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CLIENT ALERT

OZ Proposed Regulations Ease on Down the Road Toward Workable Tax Incentive

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Proposed regulations ("Regulations") released on October 19, 2018, provide guidance on provisions enacted as part of last December's Tax Cuts and Jobs Act that are designed to encourage investments in low-income communities designated as qualified opportunity zones ("Zones"). Taxpayers may rely on the Regulations, so long as taxpayers apply the rules consistently and in their entirety.

As explained in our prior alert, the opportunity zone ("OZ") rules, set forth in Section 1400Z-2 of the Internal Revenue Code, provide for benefits (and costs) at four stages:

- *Deferral*. A taxpayer can elect to defer gain from the sale or exchange of any property by investing such gain in a qualified opportunity fund ("QOF") within six months, and any such gain can be deferred through December 31, 2026 (or until an earlier sale of the QOF investment).

- *Elimination of 10% or 15% of deferred gain based on holding period*. If the taxpayer holds the QOF investment for at least five years, 10% of the gain is eliminated; if for at least seven years, an additional 5% of the gain (for a total of 15%) is eliminated.

- *Deferred gain recognized on or before December 31, 2026*. Any deferred gain must be recognized on December 31, 2026, if not recognized sooner.

- *After 10 years, permanent exclusion of new gain on QOF investment*. If the QOF investment is held for at least 10 years, the taxpayer can elect to increase the basis to its fair market value on the date of a sale or exchange (the “FMV Election”).

One key feature of the Regulations is that they create an incentive for QOFs to invest indirectly through underlying corporations and partnerships rather than directly in Zone properties.

The OZ rules essentially look at three phases of an investment: (1) taxpayers elect to defer qualified gains by (2) investing corresponding amounts in a QOF, which must (3) make qualifying investments. Guidance in these three areas is summarized below.

1. Taxpayers Electing to Defer Qualified Gains

- *Eligible gains*. Gains eligible for deferral are capital gains that would otherwise be recognized through the end of 2026 arising from a sale or exchange with an unrelated person. These gains include long-term capital gains (taxable at a maximum rate of 20%), short-term capital gains (taxable at the same rates as ordinary income) or collectibles gains (taxable at a maximum rate of 28%). They also include capital gain distributions, or undistributed capital gains, from a regulated investment company (“RIC”) or real estate investment trust (“REIT”), and gain from section 1256 contracts that are not part of a straddle or other offsetting-position transaction. It appears that eligible gains would not include gains treated as ordinary income such as depreciation recapture or items treated as ordinary income upon the sale of a partnership interest.

- *Eligible taxpayers*. Any taxpayer that may recognize gains for purposes of federal income tax accounting may elect deferral under the OZ rules. This includes individuals, C corporations – including RICs and REITs – partnerships, S corporations, trusts and estates. This would presumably also include a tax-exempt organization that is subject to tax on unrelated business taxable income (and that realizes eligible gains).

- *Additional deferral of previously deferred gain*. A taxpayer may defer gain by investing in a QOF, trigger the gain by selling all of that QOF investment, and then elect to continue deferring the same gain by investing in the same or another QOF within 180 days of the triggering event. Keeping the deferral election alive in this way would allow the taxpayer to make the FMV Election if the investment is held for at least 10 years (although it appears that the 10-year period would re-start with the new investment). This rule essentially allows recycling at the investor level, but does not address recycling at the QOF level. That appears to be an issue for future guidance.

- *Attributes preserved*. The attributes of the deferred gain – for example, as long-term or short-term capital gain – are preserved and taken into account when deferral ends.

- *Investment in QOF equity, not debt*. To be eligible for deferral, gain must be invested in an equity interest in a QOF, including preferred stock or a partnership interest with special allocations (which would presumably include a carried interest). The status of an eligible interest is not impaired if the taxpayer pledges the interest as collateral for a loan.

- *Borrowing by QOF partnership does not limit FMV Election*. A partner is generally treated as making a deemed contribution of cash to a partnership when the partnership borrows. The Regulations confirm that if a QOF partnership borrows, these deemed contributions are not treated as a separate investment in the QOF. A contrary rule would mean that the portion of the investment attributable to the deemed contribution would generally not be eligible for the FMV Election, because that portion would not represent an investment of gain. Thus, the Regulations permit a QOF partnership to borrow without limiting an investor's ability to make the FMV Election. The Regulations do not address other aspects of partnership liabilities. Presumably, a debt-financed return of capital or a decrease in a partner's share of partnership liabilities (which is generally treated as a cash distribution) that exceeds the partner's basis and thus results in taxable gain would foreclose the FMV Election with respect to a portion of the investment.

- *Election within 180 days; special rules for partnerships*. In general, the 180-day period begins on the date on which gain would otherwise be recognized, such as the trade date for a sale of publicly traded stock or the payment date of a capital gain dividend from a RIC or REIT.

  Special rules are provided for partnerships (and other pass-through entities). If the partnership elects to defer gain, the 180-day period begins on the date of the sale or exchange and the gain is then not reflected in the partners' distributive shares of income or in their basis. (The gain will be reflected later when deferral ends.)

  If the partnership itself does not elect to defer gain, the gain is passed through to the partners under the normal partnership rules. In this case, the 180-day period generally begins on the last day of the partnership's taxable year in which the partner's share of the gain is taken into account. (This would be December 31 for an individual partner in a calendar-year partnership.) A partner may elect, however, to start the 180-day period on the date of the partnership's sale or exchange. For example, if a calendar-year partnership recognizes a gain on January 17, 2019, and does not itself elect to defer the gain, a partner could elect to defer that gain by investing in a QOF during the 180-day period beginning on either (i) January 17, 2019 or (ii) December 31, 2019.

- *FMV Election available until December 31, 2047*. A taxpayer may elect to increase the basis of a QOF investment to its fair market value at the time of sale or exchange if the investment has been held for at least 10 years. A QOF, to qualify as such, must invest in a Zone, but the initial Zone designations will expire at the end of 2028. The Regulations make clear that the FMV Election may be made for a QOF investment sold until December 31, 2047, even if the relevant Zone designation has already expired. This date is 20 years and six months after the last date on which taxpayers may make an investment on which gain can be deferred. (Gain from a sale on December 31, 2026 could be deferred by making a QOF investment within 180 days.)

2. QOF Requirements

- *Preference for QOF investments in other entities*. One of the key difficulties under the OZ provisions is that a QOF must hold at least 90% of its assets in qualifying investments, based on the average of the amount invested on the last day of the first six-month period and on the last day of each taxable year of the QOF ("90% test"). The Regulations give QOFs some flexibility in meeting the 90% test by favoring QOF investments in underlying corporations or partnerships (each, a "Company") over direct investments in properties.

  This approach seems to be dictated by how the three types of qualifying investments are defined: Zone business property ("Business Property"), Zone stock, and Zone partnership interests (together with Zone stock, "Equity Interests"). Business Property is tangible property held directly by the QOF that meets certain requirements.[1] An Equity Interest must be issued by a Company that qualifies as a "Zone Business," the requirements of which include that "substantially all" of its tangible property meets these same requirements. Defining Zone Business in this way naturally creates an incentive for indirect investments, so long as "substantially all" is defined as less than 100%. For example, a QOF with $100 could meet the 90% test by investing $90 directly in Business Property. The QOF could also meet the 90% test by investing $90 in Equity Interests of a Company that invests "substantially all" of its assets in the same property; if "substantially all" is defined as 70% for this purpose, this indirect approach would only require $63 (70% of the $90 invested in the Company) to be invested in property located in a Zone.[2]

  The Regulations enhance the incentive for indirect over direct investments in two ways. First, for investments by a Zone Business in tangible property, "substantially all" is defined as 70%.[3] Second, a working capital safe harbor permits a Zone Business to hold working capital assets for up to 31 months pending investment in qualifying property. The flexibility provided by these rules is available only to a Zone Business – that is, to a corporation or

[1] Business Property must be (1) acquired by purchase from an unrelated person after 2017; (2) originally used (or substantially improved) by the QOF; and (3) located in a Zone for substantially all of its use during substantially all of the QOF's holding period.

[2] Even if "substantially all" were defined as 90% – the same percentage limitation that applies to direct QOF investments – the Company would still only need to invest $81 in qualifying properties.

[3] The preamble to the Regulations makes clear that 70% applies only for this purpose. The term "substantially all" appears a total of five times in section 1400Z-2. Thus, for substantially all of the uses of "substantially all" in the statute, the Regulations provide no guidance.

partnership in which a QOF invests – and not to a QOF with respect to its direct investments.[4] These rules are described further in item 3 below.

- *Eligible entities include LLCs*. Any entity that is treated as a corporation or partnership for federal tax purposes, including an LLC, may be a QOF. A pre-existing entity may be a QOF so long as it meets the other requirements. An entity may specify the first month in its first taxable year in which it wants to be considered a QOF. Amounts invested in the QOF before the first month are not eligible for deferral.

- *Land and Improvements*. One category of qualifying investment for a QOF is Business Property. Among other requirements, either the original use of such property in the Zone must commence with the QOF or the QOF must substantially improve the property by doubling its investment during the 30 months following acquisition. The Regulations and Revenue Ruling 2018-29, released at the same time, provide that a QOF purchasing a building on land in a Zone measures substantial improvement based solely on additions to the basis of the building without regard to the investment in the land.

- *90% test and valuation*. For purposes of the 90% test, the value of each asset is based on the value reported on an audited financial statement or a financial statement filed with the Securities and Exchange Commission or another federal agency other than the Internal Revenue Service ("applicable financial statement"). If the QOF does not have such a statement, valuation is based on cost.

- *90% test and first month*. Compliance with the 90% test is based on the average of the amount invested on the last day of the first six-month period and on the last day of each taxable year of the QOF. As noted above, an entity may specify the first month in its first taxable year in which it wants to be considered a QOF, which may ease compliance with the 90% test in the QOF's first year. In the first year, the first six-month period means the first six months each of which falls within the taxable year and in each of which the entity is a QOF. If an eligible entity becomes a QOF in the seventh or a later month of the taxable year, the 90% test will apply only on the last day of the first taxable year. Thereafter, the test will apply every six months.

3. Investments in Zone Businesses and Business Property

- *Zone Business: 70% "substantially all" threshold*. As noted above, "substantially all" of the tangible property owned or leased by a Zone Business must be Business Property. Solely for this purpose, the Regulations define "substantially all" as at least 70%. The preamble to the Regulations observes that the value of the QOF's entire interest in a Company immediately counts towards the QOF's satisfaction of the 90% test so long as the

[4] The statute itself provides another preference by continuing to treat tangible property held by a Zone Business as Business Property for up to five years even if that property ceases to qualify. The statute provides no similar rule for Business Property held directly by a QOF and the Regulations do not address this issue.

Company qualifies as a Zone Business. The 70% threshold, and the working capital safe harbor described below, give the Company additional time to meet this requirement.

- *Working capital safe harbor*. A safe harbor permits a Zone Business to hold cash, cash equivalents, or debt instruments with a term of 18 months or less ("working capital assets") for up to 31 months pending investment in qualifying assets. Specifically, tangible property that is expected to satisfy the requirement of Business Property as a result of the planned expenditure of working capital assets is not treated as failing to satisfy those requirements solely because the scheduled consumption of the working capital is not yet complete, provided that the following three requirements are met:

  (1) a written plan identifies the working capital assets as property held for the acquisition, construction, or substantial improvement of the tangible property;

  (2) a written schedule consistent with the ordinary business operations of the business provides that the working capital assets will be used within 31 months; and

  (3) the business substantially complies with the plan and schedule.

  Such working capital assets are also (i) treated as producing qualifying income for purposes of the requirement that at least 50% of the total gross income of the Zone Business is derived from the active conduct of such business, (ii) treated as satisfying the requirement that a substantial portion of the intangible property of the Zone Business is used in the active conduct of any such business, and (iii) excepted from the limitation that no more than 5% of the assets by a Zone Business may consist of nonqualified financial assets.

- *Land and Improvements*. The rules described above for a QOF's substantial improvement of a building on land located in a Zone also apply to tangible property owned or leased by a Zone Business.

- *90% test and valuation*. Rules similar to the rules described above for valuations based on an applicable financial statement is provided for Zone Businesses. A Company without its own applicable financial statement may rely on the valuation methodology used by a QOF that holds at least 5% of the Company's equity.

4. A Brand New Day . . .

The Treasury Department and Internal Revenue Service are working on more OZ guidance, which is expected to address the following:

- The meaning of “substantially all” in the statute (as noted above, the Regulations define this term only for purposes of the requirement that “substantially all” of the tangible property owned or leased by a Zone Business must be Business Property);
- Transactions that trigger inclusion of deferred gains;
- A reasonable period for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty, and other issues relating to the recycling of investments; and
- Calculation of penalties when a QOF fails to meet the 90% test.

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