Understanding the Proposed Opportunity Zone Regulations

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What Is The Opportunity Zone Program?

The Opportunity Zone Program was established in the Tax Cuts and Jobs Act (TCJA) of 2017 to spur long-term investment in low-income areas

The program provides 3 tax incentives:

- Investors can defer taxes on gains until 2026, if the gain is reinvested in a qualified opportunity fund (QOF) within 180 days after sale

- If investment in the QOF is held for 5 years, the gain subject to tax is reduced by providing a 10% step up in basis, or 15% if held for 7 years

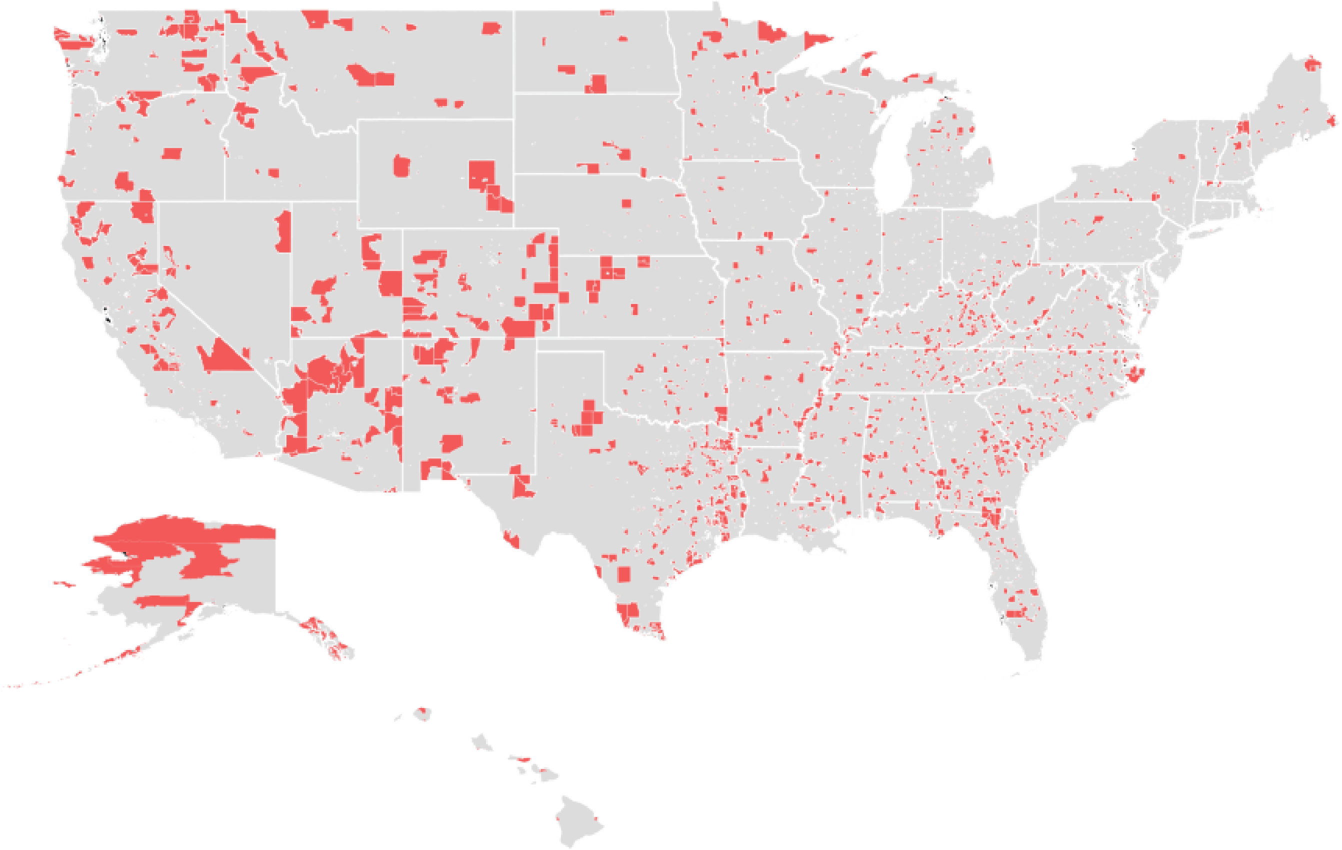
- If investment in the QOF is held for 10 years or more, the investor will have no taxable capital gain income on the sale of the investment

What are Opportunity Zones?

- A population census tract that is a low-income community which has been designated as a qualified Opportunity Zone (QOZ)
- In Spring, 2018 governors of states and territories designated up to 25% of their low-income community census tracts to be certified by the Treasury Department as QOZs
- The Treasury Department certified 8,761 zones
- QOZs retain their designation for 10 years

Land of Opportunity

Designated Opportunity Zone Census Tracts



Source: Fund for Our Economic Future's analysis of Qualified Opportunity Zone tracts, as designated by the U.S. CDFI Fund.

What are Opportunity Funds?

A Qualified Opportunity Fund (QOF) is an investment vehicle that is classified as a corporation or partnership for tax purposes and organized for the purpose of investing in an QOZ property and holds at least 90% of its assets in QOZ property. All investments in QOZs must go through QOFs.

To become a QOF, an eligible taxpayer must simply self-certify as one. No approval by the Treasury Department or the IRS is necessary.

What Can Opportunity Funds Invest In?

1. QOZ stock
   - QOFs can purchase new issue stock in a corporation, if the corporation qualifies as a QOZ business
2. QOZ Business Property
   - QOFs can invest in tangible property used in a QOZ business if the original use of the property began with the fund or if the fund substantially improves the property
3. QOZ Partnership Interest
   - QOFs can acquire interest in a partnership that is a QOZ business

Proposed Opportunity Zone Regulations

Proposed Opportunity Zone Regulations

- In October 2018, the Treasury Department released proposed regulations governing the Opportunity Zone program
- Treasury and IRS released the proposed regulations, Revenue Ruling 2018-29, and IRS Draft From 8996
- The regulations provide clarification about the program, but questions remain
- Treasury plans to release another round of proposed regulations and is accepting comments on the current round until Dec. 28

Proposed Regulations:
Tax Benefits for Investors

Capital Gains

- TCJA simply refers to ‘gains’ regarding the Opportunity Zone Program
- The regulations clarify only *capital* gains are eligible for deferral

Taxpayers

- The regulations clarify which taxpayers are eligible to defer capital gains in the Opportunity Zone Program:
  - 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 of the Regulations

Opportunity Zone Designation Expiration

- The guidance clarifies investors who hold their investment in a QOZ for at least 10 years are still eligible to increase their basis to the fair market value of the investment on the date it is sold, even after the QOZ designation expires. The sale can occur as late as Dec. 31, 2047.

Proposed Regulations:

Qualified Opportunity Funds

Draft Form 8996

- To self-certify as a QOF, entities must submit the form with their annual income tax return
- No approval is necessary

What Qualifies as a QOF

- Entities must be considered a corporation or partnership for federal income tax purposes to qualify as a QOF
- Limited liability companies can qualify as a QOF

Deemed Capital Contributions

- Deemed capital contributions under Section 752(a) don’t qualify as a QOF investment

Preexisting Entities

- Preexisting entitles can qualify as QOFs if they meet the standard requirements

Proposed Regulations:
Qualified Opportunity Zone Businesses

Substantially All is 70%

- TCJA mandated ‘substantially all’ of a QOZ Business’s tangible property must be qualified Opportunity Zone Business property
- The regulations clarify ‘substantially all’ means 70%
- Other uses in the law of ‘substantially all’ are not defined

31 Month Safe Harbor

- QOZ Businesses can hold working capital for up to 31 months if they meet certain requirements

Acting Trade or Business

- At least 50% of gross income of a QOZ Business must be generated from the active conduct of a trade or business in the QOF

Preexisting Entities

- Preexisting entities can qualify as QOZ Businesses if they meet the standard requirements

Substantial Improvement Definition

- TCJA allows QOFs to invest in QOZ Business property if original use of the property begins with the QOF or the QOF ‘substantially improves’ the property
- Revenue Ruling 2018-29 clarifies if a QOF purchases an existing building, the building’s original use doesn’t begin with the QOF and it must therefore be *substantially improved*
- The Ruling clarifies 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 improve the land

Outstanding Issues

Several outstanding ambiguities in the law remain and Treasury plans to release additional proposed regulation sometime next year.

Possible issues Treasury could address include:

- How QOFs will be treated if they sell an investment in a QOZ and reinvest the gains in another QOZ asset
- How a qualified QOZ business meets the ‘active’ trade or business requirement
- Whether QOFs will also be given 31 months to hold onto working capital
- The meaning of ‘substantially all’ in other instances in the law

Further Considerations

No Reporting Requirements

- OZ program has no tracking or reporting requirements, which could make it difficult to measure the success of the program and determine who it is benefiting
- Lack of reporting requirements differentiates the program from Enterprise Zones and New Market Tax Credits

‘Substantial Improvement’ Definition

- Definition of ‘substantial improvement’ could direct more money towards high-cost, urban areas and away from more low-income urban or rural areas

50% of Gross Income

- Rule requiring QOZ businesses to generate at least 50% of their income from within QOZs could be difficult for businesses providing services online or that want to sell products outside the QOZ
- No requirement regarding hiring employees from within the QOZ

Resources

- Opportunity Zones Fact Sheet: Summit Strategies
- Opportunity Zones Page: Economic Innovation Group
- Opportunity Zones Frequently Asked Questions: IRS

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