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New IRS and Treasury Guidance on Qualified Opportunity Zone Program

As part of the U.S. federal tax legislation enacted into law last year, Congress added provisions that provide tax benefits to encourage investments in designated low-income communities known as qualified opportunity zones ("QOZs"). On October 19, 2018, the Internal Revenue Service ("IRS") and the Department of the Treasury ("Treasury") released proposed regulations (the "Proposed Regulations"), a revenue ruling and a draft tax form with respect to QOZs.

This guidance is intended to provide clarity on a number of issues commenters have identified as gating items to closing transactions in QOZs. Note that the Proposed Regulations do not address the requirement to sell or exchange a qualified opportunity fund ("QOF") interest in order to obtain the Ten-Year Benefit (as defined below). The IRS and Treasury indicated that further guidance is expected in the near future and is expected to address the ability to reinvest proceeds from sale of QOF assets. The Proposed Regulations are effective after they are published as final regulations in the Federal Regulations, but taxpayers are permitted to rely on them before that date if they apply the rules consistently and in their entirety.

Benefits of a Qualified Opportunity Fund

Section 1400Z-2 of the Internal Revenue Code of 1986, as amended (the "QOZ Statute"), provides several benefits for investors who invest in QOFs, which in turn invest in QOZs. Investors can elect to invest an amount up to the aggregate capital gain from the sale or exchange of property within 180 days of realizing the gain into a QOF and may receive some or all of the benefits below (depending on their holding period with respect to the investment):[1]

- ***Deferral Benefit***. Capital gain recognition is deferred until the earlier of when the investor sells or exchanges its interest in the QOF and December 31, 2026.

- ***Five-Year Benefit and Seven-Year Benefit***. If the investor holds an interest in a QOF for at least five years, tax on 10% of the originally invested gain is eliminated and if the investor holds the interest for at least seven years, tax on 15% of the originally invested gain is eliminated (if these holding period requirements are met before December 31, 2026).

[1] Unlike Section 1031 where the entire proceeds of a transaction must be reinvested, under the QOZ Statute, investors are only required to invest a desired amount of eligible capital gain in the QOF to obtain the benefits of the QOF.

- ***Ten-Year Benefit***. If the investor holds its interest in a QOF for at least ten years, the investor can elect to increase its tax basis in the QOF to fair market value on the date of a sale or exchange of the interest in the QOF (the "Ten-Year Benefit"). This allows the investor to exclude all of the appreciation on the originally-invested gain from federal income tax.

New Proposed Regulations

The Proposed Regulations address a number of uncertainties in the statute and generally interpret the statute expansively to encourage investment in QOZs. The notes below assume a general familiarity with the QOZ regime and highlight some of the clarifications in the Proposed Regulations.

- ***Definition of Gains Eligible for Investment***. The Proposed Regulations clarify that only capital gain is eligible to be deferred under the QOZ Statute. However, the Proposed Regulations broadly defines capital gain, stating that eligible gain is gain "treated as capital gain for Federal income tax purposes."

- ***Eligible Taxpayers***. The Proposed Regulations clarify that taxpayers eligible for the QOZ benefits include individuals, C corporations (including regulated investment companies and real estate investment trusts), partnerships, S corporations, trusts and estates. If eligible gain is generated by a partnership, it can be invested directly by the partnership into a QOF and, if the partnership does not do so, by each of its partners.

    - A partnership may elect to defer all or part of a capital gain that it would otherwise recognize by investing it in a QOF. In that case, no part of the invested capital gain is required to be included in a partner's distributive share of income.

    - If the partnership does not elect to defer the capital gain, such gain is included in the partner's distributive share of income. The partner may then elect to defer its share by investing in a QOF.

    - The Proposed Regulations provide that the partner-level 180-day investment period does not begin until the last day of the partnership's taxable year, as that is the date the partner would otherwise recognize the gain. However, if the partner is aware of the date of the partnership's gain and the partnership elects not to defer such gain, the partner can choose to begin the 180 day period as of the day the partnership's gain. Note that this rule may be difficult for partners to take advantage of as, absent a contractual obligation, partners may not be aware of the partnership's gain until they receive a K-1. Analogous rules apply for other pass-through structures.

- ***Treatment of Debt Incurred by a QOF partnership***. The QOF rules permit taxpayers to invest eligible gain and other cash in a QOF. The other cash is treated as a separate investment in the QOF and the QOF tax benefits do not apply to the separate investment. There had been a question about whether deemed capital contributions generally arising from a partnership's incurrence of debt would be treated as ineligible investments in the QOF. The Proposed Regulations provide that such deemed capital contributions do not constitute separate ineligible investments in a QOF. This facilitates the use of leverage by QOFs treated as partnerships because the appreciation on the debt-financed portion of a QOF's investment is eligible for the Ten-Year Benefit.

- ***Clarification Regarding Ten-Year Benefit***. The Proposed Regulations also address the uncertainty about whether investments held after 2026 are eligible for the QOZ program. The Ten-Year Benefit is available until December 31, 2047, which is 20 ½ years after the last day an investor can invest eligible gain in a QOF.[2]

- ***Ninety Percent Asset Test Compliance and Valuation***. To qualify as a QOF, 90% of the QOF's assets as of the average of two annual testing dates need to qualify as QOZ property. The Proposed Regulations clarify certain aspects of this test, including for start-up years. They provide that for a QOF that has GAAP financials, the value of its assets should be determined by the financials. For a QOF that does not have GAAP financials, the value of its assets for this test is generally determined based on cost.

- ***Treatment of Land and Improvements to Land***. To qualify as a QOZ property for purposes of these rules, assets must generally either have their original use in a QOZ or be substantially improved (which generally requires making investments with a cost at least equal to the asset's purchase price) within 30 months. Land is an asset that can obviously never have its original use in a QOZ. The new rules provide clarity on the treatment of land and improvements on land for the purpose of the substantial improvement test.

  - If a QOF purchases a building located on land entirely within a QOZ, the substantial improvement requirement only applies to the QOF's basis in the building, not the land (i.e., improvements must only double the initial basis in the building).

- ***Working Capital Exception***. The Proposed Regulations provide some flexibility on the 90% asset test described above with respect to working capital assets for projects that are completed in 31 months. Previously, there was a concern that too much cash in certain of the entities could cause an investment to be ineligible for a QOF. The Proposed Regulations permit taxpayers to hold

2 The last day to defer gain by investing in a QOF is June 29, 2027, 180 days after December 31, 2026, which is the last day gain is eligible for deferral under Section 1400Z-2.

working capital assets for 31 months so long as there is a written plan detailing the amount of working capital and how it is scheduled to be deployed over the next 31 months.

- ***LLCs Can Be QOFs***. The IRS has confirmed that entities that are organized as limited liability companies can be QOFs.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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