

Treasury Releases Guidance on Opportunity Zones

On Oct. 18, 2018, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“IRS”) issued proposed regulations under Section 1400Z-2 of the Internal Revenue Code (the “Code”) regarding qualified opportunity zones and gains that may be deferred as a result of a taxpayer’s investment in a qualified opportunity fund (“QOF”).

Section 1400Z-2 was created by the *Tax Cuts and Jobs Act*, (P.L. 115-97) (“TCJA”) and due to the breadth of the new statute, Treasury has elected to release multiple sets of proposed regulations. This guidance will have a significant impact on the taxation of individuals, corporations, partnerships, S corporations, trusts and estates engaged in qualified opportunity zone investments.

Contemporaneously with the issuance of the proposed regulations, the IRS released Rev. Rul. 2018-29 addressing the application to real property of the “original use” and “substantial improvement” requirements of Section 1400Z-2 and clarifying that when a QOF acquires an existing structure, the substantial improvement test can be satisfied by reference to the adjusted basis of the structure, without taking into account the cost allocated to the land.

Background

Congress enacted Section 1400Z-2, in conjunction with Section 1400Z-1, as a temporary provision to encourage private sector investment in certain lower-income communities designated as qualified opportunity zones for years beginning after 2017 and before 2027. Under this provision, taxpayers may elect to defer the recognition of capital gain to the extent of amounts invested in a QOF, provided that the amounts are invested during the 180-day period beginning on the date such capital gain would otherwise have been recognized. The inclusion of the deferred gain in income occurs on the date the investment in the QOF is sold or exchanged, or on Dec. 31, 2026, whichever comes first.

For investments in a QOF held longer than (i) five years, taxpayers may exclude 10 percent of the deferred gain from income; (ii) seven years, taxpayers may exclude 15 percent of the deferred gain from income; and (iii) 10 years, taxpayers may exclude the entire post-acquisition gain on the qualifying investment in the QOF from income. In turn, a QOF must hold at least 90 percent of its assets in qualified opportunity zone property.

The Proposed Regulations

The proposed regulations address the type of gains that may be deferred by investors, the time by which such gains must be invested in QOFs, and the manner in which investors may elect to defer specified gains. The proposed regulations also include rules for self-certification of QOFs, valuation of QOF assets, and guidance on qualified opportunity zones businesses.

The proposed regulations are organized into seven substantive areas:

1. **Deferring Tax on Capital Gains by Investing in Opportunity Zones:** The proposed rules clarify that only capital gains are eligible for deferral and place other requirements on the capital gain to be deferred. The proposed rules allow individuals, C corporations, partnerships and other pass-through entities to elect gain

deferral. The guidance clarifies that the investment in a QOF must be an equity investment to qualify for deferral (though the equity can be pledged as collateral for debt), and provides examples of the 180-day period for deferring gain by investing in a QOF.

2. **Special Rules:** This area addresses the definition of “eligible gain” as well as the determination of the 180-day period with respect to Section 1256 contracts. It also defines “offsetting-positions transactions” and clarifies that any capital gain from a position of an offsetting-positions transaction is not eligible for deferral under Section 1400Z-2.
3. **Gain of Partnerships and Other Pass-Through Entities:** The proposed rules permit a partnership to elect deferral under Section 1400Z-2 and, to the extent that the partnership does not elect deferral, provides rules that allow a partner to do so. The proposed rules state analogous rules would also apply to other pass-through entities (including S corporations, decedents’ estates, and trusts) and to their shareholders and beneficiaries.
4. **How to Elect Deferral:** Deferral elections are required to be made at the time and in the manner proscribed by the IRS. While additional IRS guidance is expected, it is currently anticipated that taxpayers will make deferral elections on Form 8949 and attach it to their federal income tax returns.
5. **Section 1400Z-2(c) Election for Investments Held at Least 10 Years:** The proposed regulations specify that expiration of a zone designation will not impair the ability of a taxpayer to elect the exclusion from gains for investment held for at least 10 years, provided the disposition of the investment occurs prior to Jan. 1, 2048. Congress provided an incentive through this gain exclusion benefit, which is integral to the primary purpose of the provision (i.e., Congress’ intent to attract an influx of capital to designated low-income communities).
6. **Rules for a QOF:** The proposed regulations generally permit any taxpayer that is a corporation or partnership to self-certify as a QOF. While additional guidance is expected, it is currently anticipated that taxpayers will use Form 8996 for initial self-certification and annual reporting of compliance with the 90 percent asset test in Section 1400Z-2(d)(1). The proposed regulations clarify that there is no prohibition to using a pre-existing entity as a QOF, and also provide an important safe harbor for working capital that allows cash to be held for up to 31 months (if the safe harbor requirements are satisfied) in computation of the 90 percent asset test. Additionally, in determining whether an entity is a qualified opportunity zone business, the proposed regulations provide a 70 percent threshold for determining whether the “substantially all” requirement is met, but explicitly state that this definition is only applicable to Section 1400Z-2(d)(3)(A)(i).
7. **Section 1400Z-2(e) Investments from Mixed Funds:** The proposed regulations clarify that a partner’s increase in outside basis from a deemed contribution under Section 752(a) is not taken into account in determining what portion of the partner’s interest is subject to the deferral election under Section 1400Z-2(a).

Next Steps

Treasury and the IRS are working on additional guidance, including the meaning of “substantially all” as it is used throughout section 1400Z-2(d), transactions that may trigger inclusion of deferred gain, the “reasonable period” for a QOF to reinvest proceeds from a sale of qualifying assets, and information-reporting requirements. Treasury has asked for written comments on the published guidance within 60 days of the date the proposed regulations are

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published in the *Federal Register*. We anticipate comments will be due in late December as a public hearing is scheduled for Jan. 10, 2019, at 10:00 a.m.

Given that these rules will significantly impact the taxation for investors in designated distressed communities, we believe it is important for such investors to engage in the rulemaking process. By doing so, policymakers will have a better understanding of the impact these rules will have on businesses and the challenges businesses will face during the implementation process.

The Brownstein Federal Tax Policy team can assist you in assessing the impact that these rules will have on your business. In addition, we can help you determine whether to submit written comments to the proposed guidance. Our team has significant experience with the rulemaking process. To the extent questions are unanswered or the rules are not clear, our team can facilitate a dialogue with policymakers to help resolve your issues.

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