Treasury Guidance Provides Solid First Step for Opportunity Zones Investments

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Investors, fund managers, real estate developers, operating businesses and others involved in the nascent opportunity zones (OZ) community received news they were waiting for Friday when the U.S. Treasury Department issued its first tranche of guidance for the new community development incentive. That guidance included 74 pages of proposed regulations, a five page revenue ruling, an updated Q&A document and both a draft of Form 8996 for qualified opportunity funds and instructions for that form.

While the regulations are proposed, taxpayers and qualified opportunity funds (QOFs) may rely on the proposed regulations, presuming they apply the rules in their entirety and do so in a consistent manner.

The biggest takeaway is that the guidance addressed significant gating issues for which many investors and fund managers have been waiting. The OZ incentive was part of the tax reform legislation passed last December. Since enactment of OZs, many investors and fund managers have been identifying and underwriting investments, organizing funds, and otherwise preparing to invest in distressed areas. But many remained on the sidelines, eagerly and anxiously anticipating tax guidance from Treasury. Friday's guidance release (Treasury will accept comments for 60 days) means the OZ community has actionable clarity on significant tax issues. The release of this guidance will lead many investors and fund managers to begin to invest capital in OZ businesses and OZ business property.

This investment could be significant. The Economic Innovation Group estimates that there is as much as $6 trillion in gains that could be invested in OZs.

It also is now clear that there are some issues for which we are still awaiting guidance, which could come in a second tranche or third tranche.

Guidance Provided

The guidance provides answers to many questions and includes information that will help guide investors, fund managers and others. Some of the key guidance provided is described below.

Gains, Taxpayers and Gain Attributes

- **OZs are for capital gains -** This was an issue in the language of the bill–the legislative phrasing said “gains,” although many observers assumed that meant “capital gains.” The guidance provides that the OZ incentive applies to *capital gains*.
    - When recognized, the deferred gain includes the same attributes in the year of inclusion that it would have had if tax on the gain had not been deferred.
- **Eligible taxpayers -**The guidance confirms that eligible taxpayers who can defer gain under the OZ statute include:
    - Individuals
    - Corporations (including RICs and REITs)
    - Partnerships
    - Common trust funds under Section 584
    - Qualified settlement funds
    - Disputed ownership funds
    - Other entities taxable under Section 1.468B
- **Gains of partnerships (and other pass-through entities) -** Under the guidance:
    - A partnership may elect to defer all (or part) of a capital gain.
        - If an election is made, the elected deferred gain is not included in the distributive shares of the partners.
    - If the partnership does not elect to defer gain, a partner generally may elect its own deferral with respect to the partner’s distributive share.
        - The partner’s 180-day period generally begins on the last day of the partnership’s taxable year
        - Alternatively, the partner may choose to begin its own 180-day period on the same date as the start of the partnership’s 180-day period**.**
    - Analogous rules apply for pass-through entities other than partnership.
- **Attributes of deferred gain when included in income -** When the gain deferral ends,
    - All of the deferred gain’s tax attributes are preserved through the deferral period and are taken into account when the gain is included.
    - Partial dispositions of QOF investments must generally be identified using the first-in, first-out (FIFO) method.

Qualified Opportunity Funds

- **Entities eligible to be a QOF -** To be eligible to be a QOF, an entity,
    - Must be classified as a corporation or partnership for Federal income tax purposes. This means a limited liability company can qualify as a QOF.
    - Must be created or organized in one of the 50 U.S. states, D.C., or a U.S. possession
        - If organized in a possession but not one of the 50 states or D.C., then it may only be a QOF if it is organized to invest in qualified OZ property that relates to a trade or business that is operated in that territory.
- **Designating when a QOF begins.**
    - A QOF will choose the first month in their taxable year in which they will be treated as a QOF.

        - If a month is not chosen, the first month will default to the first month of the taxable year
    - The “first 6-month period of the taxable year of the fund” means the first 6-month period composed entirely of months which are within the taxable year and during which the entity is a QOF.
- **Valuation method for applying the 90-percent asset test.**
    - The QOF uses the asset values that are reported on the QOF’s applicable financial statement for the taxable year (as defined in §1.475(a)-4(h)).
    - If a QOF has no applicable financial statement, the QOF uses the cost of its assets.
- **Effect of Section 752 deemed contributions.**
    - The deemed contribution of money by an investor in a partnership QOF under Section 752(a) does not result in a QOF investment for purposes of electing gain deferral or for purposes of the mixed funds rule.

OZ Businesses

- **Substantially all means 70 percent of tangible property -** To qualify as an OZ business, “substantially all” of a partnership or corporation’s tangible property owned or leased must be qualified opportunity zone business property. The legislation doesn’t define the phrase “substantially all.” Groups, including the OZ Working Group, weighed in on potential meanings and Treasury concluded 70 percent.
    - The OZ business uses the asset values that are reported on the OZ business' applicable financial statement for the taxable year (as definied in §1.475(a)-4(h)).
    - If an OZ business has no applicable financial statement, the QOF may value the entity's assets using the same methodology it uses for determining its compliance with the 90 percent asset requirement, subject to a Five-Percent Zone Taxpayer rule.
- **Reasonable working capital safe harbor -** The guidance provides a safe harbor for OZ 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 opportunity zone. The safe harbor allows a reasonable amount of working capital to be held for a period of up to 31 months, if three requirements are met:
    - Intended uses are designated in writing.
    - There is a reasonable written schedule.
    - The working capital is used in a manner substantially consistent with the designated uses and written schedule.
- **Active trade or business –** At least 50 percent of the gross income of a qualified OZ business must be derived from the active conduct of a trade or business *in the qualified opportunity zone*.
- **Intangible property –** A substantial portion of the intangible property of an opportunity zone business is used in the active conduct of a trade or business *in the qualified opportunity zone.*

Other

- **Preexisting entities -** The regulations provide that preexisting entities can qualify as QOFs or OZ businesses, providing they satisfy the necessary requirements.

- **Effect of expiring OZ designations -** The ability to make the 10-year basis step-up election at sale of the QOF investment is preserved under the proposed regulations until Dec. 31, 2047.

Revenue Ruling – Land and Building

Revenue Ruling 2018-29 was simultaneously released and provides clarity on the substantial improvement of a building. The bottom line of the ruling is, if a QOF purchases an existing building,

- The original use of the building in the QOZ is not considered to have commenced with the QOF.
- The requirement that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located.
- A substantial improvement to the building is measured by the QOF's additions to the adjusted basis of the building (excluding the land).
- The QOF is not required to separately substantially improve the land upon which the building is located.

This ruling is significant for many reasons, including that it lowers the bar for the substantially improved test, since it reduces the adjusted basis threshold by excluding land. It also includes an example that implies that residential rental property is eligible, at least if owned by the QOF.

Still Waiting

While Friday's guidance answers some important questions, there are still significant unanswered questions and areas that need additional guidance or clarification. Treasury is expected to continue to issue guidance and many of these items will likely be included.

A few include:

- **Interim gains -** On the federal income tax treatment of any gains that the QOF reinvests, Treasury and the IRS are expected to invite additional public comment on the scope of statutorily permissible policy alternatives and will carefully consider those comments in evaluating the widest range of statutorily permissible possibilities.
- **"Reasonable period" to reinvest -** Another issue left unaddressed in Friday's guidance was what constitutes a "reasonable period" for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty.
- **Time period for QOF to invest cash received from an investor -** No safe harbor treatment as qualified OZ property or reasonable cause exception was provided for cash received by a

QOF from an investor. This means cash must generally be invested in qualified OZ property before the semiannual QOF 90 percent measuring dates.

- **The definition of other uses of "substantially all" -** While the substantially all test for qualified OZ business property held by an OZ business was set at 70 percent, the definition of substantially all for other rules was left undefined.
- **Conduct leading to decertification -** Conduct that may lead to potential decertification of a QOF was left as an identified open item.

Next Steps

Friday's guidance merits-and will receive-significantly more examination and will require follow-up guidance and clarification from Treasury and the IRS. As mentioned earlier, Treasury announced that it would accept comments on the proposed guidance for 60 days, so stakeholders should weigh in, particularly on some issues that may need addressing. The OZ Working Group will certainly be doing so.

The areas for which comments are being sought include what metrics should be used to determine whether tangible property has "original use" in an opportunity zone and whether the use of tangible property should be based on its physical presence in the opportunity zone or some other measure.

Many of the rules adopted in the proposed regulations and guidance are consistent with the consensus recommendations of the OZ Working Group. In the weeks and months ahead, the OZ Working Group will focus its attention on responding to the areas that Treasury has requested comments, comment on the proposed regulations and other guidance as released, and develop recommended practices for implementing portions of the regulations and guidance.

The good news is that the guidance is here. Now comes the heavy lifting of applying it and helping improve communities.