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TAX BREAKS FOR INVESTMENT IN OPPORTUNITY ZONES – PROPOSED TREASURY REGULATIONS

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On Friday, October 19, 2018, the Internal Revenue Service (the "IRS") released the eagerly anticipated qualified opportunity zone ("O-Zones") Proposed Treasury Regulations (the "Proposed Regulations") relating to qualified opportunity funds ("O-Zone Funds"). O-Zone Funds are investment vehicles created by the Tax Cuts and Jobs Act that provide taxpayers, with eligible capital gains, an opportunity to make an election to (i) defer eligible capital gains to the extent reinvested into an O-Zone Fund, (ii) exclude up to 15% of the deferred capital gains, if the investment in the O-Zone Fund is held long enough (the tax on 15% of the deferred gain is effectively forgiven), and (iii) receive a stepped up basis in the O-Zone Fund investment to the fair market value at the time of sale, if the investment was held more than 10 years, resulting in a tax-free return on the O-Zone Fund investment. For a greater in-depth discussion relating to the tax incentives available to eligible investing taxpayers, please refer to Part 1 of our series of O-Zone blogs in which we describe the three forms of preferential tax treatment potentially available to investors in O-Zone Funds. The Proposed Regulations still leave numerous open questions unanswered, but the Treasury has given assurances that additional guidance is pending.

In this Part 2 of our series of O-Zone blogs, we illuminate some taxpayer friendly clarifications provided by the Proposed Regulations. Highlights of the clarifications contained in the Proposed Regulations follow in bullet point format:

- Eligible Taxpayers – Eligible taxpayers include individuals, C corporations—including regulated investment companies (RICs) and real estate investment trusts (REITs)—partnerships, S corporations, trusts and estates. Eligible taxpayers may continue deferral after disposition of all, but not less than all, the initial investment, if the eligible taxpayer makes a new qualifying investment in an O-Zone Fund.
- Gains Eligible for Deferral – A gain is eligible for deferral if it is treated as a capital gain for federal income tax purposes, including, without limitation, 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. The IRS anticipates that taxpayers will make deferral elections on Form 8949, Sales and Other Dispositions of Capital Assets, which will be attached to the taxpayer's federal income tax returns for the taxable year the gain would have been recognized if it had not been deferred.
- The 180-Day Rule – Capital gains must be recognized, unless deployed into an O-Zone Fund within 180 days from the date of the sale generating the capital gain, or, in the case of a "deemed sale," within 180 days from the date capital gains resulting from a deemed sale would otherwise be recognized.
- Partnerships and Other Pass-through Entities – Partnerships may elect to invest eligible capital gains into an O-Zone Fund. If the partnership does not so elect, then the partners may elect to invest their allocable share of the capital gains in an O-Zone Fund within 180 days of the end of the partnership's tax year; alternatively, a partner may elect to start the 180-day period on the day the sale or exchange generating the eligible capital gain occurred. Similar rules apply to other eligible pass-through entities.

- Impact of Expiration of O-Zone Designation – Despite initial O-Zone designations expiring in 2028, eligible taxpayers may still receive a step-up in basis for O-Zone Fund investments made before June 29, 2017 and held for at least 10 years, provided that the investment is sold before January 1, 2048.
- 90% Asset Test and Working Capital Safe Harbor – If certain conditions are met, an O-Zone Fund that is formed to invest in tangible business property (including real property) can hold cash contributed by its investors for up to 31 months during the start-up phase without jeopardizing qualification; that is, during that 31-month period, the cash will be deemed working capital. However, to avail itself of this working capital safe harbor, the O-Zone Fund is required to (i) prepare a written plan that identifies the cash as property held for the acquisition, construction, or improvement of tangible property in the O-Zone, (ii) prepare a written schedule consistent with the ordinary operations of the business that reflects the tangible property will be used within 31 months, and (iii) substantially comply with the written plan and schedule.
- Self-Certification and Testing Dates – Taxpayers will use Form 8996, Qualified Opportunity Fund, both for initial self-certification and for annual reporting of compliance with the 90% asset test. Some flexibility exists with respect to the testing dates that an O-Zone Fund can use in its initial year to determine whether the 90% asset test is satisfied. For example, if a calendar-year entity created in February chooses April as its first month as an O-Zone Fund, then the 90% asset test testing dates for the O-Zone Fund are the end of September and the end of December. Moreover, if the calendar-year O-Zone Fund chooses a month after June as its first month as an O-Zone Fund, then the only testing date for the taxable year is the last day of the O-Zone Fund's taxable year. Regardless of when an entity becomes an O-Zone Fund, the last day of the taxable year is a testing date.
- Pre-Existing Entities – There is no prohibition to using a pre-existing entity as an O-Zone Fund, or as a subsidiary entity operating a qualified O-Zone business, provided that the pre-existing entity satisfies the qualification requirements at the time it chose to be treated as an O-Zone Fund, including that interests in "qualified opportunity zone property" are acquired after 2017 by purchase.
- 90% Asset Test and Valuation Issues – O-Zone Funds must hold at least 90% of fund assets in qualified O-Zone property. In performing the test, O-Zone Funds report values based on the applicable financial statement for the tax year; provided that, if no financial statements exist, then an asset cost approach is used.
- Substantial Improvements – The Proposed Regulations and Revenue Ruling 2018-29 together provide that where an existing building and the land on which it is located are purchased by an O-Zone Fund, the substantial improvement test must be satisfied. The O-Zone Fund has 30 months to make capital improvements to the property such that the aggregate dollar amount of the improvements at the end of such 30-month period is an amount that exceeds the portion of the cost basis of the property allocable to the building only. The land on which the building is situated need not be substantially improved for the land/building to qualify as qualified O-Zone business property.

The Treasury is working on additional guidance, including additional proposed regulations, which, among other issues, are expected to address: (i) the meaning of "substantially all" in each of the various places where it appears in the enabling statute, (ii) the transactions that may trigger the inclusion of eligible capital gains deferred under a section 1400Z-2(a) election, (iii) the "reasonable period" for an O-Zone Fund to reinvest proceeds from the sale of qualifying assets without paying a penalty, (iv) administrative rules applicable when an O-Zone Fund fails to maintain the required 90% investment standard, and (v) additional information reporting requirements.

For more information, please contact authors, Mark Wisniewski or Bryan Appel, on our Business, Finance and Tax Team.

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