

TREASURY RELEASES PROPOSED OPPORTUNITY ZONE REGULATIONS

October 10, 2018

The Department of the Treasury released their proposed implementing regulations for the Qualified Opportunity Zone program. The proposed regulations released today clarify what gains qualify for deferral, which taxpayers and investments are eligible, the parameters for Opportunity Funds, and other guidance. The hope is that the proposed regulations offer enough guidance to allow project developers, investors and fund sponsors the information they need to begin entering into new business arrangements in designated Opportunity Zones. The public comment period for this **initial** phase of proposed regulations will last for 60 days after publishing. The date that the period will conclude is expected to be January 10, 2019.

We mention that these are the initial phase of regulations, because the Department and the IRS are working on additional published guidance, including additional proposed regulations expected to be published in the near future, likely by the end of this year. The second phase of proposed regulations are expected to address additional issues, including:

- the meaning of “substantially all” in each of the various places where it appears in section 1400Z-2;
- the transactions that may trigger the inclusion of gain that has been deferred under a section 1400Z-2(a) election;
- the “reasonable period” (see section 1400Z-2(e)(4)(B)) for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty;
- what happens when a QOF fails to maintain the required 90 percent investment standard; and information-reporting requirements under section 1400Z-2.

Working with the Governors of all 50 states, the Treasury certified 8,761 communities in in total, including in the District of Columbia and five U.S. territories. Nearly 35 million Americans live in areas designated as Opportunity Zones. These communities present both the need for investment and significant investment opportunities.

Several prominent investors, such as Goldman Sachs Group Inc., hedge fund EJP Capital and New York-focused RXR Realty, have already begun making investments in opportunity zones or started raising funds to do so. Enterprise Community Partners, one of the largest affordable-housing groups in the U.S. said that it was partnering on an opportunity fund to revive Main Streets in small towns.

The Treasury Department will issue another set of regulations later this year addressing questions about the ongoing operations of a fund, including whether a fund can buy and sell assets over its lifetime.

PRELIMINARY HIGHLIGHTS OF THE TREASURY'S PROPOSED RULES ON QUALIFIED OPPORTUNITY ZONES

The proposed regulations clarify that only capital gains are eligible for deferral under section 1400Z-2(a)(1), specifying it as “*gain* from the sale to, or exchange with, an unrelated person of any property held by the taxpayer,” to the extent that such gain does not exceed the aggregate amount invested by the taxpayer in a QOF during the 180-day period beginning on the date of the sale or exchange.

The proposed regulations provide that a gain is eligible for deferral if it is treated as a capital gain for Federal income tax purposes. Eligible gains, therefore, generally include capital gain from an actual, or deemed, sale or exchange, or any other gain that is required to be included in a taxpayer’s computation of capital gain.

A host of other topics include:

Eligible Investors:

The proposed regulations clarify that taxpayers eligible to elect deferral under section 1400Z-2 are those that recognize capital gain for Federal income tax purposes. These taxpayers include individuals, C corporations (including regulated investment companies (RICs) and real estate investment trusts (REITs)), partnerships, and certain other pass-through entities, including common trust funds described in section 584, as well as, qualified settlement funds, disputed ownership funds, and other entities taxable under §1.468B of the Income Tax Regulations.

There are special rules for partnerships and other pass-through entities, and for taxpayers to whom these entities pass through income and other tax items.

Eligible Investment:

An investment in the QOF must be an equity interest in the QOF, including preferred stock or a partnership interest with special allocations. Thus, an eligible interest cannot be a debt instrument. The regulations also clarify:

- **The 180-Day Rule for Deferring Gain by Investing in a QOF** by defining the first day of the 180-day period as the date on which the gain would be recognized for Federal income tax purposes, without regard to the deferral available under section;
- Treatment of **section 1256 contract gains** as a yearly aggregate rather than on a contract by contract basis;
- **Gains of Partnerships and Other Pass-Through Entities**, permit a partnership to elect deferral and, to the extent that the partnership does not elect deferral, provide rules that allow a partner to do so.

Tax Treatment for 10-year investments made after QOZ expiration in 2026: the proposed regulations permit taxpayers to make the basis step-up election under section 1400Z-2(c) after a qualified opportunity zone designation expires, through June of 2037, as long as the investment is made prior to the end of June 2027.

Certification as a Qualified Opportunity Fund: the proposed regulations generally permit any taxpayer that is a corporation or partnership for tax purposes to self-certify as a QOF, provided that the entity self-certifying is statutorily eligible to do so. The rule further clarifies when first date of operation can be for an QOF for purposes of receiving QOZ investments.

Regulations permit usage of a valuation method for the 90% asset test, and in the alternative to that financial instrument, QOZs may value individual assets.

Defines qualified opportunity zone business property to mean tangible property used in a trade or business of a QOF, but only if (1) the property was acquired by purchase after December 31, 2017; (2) the original use of the property in the QOZ commences with the QOF, or the QOF substantially improves the property; and (3) during substantially all of the QOF's holding period for the property, substantially all of the use of the property was in a QOZ.

Proposed Date of Implementation: The proposed rule states that these rules are effective upon publishing of the final rule (sometime after the closing of the comment period ending on January 10, 2019, but further stipulates that entities may rely on these proposed rules in the meantime to begin qualified investments of eligible gains.

We will continue breaking down these regulations over the weekend, making a deeper dive, and report the same to you.