ECONOMIC DEVELOPMENT/TAX/REAL ESTATE/CORPORATE/ MUNICIPAL FINANCE
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TREASURY RELEASES PROPOSED REGULATIONS ON OPPORTUNITY ZONES

Background

The Tax Cut and Jobs Act of 2017 (TCJA) created a new economic development tool designed to assist low-income communities which are designated as Qualified Opportunity Zones (QOZs). The incentive operates to make QOZs attractive targets for investment by the lure of deferring the recognition of taxable gains. As a result, QOZs have become the topic *du jour* in the investment and economic development world.

The TCJA created two main tax incentives to encourage investment in QOZs. First, it allows for the deferral of recognizing certain tax gains to the extent a corresponding amount is reinvested in a Qualified Opportunity Fund (QOF). Second, the TCJA offers a gross income exclusion for the post-acquisition gains on investments in QOFs that are held for at least 10 years.

The first Opportunity Zone incentive allows taxpayers to postpone until 2026 paying tax on all or a portion of gains which are reinvested in QOFs. QOFs are equity funds that make investments in "Qualified Opportunity Zone Property" which is located in QOZs. QOFs are required to meet an asset test. The asset test requests QOFs to hold at least 90 percent of their assets in QOZs. While QOFs can invest capital in businesses located in QOZs, the investor interest has mostly focused on real estate development/redevelopment projects. A portion of the taxable gains which remain invested in a QOF for certain time periods are eligible for partial permanent non-recognition treatment. If the funds remain invested for at least 5 years, only 90 percent of the original gain is subject to tax. If the investment is held for 7 years, only 85 percent of the original gain is taxed. However, because the first QOZ incentive only allows taxpayers with eligible investments to defer taxes on their gains until the end of 2026, taxpayers must make eligible investments by the end of 2021 in order to qualify for the five-year incentive to reduce the required 2026 tax payment. The second QOZ incentive allows increase in value of an investment in a QOF to avoid taxation. The appreciation in value of an investment in a QOF which is held for 10 years escapes tax entirely by allowing the taxpayer to step-up the adjusted basis to fair market value.

See Dickinson Wright's Client Alert: "Treasury and IRS announce designation of Opportunity Zones for 18 States" dated April 11, 2018 which sets forth a more detailed description of the Opportunity Zone tax incentive.

Each state was allowed to designate up to 25% of its low-income, high poverty census tracts as a QOZ. The designation process concluded in July 2018. For a list of the more than 8,700 QOZs created nationally and a mapping tool for locating QOZ's, see the Opportunity Zones Resources Page maintained by the Community Development Financial Institutions Fund here: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx

The TCJA statutory language establishing QOZs left several unanswered questions. What types of tax gains can be deferred? How are the rules applied to partnerships? When can a step-up election be made? How to certify a QOF? While there has been significant interest in the new Opportunity Zone tax incentive, potential investors and fund sponsors have eagerly been waiting for additional guidance on the multitude of unanswered questions from U.S. Department of the Treasury (Treasury). On October 19, 2018, Treasury finally issued long-awaited Opportunity Zone guidance in the form of proposed regulations. The Proposed Regulations clarify the character of gains that – in Treasury's view – qualify for tax deferral, which taxpayers and investments are eligible, the parameters for QOFs, and other guidance. Treasury also announced plans to issue additional guidance before the end of 2018. The Proposed Regulations can be found here: https://www.irs.gov/pub/irs-drop/reg-115420-18.pdf

Contemporaneous with the issuance of the Proposed Regulations, the IRS released Rev. Rul. 2018-29 addressing the application to real property of the "original use" and "substantial improvement" requirements as they relate to QOZ investments.

Proposed Regulations

Below is a summary of the guidance provided by Treasury for the Proposed Regulations and Rev. Rul. 2018-29.

Gains Eligible for Deferral

Only *capital* gains are eligible for deferral under Section 1400Z-2(a)(1) of the Internal Revenue Code of 1986, as amended (Code). Gains characterized as "ordinary income" are not eligible for deferral. The Proposed Regulations address two additional gain deferral requirements. First, the gain to be deferred must be gain that would otherwise be recognized, if deferral under Section 1400Z-2(a)(1) were not permitted, not later than December 31, 2026. For example, gains deferred under the like-kind exchange rules of Section 1031 of the Code – which is mandatory and not elective – would call off the availability of deferral under Section 1400Z-2(a)(1).[1] Second, the gain must not arise from a sale or exchange with a related person. For Section 1400Z-2 purposes, a related party is more broadly defined, which will require greater scrutiny of continuing ownership interests in QOFs.

Types of Taxpayers Eligible to Elect Gain Deferral

Taxpayers must *affirmatively* elect gain deferral under Section 1400Z-2. Taxpayers eligible to elect deferral under Section 1400Z-2 are those that recognize capital gain for Federal income tax purposes. Taxpayers eligible to make an election include individuals, C corporations, partnerships, and certain other pass-through entities (e.g., REITs and RICs). The Proposed Regulations include special ordering rules for partnerships and other pass-through entities, and for partners or other

owners of pass-through entities. Under Proposed Regulations, not only can partnerships make an election under Section 1400Z-2, but partners can also make deferral elections in the event the partnership does not make an election.

Investments in a QOF

To be an eligible interest in a QOF, the investment must be an equity interest in the QOF. The equity interest could include preferred stock or a preferred partnership interest which carries special allocations. Investments in "debt" instruments are ineligible interests. Thus, QOF sponsors and investors will need to carefully structure the terms of QOF equity interests to ensure that the interest is not true debt for federal income tax purposes. As a practical matter, it is expected that the majority of the QOFs will seek to be classified as partnerships for federal income tax purposes. Accordingly, sponsors and investors of QOFs intended to be classified as a partnership will need to closely analyze the business terms in order to prevent jeopardizing the classification of the QOF as a bona fide partnership for federal income tax purposes. Provided that the eligible taxpayer is the tax owner of the equity interest for Federal income tax purposes, status as an eligible interest is not impaired by the taxpayer's use of the interest as collateral for a loan (i.e., the Proposed Regulations suggest that a taxpayer could pledge his equity interest to secure a loan). Deemed contributions of money to a QOF – such as, for example, a deemed cash contribution for liability of partnership indebtedness under Section 752 of the Code – do not result in the creation of an additional investment in a QOF.

180-Day Rule for Deferring Gain by Investing in a QOF

Under Section 1400Z-2(a)(1)(A), to be able to elect to defer gain, a taxpayer must generally invest in a QOF during an 180-day period. Prior to issuance of the Proposed Regulations, there were questions with respect to when the 180-day period would begin. Generally, the timing rule of Section 1400Z-2 provides that the 180-day period begins on the date of the sale or exchange. Some capital gains, however, may arise due to a deemed sale or exchange of a capital asset. The Proposed Regulations address the issue by providing a timing rule that, except as otherwise specifically provided in the Proposed Regulations, the first day of the 180-day period is the date on which the gain would be recognized for Federal income tax purposes, without regard to the deferral available under Section 1400Z-2. The Proposed Regulations include examples which illustrate the general rule by applying it to capital gains in a variety of situations (including, for example, gains from the sale of exchange-traded stock and capital gain dividend distributions). As discussed below, the Proposed Regulations also offer a timing rule when partners make a Section 1400Z-2 election as a result of a gain recognized by a partnership.

Attributes of Included Income When Gain Deferral Ends

Section 1400Z-2(a)(1)(B) and (b) require taxpayers to include in income previously deferred gains. The Proposed Regulations provide that all of the deferred gain's tax attributes are preserved through the deferral period and are taken into account when the gain is included. Preservation of tax attributes would mean, for example, that short term capital gains retain their characterization as such. The Proposed Regulations also address situations in which separate investments providing indistinguishable property rights (such as serial purchases of common stock in a corporation that is a QOF) are made at different times or are made at the same time with separate gains possessing different attributes (such as different holding periods). If a taxpayer disposes of less than all of its fungible interests in a QOF, the Proposed Regulations provide that the QOF interests disposed of must be identified using a first-in, first-out (FIFO) method. If FIFO method does not provide a complete answer, such as where gains with different attributes are invested in indistinguishable interests at the same time, the Proposed Regulations permit taxpayers to use a pro-rata method to determine the character, and any other attributes, of the gain recognized.

Special Rules

- *Gain not already subject to an election.*
  Under Section 1400Z-2(a)(2)(A), no election may be made under Section 1400Z-2(a)(1) with respect to a sale or exchange if an election previously made with respect to that sale or exchange is in effect. The Proposed Regulations clarify that in the case of a taxpayer who has made an election under Section 1400Z-2(a) with respect to some but not all of an eligible gain, the term "eligible gain" includes only the portion of that eligible gain as to which no election has been made.

- *Section 1256 contracts*
  The Proposed Regulations provide that the 180-day period for investing capital gain net income from Section 1256 contracts in a QOF begins on the last day of the taxable year.

- *Offsetting-positions transactions, including straddles*
  The Proposed Regulations provide special rules for offsetting-positions transactions, including straddles.

Gains of Partnerships and Other Pass-Through Entities

The Proposed Regulations provide rules that permit a partnership to elect deferral under Section 1400Z-2. Significantly, the Proposed Regulations provide rules for a partner to make a Section 1400Z-2 election when a partnership does not elect deferral. The availability of a partner level election will offer partners, and partnerships, incredible planning and investment options based on the individual partners' tax positions. The Proposed Regulations both clarify the circumstances under which the partnership or partner can elect and when the applicable 180-day period begins. Proposed Regulations § 1.1400Z-2(a)-1(c)(1) provides that a partnership may elect to defer all or part of a capital gain to the extent that it makes an eligible investment in a QOF. A partner's 180-day period generally begins on the last day of the partnership's taxable year, because that is the day on which the partner would be required to recognize the gain if the gain is not deferred. However, a partner can elect for the 180 day period to commence on the date of the sale or exchange. The change in timing may be beneficial if a taxpayer intends to invest in a QOF at an earlier time

How to Elect Deferral

The Proposed Regulations require deferral elections to be made at the time and in the manner provided by the IRS. Taxpayers will make deferral elections on Form 8949, which will be attached to their Federal income tax returns for the taxable year in which the gain would have been recognized if it had not been deferred. Form instructions to this effect are expected to be released soon.

Section 1400Z-2(c) Election for Investments Held At Least 10 Years

Under Section 1400Z-2(c), a taxpayer that holds a QOF investment for at least ten years may elect to increase the basis of the investment to the fair market value of the investment on the date that the investment is sold or exchanged. The basis step-up election under Section 1400Z-2(c) is available only for gains realized upon investments that were made in connection with a proper deferral election under Section 1400Z-2(a). It is possible for a taxpayer to invest in a QOF in part with gains for which a deferral election under Section 1400Z-2(a) is made and in part with other funds (for which no Section 1400Z-2(a) deferral election is made or for which no such election is available). Section 1400Z-2(e) requires that these two types of QOF investments be treated as separate investments, which receive different treatment for Federal income tax purposes. Pursuant to Section 1400Z-2(e)(1)(B), the Proposed Regulations reiterate that a taxpayer may make the election to step-up basis in an investment in a QOF that was held for 10 years or more only if a proper deferral election under Section 1400Z-2(a) was made for the investment.

QOF Investments and the 10-Year Zone Designation Period

Section 1400Z-2(c), as stated above, permits a taxpayer to elect to increase the basis in its investment in a QOF if the investment is held for at least ten years from the date of the original investment in the QOF. However, under Section 1400Z-1(f), the designations of all qualified opportunity zones now in existence will expire on December 31, 2028. The loss of qualified opportunity zone designation raises issues regarding gain deferral elections that are still in effect when the designation expires. Among the issues that the zone expiration date raises is whether, after the relevant qualified opportunity zone loses its designation, investors may still make basis step-up elections for QOF investments from 2019 and later. For example, will a taxpayer whose investment in a QOF has its 10-year anniversary after the 2028 calendar year be able to take advantage of the basis step-up election provided in Section 1400Z-2(c)? The Proposed Regulations confirm that taxpayers are permitted to make the basis step-up election under Section 1400Z-2(c) after a qualified opportunity zone designation expires. The ability to make this election is preserved under the Proposed Regulations until December 31, 2047, 20½ years after the latest date that an eligible taxpayer may properly make an investment that is part of an election to defer gain under Section 1400Z-2(a).

Rules for a Qualified Opportunity Fund

- *Certification of an Entity as a QOF*

  Any taxpayer that is a corporation or partnership for tax purposes is permitted to self-certify as a QOF, provided that the entity self-certifying is statutorily eligible to do so. Taxpayers will use Form 8996, Qualified Opportunity Fund, both for initial self-certification and for annual reporting of compliance with the 90-Percent Asset Test in Section 1400Z-2(d)(1). Form 8996 would be attached to the taxpayer's Federal income tax return for the relevant tax years.

- *Designating When a QOF Begins*

  The Proposed Regulations allow a QOF both to 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. If an eligible entity fails to specify the first month it is a QOF, then the first month of its initial taxable year as a QOF is treated as the first month that the eligible entity is a QOF. A deferral election under Section 1400Z-2(a) may only be made for investments in a QOF. Therefore, a proper deferral election under Section 1400Z-2(a) may not be made for an otherwise qualifying investment that is made before an eligible entity is a QOF.

- *Becoming a QOF in a Month Other Than the First Month of the Taxable Year*

  The Proposed Regulations provide guidance regarding application of the 90-Percent Asset Test in Section 1400Z-2(d)(1) with respect to an entity's first year as a QOF, if the entity chooses to become a QOF beginning with a month other than the first month of its first taxable year.

- *Pre-Existing Entities*

  While as a practical matter, most QOF sponsors would likely opt to organize a new entity, the Proposed Regulations confirm that there is no prohibition with using a pre-existing entity as a QOF. Similarly, the Proposed Regulations recognize that there is no prohibition on the use of a subsidiary entity operating a qualified opportunity business, provided that the pre-existing entity satisfies the requirements under Section 1400Z-2(d). Section 1400Z-2(d)(1) requires that a QOF must undergo semi-annual tests to determine whether its assets consist on average of at least 90 percent qualified opportunity zone property. For purposes of these semi-annual tests, Section 1400Z-2(d)(2) requires that a tangible asset can be qualified opportunity zone business property by an entity that has self-certified as a QOF or an operating subsidiary entity only if it acquired the asset after 2017 by purchase.

Valuation Method for Applying the 90-Percent Asset Test

For purposes of the calculation of the 90-Percent Asset Test in Section 1400Z-2(d)(1) by the QOF, the Proposed Regulations require the QOF to use the asset values that are reported on the QOF's applicable financial statement for the taxable year.

Nonqualified Financial Property (working capital safe harbor)

QOFs are subject to the nonqualified financial property (NQFP) limitation of Section 1397C(e)(1) of the Code. Generally, Section 1397C limits the amount of NQFP a taxpayer may hold. Money is NQFP

under the federal income tax law. Project sponsors and investors of New Market Tax Credit financing transactions are familiar with the NQFP limitations and the difficult questions which can be presented with cash held for construction of improvements to real property. The Proposed Regulations provide a working capital safe harbor for QOFs, which if met, will not cause the working capital to be treated as NQFP. The safe harbor applies to investments in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in an opportunity zone. The safe harbor allows qualified opportunity zone businesses to apply the definition of working capital provided in Section 1397C(e)(1) to property held by the business for a period of up to 31 months. To meet the safe harbor, the Proposed Regulations further require a QOF to have a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone, a written schedule consistent with the ordinary business operations of the business demonstrating that the working capital will be used within 31-months, and the business substantially complies with the schedule. From a practical standpoint, the working capital exception offers a good tool for QOFs; however, QOFs will likely need to work in conjunction with construction contractors to develop reasonable construction schedules and project budgets.

Qualified Opportunity Zone Business

Under Section 1400Z-2(d)(1), a QOF is any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property (other than another QOF). A QOF must hold at least 90 percent of its assets in qualified opportunity zone property. Compliance with the 90 Percent Asset Test is determined by the average of the percentage of the qualified opportunity zone property held in the QOF as measured on the last day of the first 6-month period of the taxable year of the QOF and on the last day of the taxable year of the QOF.

Under Section 1400Z-2(d)(2)(A), the term qualified opportunity zone property includes qualified opportunity zone business property. Qualified opportunity zone property may also include certain equity interests in an operating subsidiary entity (either a corporation or a partnership) that qualifies as a qualified opportunity zone business by satisfying certain requirements pursuant to Section 1400Z-2(d)(2)(B) and (C). The definition of qualified opportunity zone business property requires property to be used in a QOZ and also requires new capital to be employed in a QOZ.

Under Section 1400Z- 2(d)(2)(D)(i), qualified opportunity zone business property means tangible property used in a trade or business of a QOF, but only if (1) the property was acquired by purchase after December 31, 2017; (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 the property, substantially all of the use of the property was in a QOZ. To qualify as a qualified opportunity zone business, an entity must be a qualified opportunity zone business both (a) when the QOF acquires its equity interest in the entity and (b) during substantially all of the QOF's holding period for that interest. For a trade or business to qualify as qualified opportunity zone business, it must (among other requirements) be one in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property. If an entity qualifies as a qualified opportunity zone business, the value of the QOF's entire interest in the entity counts toward the QOF's satisfaction of the 90 Percent Asset Test.

In determining whether an entity is a qualified opportunity zone business, the Proposed Regulations propose a threshold to determine whether a trade or business satisfies the "substantially all" requirement in Section 1400Z-2(d)(3)(A)(i). If at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property, the trade or business is treated as satisfying the substantially all requirement.

Eligible Entities

A QOF must be a domestic entity classified as a corporation or partnership for Federal income tax purposes. No foreign entities. Qualified opportunity zone property may include stock or a partnership interest in a domestic entity classified as a corporation or partnership for Federal income tax purposes.

Section 1400Z-2(e) Investments from Mixed Funds

If only a portion of a taxpayer's investment in a QOF is subject to the deferral election under Section 1400Z-2(a), then Section 1400Z-2(e) requires the investment to be treated as two separate investments, which receive different treatment for Federal income tax purposes.

Proposed Effective Date

The Proposed Regulations generally will be effective on or after the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations. However, a taxpayer or QOF may rely on the Proposed Regulations for certain purposes described in the regulations so long as it applies the rules in their entirety and in a consistent manner.

Rev. Rul. 2018-29

Rev. Rul. 2018-29 answers the following questions:

(1) If a QOF purchases an existing building located on land that is wholly within a qualified opportunity zone (QOZ), can the original use of the building or the land in the QOZ be considered to have commenced with the QOF?

> Holding: If a QOF purchases an existing building located on land that is wholly within a QOZ, the original use of the building in the QOZ is not considered to have commenced with the QOF for purposes of § 1400Z-2(d)(2)(D)(i), and the requirement under § 1400Z-2(d)(2)(D)(i) that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located.

(2) If a QOF purchases an existing building in a QOZ and the land upon which the building is located in a QOZ, is a substantial improvement to the building measured by additions to the adjusted basis in the building or is it measured by additions to the adjusted basis in the building and the land?

> Holding: If a QOF purchases a building wholly within a QOZ, under § 1400Z-2(d)(2)(D)(ii) a substantial improvement to the building is measured by the QOF's additions to the adjusted basis of the building.

(3) If a substantial improvement to the building is measured by additions to the QOF's adjusted basis in the building, does § 1400Z-2(d) require the QOF to separately substantially improve the land?

> Holding: Under § 1400Z-2(d), measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located. The reasoning given was that excluding the basis of land from the amount that needs to be doubled under section 1400Z-2(d)(2)(D)(ii) for a building to be substantially improved facilitates repurposing vacant buildings in qualified opportunity zones.

Conclusion

The Opportunity Zone incentive is a significant tool for stimulating capital investment in QOZs. This tool may be used by fund managers to raise capital to invest in Opportunity Zones and by developers and existing businesses located in Opportunity Zones. Dickinson Wright can provide assistance in helping structure QOF investments and implementing this new tax strategy.

We will continue to provide updates on the Proposed Regulations when more information becomes available.

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[1] The risk of a like-kind exchange calling off availability of deferral under Section 1400Z-2 is merely theoretical because the TCJA narrowed the scope of Section 1031 of the Code to apply only to like-kind exchanges of real property and, moreover, even before the enactment of the TCJA, Section 1031 of the Code expressly excludes the receipt of a partnership interest from like-kind property. Other gain deferral provisions, however, such as deferral from a corporate reorganization under Section 368 of the Code would deny availability of Section 1400Z-2 gain deferral. Therefore, taxpayers may need to carefully plan transactions to ensure other tax deferral provisions of the Code, some of which are mandatory and not elective, are not impacted.

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