



Opportunity Zones Update NEW PROPOSED TREASURY REGULATIONS (PART I)

April 24, 2019

Background

In December 2017, as part of the Tax Cuts and Jobs Act (“TCJA”), Congress established a new tax incentive program to promote investment in certain low-income communities designated by the IRS as qualified opportunity zones. Section 1400Z-2 of the Internal Revenue Code provides three compelling tax incentives to encourage investment in qualified opportunity funds (“QOFs”).

- Taxpayers can defer paying taxes on capital gain from the sale or exchange of appreciated assets by investing such gain in a QOF within 180 days following such sale or exchange. Such gain may be deferred until the earlier of (i) when the investment is sold or exchanged or (ii) December 31, 2026.
- Investors receive a step-up in the basis equal to 10% of the original deferred gain if the investment in the QOF is held for at least five years, with an additional 5% basis step-up if the investment is held for seven years. These basis step-ups can result in permanent exclusion from taxation of up to 15% of the originally deferred gain.
- If the investor holds the investment in the QOF for at least 10 years, an elective basis adjustment made upon sale of the interest in the QOF provides a permanent exclusion from taxation for any appreciation in excess of the deferred gain.

On April 17, 2019, the Treasury Department released its second round of guidance on opportunity zone investment in the form of proposed regulations (the “New Proposed Regulations”). These newly proposed regulations supplement and in some cases revise the proposed regulations issued in October 2018 (The “October Proposed Regulations”).

In particular, the New Proposed Regulations provide:

- Guidance related to investments in QOFs including rules for the transfer of property other than cash to a qualified opportunity fund, guidance on the purchase of eligible investments, rules for investment rollovers, guidance on what triggers a taxable inclusion, rules for mixed investments in funds, and guidance on investments by partnerships, S-corporations and consolidated groups.
- Guidance related to qualified opportunity zone businesses including workable rules for businesses that straddle opportunity zone and non-opportunity zones, guidance on the use of intangible property and favorable safe harbors for the 50 percent gross income location test.
- Guidance on opportunity zone business property including rules that will permit investors to lease rather than purchase opportunity zone property, and a clarification that for purposes of the holding period requirement “substantially all” means 90 percent.
- Guidance on QOFs including a reinvestment rule for funds, relief from the 90 percent asset test for new capital, and anti-abuse rules.

The New Proposed Regulations do provide further clarity, but still leave many questions unanswered. In light of the length and complexity of the New Proposed Regulations we will release a multi-part series of blog posts that will each address key issues relating to a specific component of the opportunity zone rules. Key issues relating to qualified investments in QOFs are highlighted in this Part I. We will unpack and explain additional aspects of the New Proposed Regulations in future blog posts.

What types of gain can be deferred through investment in a QOF?

The TCJA left open the question of what types of “gain” are eligible for deferral by simply stating “gain from the sale to, or exchange with, an unrelated person of any property held by the taxpayer.” The October Proposed Regulations clarified that only capital gain is eligible for deferral. The New Proposed Regulations make clear that in the case of Section 1231 gain, only capital gain net income for a taxable year is eligible for deferral.

Can gain from the sale or other transfer of property to a QOF in exchange for an equity interest in the QOF be deferred?

No. Under the New Proposed Regulations, gain from the sale or other transfer of property to a QOF in exchange for an equity interest in the QOF is not eligible for deferral.

Can gain from the sale or other transfer of property to a person other than a QOF in exchange for an equity interest in a QOF be deferred?

No. Capital gain recognized for federal income tax purposes in connection with transfer of property to a person other than a QOF in exchange for an equity interest in the QOF is not eligible for deferral under the New Proposed Regulations.

Can a taxpayer defer eligible gain by acquiring an equity interest in a QOF from a person other than a QOF?

Yes. The New Proposed Regulations provide that if a taxpayer acquires an equity interest in a QOF from a person other than the QOF, then the amount of gain eligible for the taxpayer’s deferred election is the amount of the cash, or the fair market value of the other property, that the taxpayer exchanged for the eligible interest in the QOF, as determined immediately before the exchange.

Do carried interests qualify for opportunity zone tax benefits?

No. Services rendered to a QOF are not considered a Section 1400Z-2(a)(1)(A) investment. Thus, if a taxpayer receives an equity interest in a QOF for services rendered to the QOF or to a person in which the QOF holds any direct or indirect equity interest, then the interest in the QOF that the taxpayer receives is treated as a separate investment which does not qualify for opportunity zone tax benefits.

Can a taxpayer make an equity investment in a QOF by contributing property in a nonrecognition transaction?

Yes. For property contributions, the deferral election is limited to the lesser of the taxpayer's adjusted basis in the equity interest received in the transaction without regard to section 1400Z-2(b)(2)(B) (generally, the taxpayer's basis in the property contributed), or the fair market value of the equity interest received in the transaction, both as determined immediately after the contribution. This rule applies separately to each item of property contributed to a QOF. If the fair market value of the equity interest in the QOF received is in excess of the taxpayer's adjusted basis in the equity interest received, without regard to section 1400Z-2(b)(2)(B), then the taxpayer's investment is a mixed funds investment to which Section 1400Z-2(e)(1) applies.

Conclusion

The New Proposed Regulations provide clarity on key issues but leave many questions unanswered. We will address additional issues under the New Proposed Regulations in future blog posts on the topics of operating businesses, investment rollovers, leases, reinvestment, taxable inclusion events and more.

While it is important to remember that the New Proposed Regulations are not final, taxpayers may rely on the New Proposed Regulations prior to the date they become final (other than the section of the proposed regulations that addresses the rules for the exemption of gain on sales after ten years) so long as taxpayers apply the New and October Proposed Regulations consistently and in their entirety.

For assistance with establishing a qualified opportunity fund, or for additional information regarding qualified opportunity funds or opportunity zones in general, please contact the attorneys listed below.

Questions? Contact:



Amy Tranckino | Tax
858.720.8960
atranckino@sheppardmullin.com



Judy Fiorini | Tax
212.653.8458
jfiorini@sheppardmullin.com



John Crisp | Tax
714.424.8269
jcrisp@sheppardmullin.com