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Treasury and IRS Release Qualified Opportunity Fund Guidance

The U.S. Department of Treasury (the Treasury) and the Internal Revenue Service (IRS) recently released proposed regulations along with related forms and instructions that provide further guidance under the Tax Cuts and Jobs Act (TCJA), permitting investors in a Qualified Opportunity Fund (QOF) to defer and exclude certain capital gains. As with all proposed regulations, a taxpayer may rely on these proposed rules with respect to investments, and deemed contributions, before the date of publication in the Federal Register of a Treasury decision adopting these proposed rules as final regulations, but only if the rules are applied in their entirety and in a consistent manner. The text of the proposed regulations can be found here.

Under Section 1400Z-2 of the Code, any person who may recognize gain for Federal income tax purposes may elect to defer recognition of or exclude some or all of its capital gain from a sale or exchange with an unrelated party to the extent that such person invests in a QOF within the specified time (generally, 180 days from the sale or exchange generating such gain). The QOF's purpose is to facilitate investment in a "qualified opportunity zone," which is defined as a low-income community designated as a qualified opportunity zone by the state in which it is located and certified by the Treasury. Here, we summarize the requirements to (I) form and maintain a QOF and (II) defer and exclude gain from an investment in a QOF.

I. Requirements to Form and Maintain a Qualified Opportunity Fund.

The proposed regulations generally permit any newly formed or pre-existing corporation or partnership for federal income tax purpose to self-certify as a QOF. Entities treated as a C corporation, S corporation, or Real Estate Investment Trust (REIT) for federal income tax purposes are eligible to be a QOF. An eligible entity self-certifies as a QOF using IRS Form 8996.

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An entity that has self-certified to be a QOF must annually demonstrate to the IRS, by filing IRS Form 8996, that at least 90% of its assets during the year for which it is filing were "Qualified Opportunity Zone Property." Qualified Opportunity Zone Property can be either (i) "Qualified Opportunity Zone Business Property" ("Qualified OZ Business Property") or (ii) equity (stock or partnership interest) in certain qualified businesses in which "substantially all" of the tangible property owned or leased by such business is Qualified OZ Business Property.

a. Qualified OZ Business Property – Generally.

In order to determine whether tangible property is Qualified OZ Business Property, it must be used in a trade or business of the QOF (or in a corporation or partnership in which the QOF invests in equity) and meet the following requirements:

- Such property was acquired by such QOF (or such corporation or partnership) after December 31, 2017;
- The original use of such property in a Qualified Opportunity Zone commences with, or such property is substantially improved by, such QOF (or such corporation or partnership); and
- Substantially all of the use of such property was in a Qualified Opportunity Zone during substantially all of such QOF's (or such corporation's or partnership's) holding period for such property.

  Example 1: A real estate developer wants to establish a QOF to attract investors in a new project. The developer may certify as a QOF the special purpose limited liability company or partnership it has formed to take title to the property, as long as the property is within a Qualified Opportunity Zone and the investors invest qualified gains directly into the special purpose entity. The real estate developer then has 31 months to apply the cash investments of qualified gains to the costs of development of the project.

  Example 2: A business with multiple locations inside and outside of Qualified Opportunity Zones wants to establish a QOF in which to invest its own eligible gains to fund a new office building within a Qualified Opportunity Zone. The entire business itself cannot qualify as a QOF because less than 90% of its assets are Qualified Opportunity Zone Property. The business could create a new special purpose limited liability company or partnership (with a captive entity to be co-member or co-partner) to own just the property within the Qualified Opportunity Zone, thus meeting the requirement that 90% of its property be Qualified Opportunity Zone Property, and certify the special purpose entity as a QOF.

b. Qualified OZ Business Property – "Substantially Improved."

The proposed regulations allow for the purchase of existing property within a Qualified Opportunity Zone to be Qualified OZ Business Property as long as such property was purchased after December 31, 2017 and is "substantially improved" within 30 months. For this purpose, improvements within 30 months must double the basis of such property to satisfy the "substantially improved" requirement. Under the recently issued Revenue Ruling 2018-29, the IRS indicates that the basis of any underlying land that is purchased in conjunction with an existing building is excluded from the determination of whether improvements doubled the basis of such property. In that case, improvements must double the basis of only the existing building during the 30-month period.

Example 1: If Business A purchased property for $1,000,000, and 50% of the purchase price is attributed to the value of the building and 50% of the purchase price is attributed to the value of the land, Business A must make at least $500,000 worth of improvements to the building to satisfy the substantially improved requirement. Business A is not required to improve the land.

c. Equity in Qualified Business that Owns/Leases Qualified OZ Business Property.

Equity (stock or partnership interest) held by a QOF in certain qualified businesses can be Qualified Opportunity Zone Property if "substantially all" of the tangible property owned or leased by such businesses is Qualified OZ Business Property. For this purpose, the proposed regulations indicate that if at least 70% of the tangible property owned or leased by a business is Qualified OZ Business Property, the business will be deemed to have satisfied the "substantially all" requirement.

If a QOF invests in equity (stock or partnership interest) of a business, such a business must not maintain more than a reasonable amount of working capital, in addition to certain other requirements. The proposed regulations provide a safe harbor under which a business is treated as having a reasonable amount of working capital if a written schedule provides that the working capital will be spent to improve tangible property within 31 months of receipt and the working capital is actually spent during that time. The preamble to the proposed regulations indicates that Treasury anticipates that certain projects may take upwards of 30 months to substantially improve the property. The Treasury and the IRS are requesting comments on whether the 31-month safe harbor for working capital is reasonable.

d. Measurement Dates for 90% Test.

The determination of whether a QOF meets the 90% test is made based on the average percentage of the Qualified Opportunity Zone Property held by the QOF as measured on the last day of the sixth month and the last day of the last month of each taxable year that the QOF designation was made. Certain adjustments in the calculation are made for the first year in which an entity self-certifies as a QOF if such entity chooses to become a QOF beginning with a month other than the first month of a taxable year. For example, if an entity with a calendar year-end self-certifies as a QOF beginning in March, the 90% test for its first year is measured on August 31 (the last day of the six month after the first date in which it self-certified as a QOF) and December 31 (the last day of the last month of the first taxable year). The value of the assets is generally determined based on the QOF's financial statements that are used for other business purposes.

II. Requirements to Defer and Exclude Gain.

An investor achieves deferral of gain until December 31, 2026 by investing in a QOF within the specified time (generally, 180 days from the sale or exchange generating such gain) and making the proper election. Section 1400Z-2 of the Code requires an investor to recognize gain at the earlier of the date on which the investment is sold or December 31, 2026. The amount of gain recognized at that time is limited to the lesser of the amount of previously deferred gain or the fair market value of the investment as of that date. Investors can exclude some or all of the gain through a basis step-up by holding such investment for the holding periods specified below. An investor's initial basis in an investment is $0.

Holding Period	Basis Step-Up
At least 5 years	10% of deferred gain
At least 7 years	15% (10% plus additional 5%) of deferred gain
At least 10 year	Fair market value

a. Gain Exclusion and Deferral Implications.

Because previously deferred gain must be recognized by December 31, 2026, the 10% and 15% basis step-up is relevant for only investments made by the end of 2021 and 2019, respectively. Investments made after 2021 can benefit only from gain deferral until December 31, 2026. Each year after December 31, 2021, the value of gain deferral diminishes and the only other potential remaining benefit to an investor is exclusion of any appreciation of the investment if the investment is held for at least 10 years.

Managers of a QOF should be aware of the intent of each investor. For those investors desiring to qualify for exclusion of previously deferred gain or appreciation, managers of a QOF should track the initial investment date and holding periods of each investment to ensure that the requisite holding period is met before such investor disposes of its investment.

b. Limitations of Gain Exclusion.

Because the designation of all qualified opportunity zones will expire on December 31, 2028, prior to the issuance of the proposed regulations, potential investors were concerned that, to achieve exclusion of any appreciation, an investment must be made by December 31, 2018 (*i.e.*, 10 years before the December 31, 2028 expiration of the designated qualified opportunity zones) in order to meet the 10-year holding period. The proposed regulations attempt to address this concern by permitting investments made as late as June 2027 to be eligible for gain exclusion, so long as the gain is eligible gain and is invested within the specified time (generally, 180 days from the sale or exchange generating such gain).

The proposed regulations permit an investor to hold an investment in a QOF until December 31, 2047 and still qualify for exclusion of any appreciation. This allows an investor to hold an investment in a QOF for an additional 10 years beyond the latest that an investor could achieve a 10-year holding period of its investment (*i.e.*, 10 years beyond June 2037). If an investor holds its investment beyond December 31, 2047, exclusion of appreciation is no longer available upon disposition of its investment.

The Treasury and the IRS recognized that the proposed end date of December 31, 2047 is arbitrary and may have unintended consequences. In the preamble to the proposed regulations, the Treasury and the IRS requested comments about how to better align the rule with investors' economic interest. The preamble discusses the possibility of providing for a basis step-up to fair market value immediately before the expiration of the ability to elect to step-up the basis upon disposition. Under this circumstance, the Treasury raises the concern about how one would value the investment at the time of the basis step-up to fair market value.

c. Investment Examples Under Proposed Regulations.

Example 1 (Investment held for at least 7 years and disposed of prior to December 31, 2026):

Facts: In 2018, Investor A invests $100 of eligible gains in QOF in exchange for 100 units of QOF and makes an election to defer the gain under the Opportunity Zone rules. In 2026, Investor A sells all of its 100 units for $120.

Analysis: Investor A is able to defer the $100 gain until 2026, when the investment is sold. Because Investor A held its investment for at least 7 years (but less than 10 years), it can elect to increase its basis by $15 (15% of the previously excluded $100 gain). Investor A will have to recognize $105 of gain upon the sale of its investment in 2026 ($85 of previously deferred gain and $20 of appreciation).

Example 2 (Investment held for at least 10 years):

Facts: In 2020, Investor A invests $100 of eligible gain in QOF in exchange for 100 units of QOF and makes an election to defer the gain under the Opportunity Zone rules. As of December 31, 2026, the fair market value of the 100 units were $110. At the end of 2028, the qualified opportunity zone designation expires for the relevant census tract. In 2031, Investor A sells all of its 100 units for $120.

Analysis: Investor A is able to defer the $100 gain until December 31, 2026, at which point it must recognize $85 of its previously deferred gain. Because Investor A held its investment for at least 7 years on December 31, 2026, it can avoid recognizing $15 of its previously deferred gain by electing to increase its basis by $15 (15% of the previously excluded $100 gain). Although the designation of the qualified opportunity zone expired on December 31, 2028, the proposed regulations permit exclusion of any appreciation to the extent that the investment is held for at least 10 years, but no longer that December 31, 2047. When Investor A sells its investment in 2031, it can exclude the $20 of appreciation from income because it held its investment for at least 10 years and disposed of its investment by December 31, 2047.

Example 3 (Investment made on December 31, 2026, held for at least 10 years, and disposed of prior to December 31, 2047):

Facts: On December 31, 2026, Investor A invests $100 of eligible gains in QOF in exchange for 100 units of QOF and makes an election to defer the gain under the Opportunity Zone rules. At the end of 2028, the qualified opportunity zone designation expires for the relevant census tract. In 2037, Investor A sells all of its 100 units for $120.

Analysis: Investor A is ineligible to defer the $100 gain because Section 1400Z-2 of the Code requires recognition of any deferred gain by December 31, 2026. Investor A's only potential benefit is exclusion of appreciation of its investment. Although the designation of the qualified opportunity zone expired on December 31, 2028, the proposed regulations permit exclusion of any appreciation to the extent that the investment is held for at least 10 years, but no longer that December 31, 2047. When Investor A sells its investment in 2037, it can exclude the $20 of appreciation from income because it held its investment for at least 10 years and disposed of its investment by December 31, 2047.

Example 4 (Investment made on December 31, 2026, held for at least 10 years, and disposed of after December 31, 2047):

Facts: On December 31, 2026, Investor A invests $100 of eligible gains in QOF in exchange for 100 units of QOF and makes an election to defer the gain under the Opportunity Zone rules. In 2048, Investor A sells all of its 100 units for $120.

Analysis: Investor A is ineligible to defer the $100 gain because Section 1400Z-2 of the Code requires recognition of any deferred gain by December 31, 2026. Investor A's only potential benefit is exclusion of appreciation of its investment. Because Investor A sold its investment after December 31, 2047, it's ineligible to exclude any appreciation even though it held its investment for at least 10 years.

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- First Round of Qualified Opportunity Zone Designations Announced
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