

# Qualified Opportunity Zone Program

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The 2017 “Tax Cuts and Jobs Act” created the “Opportunity Zone” program to encourage investment in distressed communities. On Oct. 19, 2018, the U.S. Treasury Department and the IRS released its first significant guidance on the Opportunity Zone program in the form of Proposed Regulations, a Revenue Ruling and a draft IRS Form with instructions.

## BACKGROUND

A taxpayer that reinvests capital gain from the sale of property in a Qualified Opportunity Fund (“QOF”) within 180 days from the sale date may elect (the “Original Deferral Election”) to defer taxation on such capital gain until up to Dec. 31, 2026.

In addition, up to 15% of such deferred capital gain may be excluded from U.S. federal income taxation if the taxpayer can satisfy certain holding period requirements with respect to its QOF investment.

Furthermore, if a taxpayer holds its QOF interest (with respect to which an Original eDeferral Election has been made) for at least 10 years, any appreciation on the QOF investment is exempt from U.S. federal income taxation.

The Opportunity Zone program provides that a QOF can invest qualified opportunity zone property (“QOZ Property”) by investing directly in qualified opportunity zone business property (“QOZ Business Property”) or indirectly through a qualified opportunity zone business (“QOZ Business”).

## PROPOSED OPPORTUNITY ZONE REGULATIONS

Recently proposed Treasury Regulations and a Revenue Ruling were released in order to address issues related to investing in and forming a QOF and the QOF’s investments in QOZ Property.

The proposed regulations reserve some questions for later regulations and leave other questions unaddressed. The proposed regulations are subject to further revisions based on comments to be received, but in the interim, taxpayers generally may rely on them for guidance on the applicable issues.

Among the issues addressed by the proposed regulations are:

- **Gains are Limited to Capital Gain.** Gains eligible for deferral through investment in a QOF include only gains treated as capital gain for U.S. federal income tax purposes, including long-term and short-term capital gain, as well as net Section 1231 gain and unrecaptured Section 1250 gain.
- **Treatment of Land.** The Proposed Regulations and Revenue Ruling provide that if land and a building are purchased by a QOF, for purposes of measuring whether substantial improvements have been made to the property, only the adjusted basis of the building must be taken into account. The adjusted basis of the land in such case may be disregarded and the QOF is not required to separately substantially improve the land for the entire property to qualify as QOZ Property.
- **Treatment of Working Capital.** The Proposed Regulations provide a working capital exception for a QOF conducting business through a QOZ Business (i.e., certain corporations or partnerships that hold QOZ Business Property and carry on an active trade or business in a designated Opportunity Zone).
- **Election for QOF Held at Least 10 Years.** The election (the “Exclusion Election”) to exclude from taxation the appreciation on a QOF investment that has been held for at least 10 years is available after the expiration of the Opportunity Zone designation (Dec. 31, 2028) and the Exclusion Election can be made until December 31, 2047.
- **Substantially All.** The Proposed Regulations clarify that “substantially all” means 70% for purposes of determining whether a QOZ Business holds sufficient QOZ Business Property.
- **Partnerships or Partner Capital Gain Deferral Election.** Either partnerships or partners therein may elect to reinvest eligible capital gains of the partnership in a QOF and defer taxation thereon.

- **Leveraging the QOF.** The Proposed Regulations clarify that loan proceeds will not be treated as either a “bad asset” for QOF investment purposes or a deemed contribution resulting from an allocation of a partnership liability that creates a separate, non-qualifying investment in the QOF.

The Proposed Regulations leave a number of issues open, including:

- **Raw Land.** Neither the Proposed Regulations nor the Revenue Ruling provides explicit guidance on how to treat unimproved land upon which buildings and improvement will be newly constructed.
- **Recycling QOF Investments in a Reasonable Period of Time.** The Proposed Regulations invited additional comments on the length of a “reasonable period of time to reinvest” the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests.
- **Working Capital Safe Harbor for QOF Investments in QOZ Business Property.** While, the preamble to the Proposed Regulations suggests that the working capital safe harbor was intended to also apply to QOF direct investments in QOZ Business Property, the language of the Proposed Regulations appears to limit this safe harbor to QOFs investing in a QOZ Business.
- **Failure to meet 90 percent test.** The preamble to the Proposed Regulations states that the IRS intends to publish additional guidance addressing the penalty and conduct that may lead to decertification of a QOF.

The Proposed Regulations are generally favorable to investors and provide significant guidance to encourage Opportunity Zone investment. Because of the working capital safe harbor, the substantially all test, and certain other factors, currently there is more clarity and flexibility for QOFs that own a QOF Business rather than directly-owned QOZ Business Property.

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