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New Guidance on Opportunity Zones: Incentives for Investments in Low-Income Communities

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- Holland & Knight previously published a three-part series describing the powerful new tax incentive contained in the Tax Cuts and Jobs Act for investments in low-income communities designated as "Opportunity Zones."
- In Part 1 of that series, we discussed the new tax incentive generally and explained the process for designation of Opportunity Zones for the 10-year period. In Part 2, we discussed the requirements for formation and certification of a Qualified Opportunity Fund and the rules governing its operations. Finally, in Part 3, we discussed the benefits for investing taxpayers, namely the deferral or partial exclusion of gain from the sale or exchange of an asset by a taxpayer who invests in a Qualified Opportunity Fund, as well as the potential exclusion of gain from disposition of an investment in a Qualified Opportunity Fund.
- In this alert, we highlight the clarifications provided by the U.S. Department of the Treasury and the IRS on Oct. 19, 2018, through issuance of guidance and a draft tax form.

There is a great deal of excitement about the new tax incentive for investments in low-income communities designated as "Opportunity Zones." This enthusiasm is being expressed by investors, those who want to attract investment, and the state, local and tribal governments that have high hopes for the economic development it can spur in the low-income communities they serve.

The new tax incentive, found in the Internal Revenue Code at 26 U.S.C. §§1400Z-1 and 1400Z-2, was created by the Tax Cuts and Jobs Act, signed into law in December 2017. While many began planning for the new tax incentive by raising capital, establishing Qualified Opportunity Funds and laying the groundwork for starting a Qualified Opportunity Zone Business, some plans were stymied by the lack of guidance from the U.S. Department of the Treasury and the IRS. On Oct. 19, 2018, the Treasury Department and IRS released much anticipated Opportunity Zones guidance, clearing the way for the success of the new tax incentive.

Specifically, on Oct. 19, 2018, the Treasury Department and the IRS issued proposed regulations[1], Revenue Ruling 2018-29 and draft IRS Form 8996. In addition, the IRS updated on its website the frequently answered questions regarding Opportunity Zones. On the whole, these developments are welcomed by stakeholders who are pleased to see the new tax provisions interpreted in a manner designed to spur economic growth and investment. The guidance still leaves many questions unanswered but with a promise that additional answers are forthcoming.

For a general background on the new Opportunity Zone incentive, please refer to Holland & Knight's prior three-part series (see Highlights above). Below, we focus solely on the developments of Oct. 19, 2018 – specifically the proposed regulations, Revenue Ruling 2018-29 and draft IRS Form 8996 – and assume the reader's general familiarity with the incentive.

Tax Benefits for Taxpayer Investors

- Clarification was provided that only gains from the sale or exchange of capital assets are eligible for deferral and the benefits that flow from such deferral.
- Clarification was provided on which taxpayers can defer gain. In the case of a partnership, the partnership can elect to defer gain, and if it does not so elect, each partner can elect to defer gain. The proposed regulations provide for how the gain deferral is treated under partnership allocation and distribution rules in each case.
- The timing of the commencement of the 180-day period for investment of deferred gain in the case of a partner in a partnership is clarified. The proposed regulations provide a default rule, namely that the 180-day period begins on the last day of the partnership tax year in which the sale or exchange generating the gain occurs. As an alternative, the proposed regulations allow the partner to elect to start the 180-day period on the day on which the sale or exchange occurred.
- Helpfully, the proposed regulations clarify that if a taxpayer disposes of its investment in a Qualified Opportunity Fund and recognizes gain, the taxpayer can reinvest that gain in a Qualified Opportunity Fund within 180 days and the tax benefits are available for that reinvestment.
- One ambiguity in the law is whether taxpayers who invest in a Qualified Opportunity Fund can reap the benefits allowed for investments held for 10 years – namely, whether an election can be made to increase basis in the investment to fair market value – after the designation of Opportunity Zones expires in 2028. The proposed regulations clarify that a taxpayer can make such election upon sale of the investment as late as Dec. 31, 2047, even if the designation has expired.
- The proposed regulations clarify that a taxpayer can make the election to step up basis in an investment in a Qualified Opportunity Fund that was held for 10 years or more only if a proper gain deferral election was made for the investment.
- The proposed regulations clarify that a deemed capital contribution of partnership debt under Code Section 752(a) – which results in an increase in the investor's basis in his interest – is not treated as a separate investment in a Qualified Opportunity Fund under the mixed investment rules. Accordingly, debt does not dilute the benefit of deferral.

Qualified Opportunity Funds

- Clarification was provided that a Qualified Opportunity Fund can be a limited liability company (LLC) so long as it is taxed as a partnership or a corporation for federal income tax purposes.

- The IRS draft Form 8996 allows a Qualified Opportunity Fund to self-certify to the IRS by filing such form as an attachment to the Fund's annual income tax return.
- Clarification was provided that pre-existing entities can be Qualified Opportunity Funds so long as they satisfy the qualification requirements at the time they choose to be treated as a Qualified Opportunity Fund, including that interests in "qualified opportunity zone property" included in the calculation of the 90 percent test were acquired after Dec. 31, 2017.
- The proposed regulations provide some flexibility on the testing dates that a Qualified Opportunity Fund can use in its initial year to determine whether it meets the required test that 90 percent of its assets must be "qualified opportunity zone property." The Qualified Opportunity Fund can choose both its first tax year as a Qualified Opportunity Fund and the month in which its first six-month testing period begins. This flexibility means that a Qualified Opportunity Fund can conduct some activities before it needs to meet the test on it first testing date. However, in no event can the first testing date be later than the last day of the Qualified Opportunity Fund's first tax year. The proposed regulations do not permit any ramp-up period for a fund's initial period of operations in which it could raise investor money but not invest.
- Clarification was provided that for purposes of the 90 percent of assets test, assets are valued based on the Qualified Opportunity Fund's qualified financial statements if available. If the Qualified Opportunity Fund does not maintain qualified financial statements assets can be valued based on cost.

Qualified Opportunity Zone Businesses

- Similar to Qualified Opportunity Funds, clarification was provided that pre-existing entities can be Qualified Opportunity Zone Businesses so long as they satisfy the qualification requirements at the time they choose to be treated as a Qualified Opportunity Zone Business, including that substantially all of the business's tangible property was acquired after Dec. 31, 2017.
- By law, in order to be a Qualified Opportunity Zone Business, the business must have "substantially all" of its tangible property located in an Opportunity Zone. Clarification was provided that in this instance "substantially all" means a threshold of only 70 percent. The proposed regulations acknowledge that there are numerous parts of the law that use the term "substantially all," and the meaning of the term in these other sections will be defined in future guidance.
- Helpfully, the proposed regulations allow a Qualified Opportunity Zone Business to maintain working capital (cash) for up to 31 months if certain conditions are met, without threatening its status as a Qualified Opportunity Zone Business.
- The proposed regulations and contemporaneous Revenue Ruling discuss the rules around land and existing buildings in Opportunity Zones. The Revenue Ruling notes that land can never meet the "original use" requirement. Accordingly, where an existing building and the land on which it is located are purchased, the substantial improvement test must be met. For purposes of this test, however, the proposed regulations provide that the land value can be ignored and the substantial improvement test is applied to the basis of the building only.

Conclusion and Considerations

The recent guidance provided by the Treasury Department and the IRS is very helpful for stakeholders who are trying to unleash the power of the new Opportunity Zone incentive. Unfortunately, as was anticipated given the complex and novel law, certain important questions remain unanswered. These questions include how the penalty should apply when a Qualified Opportunity Fund fails to meet the 90 percent asset test, how Qualified Opportunity Zone Businesses satisfy the requirement that they must be an "active" trade or business, how vacant land will be treated, how long a Qualified Opportunity Fund will have to redeploy funds from an investment it has disposed of, and how an investor's exit from a Qualified Opportunity Fund after 10 years will work and whether debt will be treated as a separate investment for such purposes. Nevertheless, the enthusiasm around the new Opportunity Zone incentive is well-founded. Investors, those who want to attract investment, and state, local and tribal governments should act sooner rather than later to determine how to take advantage of this powerful new tax incentive.

Notes

[1] Although these regulations were issued in proposed form, reliance on the proposed regulations is generally permitted (if followed in their entirety) until final regulations are promulgated. In addition, the U.S. Treasury Department and IRS are actively encouraging and seeking comments on several issues, including the rules announced in the proposed regulations.
