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INSIGHT: Window of Opportunity With Opportunity Zones: Top 10 Takeaways

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On Oct. 19, 2018, the IRS released much anticipated guidance regarding opportunity zone funds. The guidance includes proposed regulations, a revenue ruling, and a draft reporting form (with instructions). Overall, this highly anticipated guidance is taxpayer friendly and addresses many of the issues that were causing investors uncertainty.

Opportunity Zones

A new provision in the tax code promulgated by the Tax Cuts and Jobs Act (TCJA) provides a tax incentive for making investments in certain low income communities that have been designated as qualified opportunity zones (QOZs).

The tax incentive would allow investors selling appreciated property or other investment property to defer tax on capital gains until 2026, to the extent that the gain is reinvested in a qualified opportunity zone fund (QOF), within 180 days after the gain recognition event. The provision would reduce the gain subject to tax if the investment in a QOF is held for five years to seven years, by providing up to a 15 percent increase in basis. Lastly, the tax incentive would exempt from tax any post acquisition gains on investments in QOFs, if the QOF investment is held for at least ten years.

Top Ten Takeaways from the new QOZ guidance

- A QOF can be a multimember limited liability company.
- A QOF can be a pre-existing entity but the QOZ business property must be acquired after Dec. 31, 2017, and proper elections must be made.
- Gain retains character (i.e., short term, collectible, long term), but if less than all of the taxpayer's interest in a QOF is being disposed of, the gain will be identified on a first in, first out basis.
- Taxpayers may use their QOZ interests as collateral for a loan whether a purchase-money borrowing or otherwise, although the QOZ investment itself must remain equity (and not debt) but can be a preferred interest.
- Significantly extended deferral period for partners in a partnership that recognized gain (180 days from the partnership's year end in the year of the gain).
- Rolling over investments in a QOF is allowed.
- Multiple investments in QOFs can be made with capital gain from the same event (multiple gain deferral elections can be made).
- Working capital can be held by a QOF and count towards the 90 percent asset test.
- Clarification on the definition of "original use" and "substantial improvement" with regard to QOZ business property.
- Taxpayers have until Dec. 31, 2047, to elect to dispose of their interest in QOFs and receive a step-up in basis.

For real estate investors, the proposed regulations and Revenue Ruling 2018-29 provide significant guidance on how to structure a QOF.

Working Capital

A QOF must satisfy a 90 percent asset test within the first six months of the QOF taxable year of the fund and on the last day of the QOF's taxable year, meaning 90 percent of the entity's assets must be qualified opportunity zone property within such time frame. The proposed regulations clarify the phrase the ''first 6 months'' means the first six-month period composed entirely of months which are within the taxable year and during which the entity is a QOF.

If an entity qualifies as a qualified opportunity zone business, the value of the QOF's entire interest in the entity counts towards the QOF's satisfaction of the 90 percent asset test. The proposed regulations state that if a QOF operates a trade or business (or multiple), through one or more entities, then the QOF may satisfy the 90 percent asset test if each of the entities qualifies as a qualified opportunity zone business.

Further, commentators had requested the IRS adopt a rule that provides that cash may be appropriate QOF property for the purposes of the 90 percent asset test. In response, the Treasury provided a working capital safe harbor for QOF investments into QOZs. The safe harbor allows QOFs to hold cash, cash equivalents, or debt instruments with a term of 18 months or less for a period of up to 31 months, provided there is (1) a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the QOZ; (2) a written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months; and (3) the business substantially complies with the schedule.

Original Use and Substantial Improvement

Qualified opportunity zone business property is tangible property used in a trade or business of a QOF, provided that (1) such property was acquired by purchase from an unrelated party after Dec. 31, 2017; (2) the original use of such property in the opportunity zone commences with the QOF or the QOF substantially improves the property; and (3) during substantially all of the QOF's holding period for such property, substantially all of the use of such property was in a QOZ.

Previously, a point of concern for many investors was the definition of the terms ''original use'' and ''substantial improvement,'' particularly with regard to a purchase of a building located on land that is within an opportunity zone and the improvements necessary to qualify. Revenue Ruling 2018-29 and the proposed regulations address some of these issues.

Revenue Ruling 2018-29 states that if a taxpayer purchased an existing building located on land within a QOZ, because of the permanence of land, land can never have its original use in a QOF, but the regulations do not require the portion of the purchase price allocated to land to be ''substantially improved.'' Further, the original use of an existing building is not considered to have commenced with the QOF.

Tax code Section 1400Z-2(d)(2)(D) provides that property will be treated as ''substantially improved'' by the QOF if, during any 30-month period beginning after the date of acquisition, additions to basis with respect to such property in the hands of the opportunity fund exceed an amount equal to the adjusted basis of such property at the beginning of the 30-month period. The revenue ruling clarifies that the cost of the land within the QOZ is not included in the taxpayer's adjusted basis in the building. The proposed regulations provide that measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately ''substantially improve'' the land upon which the building is located. The Treasury stated that ''excluding the basis of land from the amount that needs to be doubled for a building to be substantially improved facilitates repurposing vacant buildings in QOZs.''

Further, the new guidance provides that if at least 70 percent of the tangible property owned or leased by a trade or business of an entity held by the QOF is qualified opportunity zone business property, then the trade or business is treated as satisfying the ''substantially all'' requirement.

Conclusion

There are many planning opportunities for investors with appreciated assets who have previously incurred 2018 or upcoming large capital gain events. While the Treasury is seeking public comment on a number of issues discussed above, investors may rely on the new guidance until final regulations are published. Thus, this new guidance provides taxpayers with further certainty to approach new investments in qualified opportunity zones.

It is important to note that the proposed regulations make clear that taxpayers may rely on the rules prior to the effective date, provided certain requirements are met. This appears to be intended to encourage taxpayers to move forward with their transactions with more certainty and confidence.

Qualified Opportunity Zones and associated tax planning were previously discussed in our June 2018 article.

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