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ALERTS

Opportunity Zone Tax Incentives New IRS Guidance Clarifies Tax Incentives

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In October 2018, the Internal Revenue Service and the U.S. Department of Treasury issued IRS Revenue Ruling 2018-29 and the first round of proposed regulations on the Opportunity Zone program. The guidance provides the first round of proposed regulations. The Department of Treasury is accepting comments on the proposed regulations for 60 days, and expects to issue additional guidance later this year.

Background

In December 2017, Congress enacted a very attractive tax incentive program to promote long-term investments in economically distressed communities designated as opportunity zones (Opportunity Zones). Designated Opportunity Zones exist in every state and represent over 10% of the land mass in the United States, including all of Puerto Rico. View a list and map of all the opportunity zones.

A taxpayer can realize the tax benefits of the Opportunity Zone program by investing the amount of any eligible capital gain in a “qualified opportunity fund” (QOF) during the 180-day period beginning on the date the capital gain would have been recognized by the taxpayer. The QOF, in turn, invests directly or indirectly in property or a business located in a designated Opportunity Zone. Specifically, Section 1400Z-2 of the Internal Revenue Code (Code) provides the following three major tax incentives for investing in a QOF:

- **Initial Gain Deferral.** Taxpayers may elect to defer the recognition of capital gain to the extent such gain amount is invested in a QOF within the 180-day period beginning on the date such capital gain would have been recognized by the taxpayer. Such gain is deferred until the earlier of: (i) when the investment is sold or exchanged or (ii) December 31, 2026.
- **Partial Reduction in Deferred Gain.** For an investment in a QOF held at least five years, the taxpayer may permanently exclude 10% of the deferred gain from income. For an investment in a QOF held at least seven years, the taxpayer may permanently exclude an additional 5% of the deferred gain from income (i.e., 15% in total). In order to realize the full 15% reduction, a taxpayer must invest in a QOF no later than December 31, 2019.
- **QOF Gain Exclusion.** If a taxpayer holds an investment in a QOF for at least 10 years, the taxpayer may generally elect to exclude from income any post-acquisition gain realized from its investment in the QOF.

RELATED PEOPLE

James R. Browne
Partner
Dallas

P 214-258-4133
F 214-258-4199
jim.browne@btlaw.com

Erik J. Rickard
Partner
Columbus

P 614-628-1444
F 614-628-1433
erik.rickard@btlaw.com

Salvador P. LaViña
Partner
Los Angeles

P 424-239-3743
F 310-284-3894
spl@btlaw.com

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Example

If a calendar-year taxpayer realizes a $100,000 capital gain from the sale of property to an unrelated person on September 1, 2018, and invests that gain in a QOF on December 31, 2018, the taxpayer will not pay any tax on the $100,000 gain realized in 2018. If the taxpayer holds its investment in the QOF until December 31, 2026, 15% of the $100,000 deferred gain will be permanently excluded from the taxpayer's income because the taxpayer will have held its investment in the QOF for more than seven years, and the remaining $85,000 of deferred gain will be included in the taxpayer's income for the 2026 calendar year.

In contrast, if the taxpayer sells its interest in the QOF on May 31, 2023 (less than five years from the date of investment in the QOF), then the taxpayer will pay tax on the entire $100,000 of deferred gain in 2023. Alternatively, if the taxpayer sells or exchanges its interest in the QOF on May 31, 2024 (more than five years, but less than seven years from the date of the investment in the QOF), the taxpayer will pay tax on $90,000 of the deferred gain in 2024. However, a taxpayer can maintain the original gain deferral by reinvesting the proceeds from a sale of the original QOF interest in a new QOF within 180 days from the sale of the original QOF investment. If the taxpayer sells its entire interest in the QOF for $170,000 in 2029 (more than 10 years after the date of investment in the QOF), then none of the $70,000 gain realized on the $100,000 investment in the QOF will be subject to tax.

Recent Guidance Provides Clarity

The Revenue Ruling and Proposed Regulations answer many questions and provide clarity regarding the provisions in Code § 1400Z-2 and the requirements for a QOF. Significant highlights from the recent guidance include the following:

- **Eligible Capital Gains**. The statutory language in Code § 1400Z-2 left open the question of what type of gains could be deferred. The Proposed Regulations clarify that only capital gains are eligible for deferral. Eligible capital gains may be short-term or long-term capital gains, and include amounts treated as capital gains (such as mutual fund capital gain dividends, net Code § 1231 gains, and unrecaptured Code § 1250 gains). Gains not eligible for deferral include Code §§ 1245 and 1250 depreciation recapture (taxed as ordinary income) and capital gains from a sale with a related party (which applies 20% as the threshold of common ownership for a "related party"). Also, a capital gain from a position that is or has been part of an offsetting position transaction (i.e., a straddle or other transaction that substantially diminished a taxpayer's risk of loss) is not eligible for deferral.

- **Eligible Taxpayers**. Under the Proposed Regulations, eligible taxpayers include individuals, C corporations (including regulated investment companies and real estate investment trusts), partnerships, Subchapter S corporations, trusts and estates. Also, under the Proposed Regulations, only equity (including preferred stock and partnership interests with special allocations) in a QOF entitles the taxpayer to the Opportunity Zone tax benefits described above. A taxpayer that invests in a debt instrument issued by a QOF will not qualify for the deferral. The equity interest in the QOF may be used as collateral for a loan without jeopardizing the taxpayer's deferral.

- **Special Rule for Pass-Through Entities**. A pass-through entity, such as a partnership, Subchapter S corporation, trust or estate, may elect to defer all or part of the capital gain at the entity level to the extent that it makes an eligible investment in a QOF within the 180-day period. Under the Proposed Regulations, if the partnership or other pass through entity does not make the entity level election to defer all or some of the capital gain, then each partner or other pass-through owner may make its own election to defer the partner's or pass-through owner's distributive share of the eligible gain. A partner's or other pass-through owner's 180-day period with respect to its share of the entity level gain generally begins on the last day of the pass-through entity's taxable year when the pass-through entity realized the capital gain, though the partner or other pass-through owner could elect to have the 180-day period commence when the entity realizes such gains.

- **QOF Requirements**. A QOF must be an entity classified as a corporation or partnership for federal tax purposes and organized for the purpose of investing in "qualified opportunity zone property" (other than another QOF). A limited liability company classified as a partnership or corporation for federal tax purposes will qualify as a QOF. Also, under the Proposed Regulations, the QOF self-certifies as a "qualified opportunity fund" on IRS Form 8996.

- **90% Test for QOF**. At least 90% of the assets of a QOF must consist of "qualified opportunity zone property" (Qualified Zone Property), which consists of: (i) "qualified opportunity zone stock" (Zone Stock), (ii) "qualified opportunity zone partnership interests" (Zone Partnership Interests), or (iii) "qualified opportunity zone business property" (Zone Business Property). Accordingly, a QOF may invest directly in Zone Business Property or indirectly through a corporation (Zone Stock) or partnership (Zone Partnership Interests) (collectively, a Zone Entity) so long as the Zone Entity qualifies as a "qualified opportunity zone business" (Qualified Zone Business).

  The 90% test is determined by the average of the percentage of Qualified Zone Property held on (i) the last day of the first six-month period of the taxable year of the QOF, and (ii) last day of the taxable year of the QOF (e.g., June 30 or December 31 would be the relevant testing dates for a calendar year QOF). The Proposed Regulations generally provide that if the QOF has a certified audited financial statement (prepared in accordance with GAAP), then the value of each asset of the QOF is the value of the asset as reported on the QOF's financial statement. If the QOF does not have an applicable financial statement, then the assets are valued at cost.

- **Qualified Zone Business**. A Qualified Zone Business is a trade or business (i) in which "substantially all" of the tangible property owned or leased by the Qualified Zone Business is Zone Business Property, (ii) which satisfies certain tests as described below, and (iii) which is not engaged in a prohibited business. For this purpose, the Proposed Regulations clarify that "substantially all" means 70%. Accordingly, if at least 70% of the tangible property held by the Qualified Zone Business is Zone Business Property, then the Qualified Zone Business will be treated as satisfying the substantially all requirement. Since a QOF needs to invest at least 90% of its assets in Qualified Zone Property and interests in a Zone Entity qualify as Qualified Zone Property, then only 63% of the indirect assets of a QOF need to qualify as Qualified Zone Property, i.e., 70% of 90%.

In addition to the "substantially all" requirement, a Qualified Zone Business must satisfy the following three tests: (i) at least 50% of the entity's total gross income is derived from the active conduct of a business in an Opportunity Zone; (ii) a substantial portion of the intangible property of the entity is used in the active conduct of the entity's business within the Opportunity Zone, and (iii) less than 5% of the entity's average unadjusted tax basis in its property is attributable to "nonqualified financial property" (meaning debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, and annuities, but excluding (1) reasonable amounts of working capital held in cash, cash equivalents, and debt instruments with a term of 18 months or less, and (2) trade receivables). A prohibited business is 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.

- **Working Capital Safe Harbor**. Under the Proposed Regulations, a Qualified Zone Business' working capital assets will be treated as reasonable in amount if all of the following three requirements are satisfied: (1) the working capital amounts are designated in writing in a plan for the acquisition, construction, and/or substantial improvement of tangible property in an Opportunity Zone, (2) the Qualified Zone Business has a written schedule consistent with ordinary start-up of a trade or business for the expenditure of the working capital assets and, under the schedule, the working capital assets must be spent within 31 months of the receipt by the business of the assets, and (3) the working capital assets are actually used in a manner substantially consistent with the plan and schedule.

- **Substantial Improvements to Existing Propertie**s. The "original use" of the property in the Opportunity Zone must begin with either the QOF or the applicable Zone Entity. If the original use of the property does not commence with the QOF or the applicable Zone Entity (such as an existing office building), then the QOF or applicable Zone Entity, as the case may be, must substantially improve the property. An existing property will be treated as substantially improved only if, during any 30-month period beginning after the acquisition date of such property, the QOF or the applicable Zone Entity at least doubles the basis of the property relative to the QOF's or applicable Zone Entity's adjusted basis of the property at the beginning of the 30-month period.

  Revenue Ruling 2018-29 provides a very favorable rule to the effect that, if a QOF or applicable Zone Entity purchases an existing building located on land that is wholly within an Opportunity Zone, the "original use" and "substantial improvement" requirements under the Code do not apply to the land. In addition, whether a substantial improvement is made to the building is measured by the additions to the basis of the building (i.e., the basis attributable to the land on which the building sits is not taken into account). Thus, if a QOF purchases a property wholly within an Opportunity Zone for $800,000, consisting of land worth $480,000 and a building worth $320,000, and the QOF invests at least $320,000 to improve the building, then the original $800,000 purchase price plus the $320,000 of improvements to the building may all qualify as Zone Business Property.

- **Availability of Fund Gain Exclusion after Opportunity Zones Expire**. A taxpayer that holds a QOF interest for 10 years or more may elect to step up its basis in the QOF interest to the fair market value of the QOF interest on the date it is sold or exchanged, and thereby eliminate all gain with respect to the investment in the QOF interest. Because the designation of Opportunity Zones expires no later than December 31, 2028, a question arises as to whether the basis step-up election is allowable if the QOF interest is be sold later than December 31, 2028. The Proposed Regulations provide that the ability to make the basis step-up election is not impaired by the termination of an Opportunity Zone designation, and the basis step-up election is available for QOF interest dispositions occurring on or before December 31, 2047.

Conclusion

The Proposed Regulations and Revenue Ruling 2018-29 answer many of the most pressing questions associated with the Opportunity Zone program in a very taxpayer friendly manner. A taxpayer may rely on the Proposed Regulations prior to the date they become final if the taxpayer applies the Proposed Regulations consistently and in their entirety. It is expected that the Treasury Department will be issuing additional proposed regulations soon to address remaining open issues associated with the Opportunity Zone program.

The foregoing is merely a general summary of the Opportunity Zone program and the recent guidance and does not purport to be a complete and comprehensive analysis of every aspect of the Opportunity Zone program. For more information regarding the Opportunity Zone program, please contact the Barnes & Thornburg attorney with whom you work or Bill Ewing at william.ewing@btlaw.com or 404-264-4050; Jim Browne at jim.browne@btlaw.com or 241-258-4133; Holly Heer at holly.heer@btlaw.com or (614) 628-1458; Erik Rickard at erik.rickard@btlaw.com or (614) 628-1444; or Sal LaViña at spl@btlaw.com or (424) 239-3743.