The New Regs Are Here! The New Regs Are Here! The United States Treasury's Proposed Opportunity Zone Regulations

November 12, 2018

At long last, on Friday, October 19, Treasury released its initial proposed opportunity zone regulations (Proposed Regs), together with a revenue ruling. While Treasury and the IRS intend to release additional proposed regulations that will cover important areas, for the most part the Proposed Regs did not disappoint. Comments made throughout the Proposed Regs' preamble evidence the government's desire to make the opportunity zone program – which is contained in new sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code (Program) – work in a manner that will best encourage opportunity zone (O-Zone) investment.

As discussed in our prior article, the Program was created by the Tax Cuts and Jobs Act of 2017 (Act) to spur investment in lower-income areas across the country designated as O-Zones. The Act permits taxpayers to elect to defer recognition of capital gain to the extent of the amount it invests in a qualified opportunity fund (OFund), as long as the investment is made in the O-Fund within a 180-day period beginning on the date the taxpayer would have recognized the capital gain. A taxpayer must include the deferred capital gain in income on the earlier to occur of: (1) the date the taxpayer sells or exchanges its O-Fund investment, or (2) December 31, 2026. If an O-Fund investment is held at least 5 years, the taxpayer's basis in the O-Fund (which is initially set at $0) is stepped-up by 10%. For an investment held at least 7 years, the taxpayer receives an additional 5% step-up in basis. If an O-Fund investment is held at least 10 years, any gain on the investment is entirely excluded from income if disposed of prior to the end of 2047. To avoid penalty, an O-Fund is required to hold not less than 90% of its assets in qualified opportunity zone property (O-Zone Property).

Because the Act's Program provisions are fairly short, a significant number of questions have been raised, the answers to which are critical to investors. While many investors have been preparing to invest in O-Zones, most have been waiting to actually make their investment until Treasury released significant guidance. Now that Treasury's first set of proposed regulations have been issued, we are likely to see some actual O-Zone investment.

Significant Provisions

What gains are eligible for deferral?

Only capital gains are eligible for deferral under the O-Zone Program.

What types of taxpayers are eligible to elect gain deferral under the program?

Any taxpayer that recognizes capital gain for federal income tax purposes is eligible to elect deferral.

In addition, an O-Fund must be organized in one of the 50 States, the District of Columbia, or a U.S. possession. If it is organized in a U.S. possession, it may be an O-Fund only if it is organized for the purpose of investing in O-Zone Property that relates to a trade or business operated in the possession in which the entity is organized.

May a Limited Liability Company be an O-Fund or an O-Zone Business?

Yes. The Proposed Regs clarify that the entity must be either a corporation, or a partnership "for Federal income tax purposes." Therefore, a limited liability company classified as a partnership qualifies.

Will a debt instrument qualify as an investment in an O-Fund?

No. To be eligible as an interest to defer gain in a O-Fund, the investment must be an equity interest in the O-Fund. A debt instrument (i.e., bonds, debentures, notes, certificates, or other evidence of indebtedness) is not an eligible interest.

Gains of partnerships and other pass-through entities

Any person that recognizes capital gain for federal tax purposes is eligible to defer the capital gain by reinvesting in a O-Fund.

A partnership, or other pass-through entity, may elect to defer all or part of a capital gain to the extent it makes an eligible investment in an O-Fund. If the election is made, no part of the deferred gain is required to be included in the distributive shares of the partners.

To the extent a partnership does not elect to defer capital gain, the capital gain is included in the distributive shares of the partners, but, provided all or any portion satisfies all the rules for eligibility under section 1400Z-2(a)(1), then the partner generally may elect its own deferral with respect to the partner's distributive share.

The 180-day period within which a capital gain must be invested in the O-Fund by a partner generally begins on the last day of the partnership's taxable year, because that is the day the partner would be required to recognize the gain if it is not deferred. However, the proposed regulations provide an alternative for situations in which the partner knows (or receives information) regarding both the date of the partnership's gain and the partnership's election not to elect deferral under section 1400Z-2. In that case, the partner can choose to begin its own 180-day period on the same date as the start of the partnership's 180-day period.

The Proposed Regs provide that rules analogous to the rules provided for partnerships and partners apply to other pass-through entities and to their shareholders and beneficiaries (e.g., limited liability companies and applicable trusts).

The Proposed Regs provide special rules on gains that may be deferred under Section 1256 contracts (generally "mark to market" gains). However, any capital gain that is part of an "offsetting positions transaction" (such as a straddle) is generally not eligible for deferral.

What happens when O-Zones expire on December 31, 2028?

The Proposed Regs permit taxpayers to make the 10-year basis step-up election after an O-Zone designation expires. The rationale is that the incentive of step-up gain deferral after 10 years is integral to the primary purposes of the provision.

Not only do the Proposed Regs clarify that the 10-year step-up continues after an O-Zone designation expires; it also preserves the election until December 31, 2047 (20 1/2 years after the latest date that an eligible taxpayer may properly make an investment that is part of the election to defer gain). In other words, the latest gain subject to deferral would be December 31, 2026, so the last day of the 180-day period for that gain would be June 30, 2027. This allows a taxpayer to make an eligible investment in an O-Fund as late as the end of June 2027, with the 10-year period occurring in late June 2037. The proposed rule even adds an additional 10 years to that period (i.e., until late December 2047). Treasury's explanation of the extended time period is that it serves to both encourage investment after 2018, and to avoid the liquidation of investments by O-Zone Funds and O-Zone Businesses in O-Zones within a short period of time at, or shortly after, the end of a 10-year investment period – both of which had been a concerns.

When does an O-Fund begin?

The Proposed Regs allow an O-Fund to both (1) identify the taxable year in which it becomes an O-Fund, and (2) choose the first month in that year to be treated as an O-Fund.

If the O-Fund fails to specify the first month it is an O-Fund, then the first month of its initial taxable year as an O-Fund is treated as its first month as an O-Fund.

How is the 90% Asset Test applied when an entity chooses to become an O-Fund beginning with a month other than the first month of its taxable year?

The Proposed Regs define the phrase "first 6-month period of the taxable year of the fund" as meaning the first 6-month period composed entirely of: (1) months which are within the taxable year, and (2) during which the entity is an O-Fund. The six-month period always ends on the last day of the year for those entities which choose to become an O-Fund after June 1, even though the time period is less than six months.

Examples (as provided in the Proposed Regs):

If a calendar-year entity created in February chooses April as its first month as an O-Fund, then the 90% Asset Test testing dates for the O-Fund are the end of September and the end of December.

If a calendar-year entity chooses a month after June, then the only testing date for the taxable year is the last day of the entity's taxable year – i.e., December 31. In other words, the last day of the taxable year is always a testing date, regardless of when the entity becomes an O-Fund.

Will pre-existing entities qualify as an O-Fund or as issuer of O-Zone stock or of an O- Zone partnership interest?

The Proposed Regs clarify that there is no prohibition to using a pre-existing entity as an O-Fund, or as a subsidiary entity operating a qualified opportunity zone business ("O-Zone Business"), as long as the pre-existing entity satisfies the section 1400Z-2(d) requirements.

What is the valuation method for applying the 90% Asset Test?

The O-Fund must use the asset values reported on its applicable financial statement for the taxable year. If the O-Fund does not have an applicable financial statement, the proposed regulations require the O-Fund to use the cost of its assets. Note that Treasury and the IRS are requesting comments on the suitability of both valuation methods and whether another method, such as tax adjusted basis, would be better.

Working Capital Safe Harbor

The proposed regulations provide a working capital safe harbor for O-Fund investments in O-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 O-Zone.

The safe harbor allows O-Zone Businesses to apply the definition of working capital (specifically, reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less) to property held by the business for a period of up to 31 months if: (1) there is a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement in the O-Zone; (2) there is a written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months; and (3) the business substantially complies with the schedule.

Treasury and the IRS have requested comments on the adequacy of the working capital safe harbor and of ancillary safe harbors that protect a business during the working capital period, and on whether there is a statutory basis for any additional relief. Comments have also been requested about the appropriateness of any further expansion of the working capital concept beyond the acquisition, construction, or rehabilitation of tangible business property to the development of business operations in the O-Zone.

What does "substantially all" mean as it applies to whether a trade or business qualifies as a Qualified Opportunity Zone Business?

To be considered an O-Zone Business, "substantially all" of the entity's owned or leased tangible property must be qualified O-Zone Business Property. Because the Act does not define "substantially all" for that purpose, the proposed regulations provide that, solely for the purpose of determining whether the tangible property is O-Zone Business Property, the "substantially all" requirement is satisfied if at least 70% of the tangible property owned or leased by a trade or business is O-Zone Business Property.

Treasury's explanation of provisions admits this would allow an investment structure where as low as 63% of investment proceeds from an O-Zone Fund could be invested in O-Zone tangible property. An example of this is as follows:

An O-Zone invests 90% of its investment funds in a qualified O-Zone Business with the remaining 10% invested elsewhere. The O-Zone Business invests 70% of the funds it received (to meet the "substantially all" test) in tangible property located in the O-Zone. Thus, 90% times 70% (or 63%) of the O-Zone's funds are invested in tangible property located in the O-Zone.

Treasury and the IRS are requesting comments regarding proposed meaning of "substantially all" in section 1400Z-2(d)(3)(A)(i), as well as in the various other locations in section 1400Z-2(d).

What does "substantial improvement" mean when an existing building is purchased in an O-Zone?

In response to questions raised pertaining to the treatment of land and buildings located within O-Zones, the IRS published Revenue Ruling 2018-29 ("Revenue Ruling") simultaneously with the release of the Proposed Regs. The Revenue Ruling addresses 3 issues:

1. If an O-Fund purchases an existing building that is located wholly within a O-Zone, can the original use of the building, or the land on which it is situated, be considered to have "commenced" with the O-Fund?

The Act provides that O-Zone Business Property is tangible property used in a trade or business of the O-Fund. To qualify as O-Zone Business Property: (a) the property must be purchased by the O-Fund after December 31, 2017; (b) the property's original use must commence with the O-Fund, or the O-Fund must "substantially improve" it; and (c) during substantially all of the O-Fund's holding period for the property, substantially all of its use is in an O-Zone.

The tangible property used by the O-Fund in its trade or business is treated as "substantially improved" by the O-Fund only if, during any 30-month period beginning after the date the O-Fund acquires it, additions to basis with respect to the tangible property in the hands of the O-Fund exceed an amount equal to the property's adjusted basis.

The original use of the building is not considered to have "commenced" with the O-Fund (i.e., it already exists). Further, because land is permanent, land can never have its original use in an O-Zone that commences with an O-Fund.

2. If an O-Fund purchases an existing building in an O-Zone, 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 both the building and the land?

The "substantial improvement" requirement applies only to the building and is measured by the O-Fund's additions to the basis of the building only – the value of the land is backed-out of the calculation.

3. If a substantial improvement to the building is measured by additions to the O-Fund's adjusted basis in the building, is the O-Fund required to separately substantially improve the land?

No.

The Revenue Ruling provides the following scenario as an illustration of its holdings:

In September 2018, an O-Fund purchases for $800x Property X, which is located wholly within the boundaries of an O-Zone. Property X consists of a building previously used as a factory erected prior to 2018 and land on which the factory building is located. The O-Fund intends to convert the factory building into a residential rental property. Sixty percent ($480x) of the $800x purchase price for Property X is attributable to the value of land and 40% ($320x) is attributable to the value of the building. Within 24 months after the date of the O-Fund's acquisition of Property X, the O-Fund invests an additional $400x in converting the building to residential rental property.

Under these facts, the Revenue Ruling holds that: (1) the O-Fund is not required to substantially improve the land; (2) because the factory building existed on land within the O-Zone prior to the O-Fund's purchase of Property X, the building's original use within the O-Zone did not commence with the O-Fund; and (3) the O-Fund substantially improved Property X because, during the 30-month period beginning after the date of the O-Fund's acquisition of Property X, the O-Fund's additions to the basis of the factory building ($400x) exceeded an amount equal to the O-Fund's adjusted basis of the building at the beginning of the 30-month period ($320x).

Reliance

Although the Proposed Regs will not become final until after Treasury has adopted them as final regulations and published them in the Federal Register, the Proposed Regs permit a taxpayer to rely on the proposed rules, provided the taxpayer applies the rules in their entirety and in a consistent manner. Be aware, however, that there may, and very likely will, be changes to the Proposed Regs upon issuance of the final Regulations.

Conclusion

Although the Proposed Regs and the Revenue Ruling have answered significant questions arising out of the Program's statute, numerous questions remain unanswered, some or all of which will be addressed by Treasury in response to comments to the Proposed Regs, and others of which will be addressed in subsequently released proposed regulations and revenue rulings.

The Proposed Regs should, however, give those creating, and investing in, O-Funds more comfort in moving forward with actual O-Zone investment. Of course, it remains critical that individuals consult with both legal and tax advisors in structuring and implementing any investment in an O-Zone.

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