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Proposed Regulations Released on Opportunity Zone Tax Incentive

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On October 19, 2018, the United States Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) released proposed regulations and other guidance concerning the Opportunity Zone tax incentive.

Background

Internal Revenue Code (“Code”) Section 1400Z-2, which was enacted as part of the 2017 tax legislation, provides certain incentives for capital gains invested in “Opportunity Zones.” An Opportunity Zone is a designated economically-distressed community. Sections 1400Z-2(a) and 1400Z-2(b) provide that gains invested in a Qualified Opportunity Fund (“QOF”) that invests in property in an Opportunity Zone are deferred until the earlier of December 31, 2026 or the date that the investment is sold or exchanged (the “Section 1400Z-2(a) Incentive”). In addition, the basis of any investment is increased by 10% of the amount of gain deferred if the investment is held for 5 years and an additional 5% for any investments held for 7 years. Furthermore, if an investment is held for 10 years then any post-investment capital gains realized from the investment in the QOF are tax exempt (the “Section 1400Z-2(c) Incentive”).

Section 1400Z-2(d) provides that an entity will only qualify as a QOF if at least 90% of its assets are held in qualified opportunity zone property as measured on the last day of the first six month period of the QOF’s taxable year and the last day of the taxable year of the Fund. In general, qualified opportunity zone property includes: 1) qualified opportunity zone stock of a qualified opportunity zone business; 2) qualified opportunity zone partnership interests of a qualified opportunity zone business; and 3) qualified opportunity zone business property. Qualified opportunity zone business property is tangible property used in a trade or business of the QOF if such property was acquired after December 31, 2017 and the original use of such property in the Opportunity Zone commences with the QOF or the QOF substantially improves the property.

After Section 1400Z-2 was enacted, both tax practitioners and potential investors had many questions concerning the mechanics and implementation of its various provisions. In order to provide clarity on such questions, Treasury and the IRS recently released proposed regulations and other guidance. A summary of some of the highlights of the proposed regulations follows.
Incentive is For Capital Gains Only

The enacted legislation concerning Opportunity Zones appeared to be ambiguous as to whether ordinary gains also would qualify for the Opportunity Zone tax incentive. The proposed regulations clarify that only gains that are treated as capital gains for Federal income tax purposes are eligible for tax deferral. The proposed regulations also provide that if short-term capital gains are deferred, then the gains with respect to such short-term capital gains will be recognized as short-term gains even if they are deferred for longer than one year.

Eligible Investors in QOFs

In general, eligible taxpayers who can invest in QOFs include individuals, C corporations, partnerships, S corporations, trusts, and estates. The proposed regulations also provide that if a partnership does not elect to invest in a QOF, then a partner may elect on its own to be an investor in a QOF. This provision also applies for other pass-through entities, such as S corporations, estates, and trusts.

Qualifying Investment in a QOF

The proposed regulations confirm that to qualify for the Section 1400Z-2(a) Incentive, an investment in the QOF must be an equity investment. Thus, common stock, preferred stock, and partnership interests, including interests with special allocations, are permitted. However, interests in QOF that are classified as debt instruments do not qualify for the Section 1400Z-2(a) Incentive. The proposed regulations do however permit an eligible taxpayer to use an interest in a QOF as collateral for a loan.

How to Elect Deferral

In general, taxpayers have 180 days from the date that a capital gain would be recognized to make an investment in a QOF. Under certain circumstances, a partner in a partnership has 180 days from the end of a partnership’s taxable year to invest in a QOF. The proposed regulations indicate that the Commissioner of the IRS may provide guidance as to the time, form, and manner in which an eligible taxpayer may elect to defer gains under the Section 1400Z-2(a) Incentive. Guidance that was released concurrently with the proposed regulations indicates that such deferral elections will be made on Form 8949, which will be attached to the taxpayer’s federal income tax return for the taxable year in which the capital gain is deferred.

Eligible Entities for QOFs

The proposed regulations provide that a QOF must be an entity classified as a corporation or partnership for Federal tax purposes and must be created or organized in one of the 50 states, the District of Columbia, or the U.S. possessions. However, if an
entity is organized in a U.S. possession, it can only qualify as a QOF if it invests in qualified opportunity zone property in that U.S. possession. The proposed regulations do not prohibit pre-existing entities from qualifying as QOFs. The proposed regulations appear to approve use of limited liability companies as QOFs, such as limited liability companies organized under the laws of the State of Delaware or State of Florida. In addition, entities formed prior to 2018 may also qualify as QOFs.

Qualification Period for the Section 1400Z-2(c) Incentive

Prior to the issuance of the proposed regulations, it was unclear if a taxpayer would qualify for the Section 1400Z-2(c) Incentive after the opportunity zone designation expires on December 31, 2028. The proposed regulations provide that a taxpayer may qualify for the Section 1400Z-2(c) Incentive provided that the taxpayer disposes of the interest in a QOF by December 31, 2047, which is 20.5 years after the latest date that an eligible taxpayer may make a qualifying investment in a QOF (i.e., 20.5 years after late June 2027 when capital gains occurring on December 31, 2026, the deadline for the Section 1400Z-2(a) Incentive, must be reinvested). This should provide potential investors with comfort that they have flexibility to qualify for the Section 1400Z-2(c) Incentive in the future.

Certification of a QOF

The proposed regulations provide that an entity may self-certify as a QOF in such time, manner, and form as prescribed by the Commissioner of the IRS. The IRS has indicated that taxpayers will use Form 8996, Qualified Opportunity Fund, for both self-certification and for annual reporting of compliance of the 90% asset test, as described below.

Valuation Method of Assets of a QOF

As described above, an entity will only qualify as a QOF if at least 90% of its assets are held in qualified opportunity zone property as measured on the last day of the first 6 month period of the QOF’s taxable year and the last day of the taxable year of the QOF. The proposed regulations provide that to calculate whether a QOF satisfies these requirements, the asset values that are reported on the QOF’s applicable financial statement must be used. Furthermore, if the QOF does not have an applicable financial statement, then the QOF is required to use the cost of its assets.

Substantially All Requirement

Under Section 1400Z-2(d)(3)(A), one of the requirements for a trade or business to qualify as a qualified opportunity zone business is that “substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business
property.” The proposed regulations provide that the threshold of the substantially all requirement for these purposes is at least 70%.

**Working Capital of a Qualified Opportunity Zone Business**

The proposed regulations provide a safe harbor for working capital (e.g., cash, cash equivalents, or debt instruments with a term of 18 months or less) held by a qualified opportunity zone business to qualify as qualified opportunity zone property so long as the working capital is held for no more than 31 months and the qualified opportunity zone business complies with certain documentation and usage requirements. In essence, the safe harbor for working capital permits a qualified opportunity zone business to hold cash for 31 months prior to the acquisition, construction, or substantial improvement of property provided that the documentation and usage requirements prescribed by the proposed regulations are satisfied.

**Land and the Substantial Improvement of Property**

A property qualifies as qualified opportunity zone business property only if the original use of such property commences with the QOF or the QOF substantially improves the property. Property is treated as substantially improved only if additions to the basis of such property during any 30-month period beginning after the acquisition of the property exceed an amount equal to the adjusted basis of such property. For purposes of this substantial improvement requirement, the proposed regulations and Revenue Ruling 2018-29 provide that the basis attributable to land is not included in the calculation. In other words, a QOF must only improve a building and not the underlying land.

**For More Information**

The information provided above addresses only some of the highlights of the recently issued proposed regulations and related guidance.

For more information regarding the Opportunity Zone tax incentive or the proposed regulations, please contact Gary J. Cohen, Esq. (gcohen@shutts.com), Logan E. Gans, Esq. (lgans@shutts.com), or any of the other attorneys in our Tax and International Law Practice Group.

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