunity Zone Stock – If an entity is classified as a corporation for Federal income tax purposes, then an equity interest (stock) in the entity is qualified opportunity zone stock if:
    - The stock is acquired by a QOF after December 31, 2017, at its original issue (directly or through an underwriter) from the corporation solely in exchange for cash;

- As of the time the stock was issued, the corporation was a qualified opportunity zone business (as defined below) (or, in the case of a new corporation, was being organized for purposes of being such a business); and

- During *substantially all of the QOF's holding period for the stock*, the corporation was a qualified opportunity zone business.

The proposed regulations also provide various rules relating to the redemption of stock. Analogous rules to those described above apply for defining a "qualified opportunity zone partnership interest."

- Qualified Opportunity Zone Business Property – Tangible property used in a trade or business of a QOF is "qualified opportunity zone business property" if:

  - The tangible property was acquired by the QOF by purchase from an unrelated party after December 31, 2017;

  - The *original use of the tangible property* in the qualified opportunity zone commences with the QOF, or the QOF substantially improves the tangible property; and

    - Tangible 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 the basis of the property in the hands of the QOF exceed an amount equal to the adjusted basis of the property at the beginning of the 30-month period in the hands of the QOF – i.e., the QOF doubles the basis of the property during the initial 30-month period. The proposed regulations provide a special rule for buildings located on land wholly within a qualified opportunity zone which only takes into account the substantial improvement to the building and does not require the QOF to separately substantially improve the land on which the building is located.

  - During *substantially all of the QOF's holding period for the tangible property*, *substantially all of the use of the tangible property* was in a qualified opportunity zone.

The proposed regulations do not define and reserve on the meaning of the terms underlined and italicized above including: (i) original use of the tangible property, (ii) substantially all of the QOF's holding period for the applicable property (stock, partnership interest or tangible property), and (iii) substantially all of the use of the tangible property by a QOF in a qualified opportunity zone.

Qualified Opportunity Zone Business – A trade or business is a qualified opportunity zone business if:

- Substantially all of the tangible property owned or leased by the trade or business is (1) acquired by the entity by purchase from an unrelated person after December 31, 2017, (2) the original use of the tangible property in the qualified opportunity zone commences with the entity or the entity substantially improves the tangible property, and (3) during *substantially all of the entity's holding period for the tangible property*, *substantially all of the use of the tangible property was in a qualified opportunity zone*.

  - A trade or business of an entity is treated as satisfying the "substantially all" requirement regarding the amount of tangible property owned by the entity if at least 70% of the tangible property owned or leased by the trade or business is qualified opportunity zone business property as defined above.

        - In general, satisfaction of the 70% requirement is determined utilizing the same rules used to determine compliance with the 90% test as described above.

        - A special rule is provided for entities with two or more taxpayers that have self-certified as QOFs and that hold more than 5% of the stock or interest in the entity.

    - Substantial improvement of tangible property is defined in the same manner as for qualified opportunity zone business property above.

    - Similar to the definition of "qualified opportunity zone business property," the proposed regulations do not define and reserve on the meaning of the terms underlined and italicized above.

- The trade or business satisfies the following three requirements, and

    - For each taxable year at least 50% of the gross income of a qualified opportunity zone business is derived from the *active conduct of a trade or business* in the qualified opportunity zone,

    - A substantial portion of the intangible property of an opportunity zone business is used in the *active conduct of a trade or business* in the qualified opportunity zone, and

        - The proposed regulations do not define and reserve on the meaning of "active conduct of a trade or business."

    - In each taxable year, less than 5% of the average of the aggregate unadjusted bases of the property of a qualified opportunity zone business is attributable to "nonqualified financial property."

        - Working Capital Safe Harbor – The proposed regulations allow qualified opportunity zone businesses to hold "reasonable amounts of working capital held in cash, cash equivalents, [and/or] debt instruments with a term of 18 months or less" for a period of up to 31 months if three requirements are satisfied:

            - There is a written plan that designates the amounts for the acquisition, construction, and/or substantial improvement of tangible property in the qualified opportunity zone,

            - There is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets and working capital assets must be spent within 31-months, and

            - The business substantially complies with the plan and schedule.

        - If any gross income is earned from such working capital, it is counted toward the satisfaction of the 50% gross income test above. In addition, the "use of intangible property" requirement above will also be treated as satisfied during any period in which the business is proceeding in a manner consistent with the plan and schedule described above.

- The trade or business is not described in Section 144(c)(6)(B) of the Code (i.e., any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or

other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises).

Eligible Entities - A QOF must be an entity classified as a corporation or a partnership for Federal income tax purposes. In addition, the entity must be created or organized in one of the 50 States, the District of Columbia or a US possession. The proposed regulations provide special requirements for QOFs or entities organized in a US possession (American Samoa, Guam, Northern Mariana Islands, Puerto Rico, and the US Virgin Islands).

Effective Date - Generally, the proposed regulations will become effective on or after the date of publication in the Federal Register of a Treasury decision adopting the regulations as final regulations. However, taxpayers may rely on certain of the rules in the proposed regulations prior to such date as long as the taxpayer applies the proposed rules in their entirety and in a consistent manner.

Summary of Revenue Ruling 2018-29

QOFs must invest in qualified opportunity zone stock, a qualified opportunity zone partnership interest or qualified opportunity zone business property (OZ Property). To qualify as OZ Property, the Code requires, among other things, that the "original use" of the OZ Property commence with the QOF or that the QOF "substantially improve" the OZ Property. Revenue Ruling 2018-29 (the Revenue Ruling) provides guidance regarding the original use and substantial improvement requirements. Specifically, the Revenue Ruling addresses situations in which a building is located on land within a qualified opportunity zone.

- The Land - The Revenue Ruling states that, given the permanence of land, the original use of land can never commence with a QOF. Thus, the Revenue Ruling holds that the original use requirement is *not applicable* to the land on which the building is located.

- The Building - The original use of an existing building located on land does not commence with the QOF. The QOF must substantially improve the building in order for the building to qualify as OZ Property. For purposes of determining whether or not the building is substantially improved, the land's adjusted basis is *not* included in a building's adjusted basis for purposes of calculating whether the building is substantially improved. In addition, the land on which a substantially improved building is located does not itself need to be separately substantially improved for the building to qualify as OZ Property.

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