TAX ALERT

QUALIFIED OPPORTUNITY ZONE GUIDANCE RELEASED BY TREASURY

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The 2017 Tax Reform Act, commonly referred to as the "Tax Cuts and Jobs Act," created a new tax incentive program designed to spur economic development and job creation in distressed communities by providing tax benefits to those that invest in specified areas known as Qualified Opportunity Zones. The tax incentive is a potential reduction in one's capital gains tax.

On October 19, 2018 the Department of Treasury and the Internal Revenue Service released Proposed Regulations in reference to Qualified Opportunity Zones (QOZ). The Proposed Regulations have provided guidance and clarity on what types of gains would qualify, the time period during which amounts must be invested in a Qualified Opportunity Fund (QOF), and the requirements that must be met by such QOFs to provide deferral for the investors. Taxpayers are permitted to rely on the Proposed Regulations until the final regulations are published.

The IRS and Treasury Department have indicated that additional guidance will be released prior to year-end. This alert will highlight key components of the Proposed Regulations which have generated comments from taxpayers.

Benefits of an investment into a Qualified Opportunity Fund

If a taxpayer realizes gains from the sale or exchange of property and invests some or all of the realized gain into a QOF within 180 days, the QOF investment allows a taxpayer to:

1. Defer those gains from taxable income until the earlier of (a) selling the investment or (b) December 31, 2026;
2. Permanently exclude 10% of the originally-invested gain from taxable income if the investment is held for at least 5 years (5 year period must be met prior to December 31, 2026);
3. Permanently exclude an additional 5% for a total exclusion of 15% of the originally invested gain from taxable income if the investment is held for at least 7 years (7 year period must be met prior to December 31, 2026);
4. Permanently exclude post acquisition appreciation in the investment if the taxpayer holds the investment for a minimum of 10 years.

Initially the taxpayer's basis in the fund is zero. The exclusion described in items two and three above is accomplished through an increase to the basis of the investment. If the investment is held for at least 5 years, the taxpayer's basis is increased by 10% of the deferred gain. If the investment is held for at least 7 years, the taxpayer's basis is increased by another 5% of the deferred gain, totaling 15%.

It is important to note that the law requires only the gain to be reinvested in a QOF, which differs from a Section 1031 "like-kind" exchange that also provides tax deferral treatment through reinvestment; Section 1031 requires total sales proceeds to be reinvested in order to achieve deferral treatment.

Election for investments held at least 10 years

A taxpayer that holds a QOF investment for at least 10 years may elect to increase the basis of the investment to the fair market value on the date the investment is sold or exchanged. The Proposed Regulations clarified that investments that meet the 10-year holding period requirement post December 31, 2026 are eligible for the exclusion as long as they are sold no later than December 31, 2047.

Gains that are eligible for deferral or exclusion

The Proposed Regulations clarify that only "capital gains" for federal income tax purposes are eligible for deferral under IRC Section 1400Z-2. The preamble of the Proposed Regulations state that these gains generally include capital gains 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.

The gain must not arise from a sale or exchange with a related person which, for the purpose of these regulations, means more than a 20% common ownership (instead of 50%).

Who is eligible to make the election?

Individuals, corporations, regulated investment companies, REITS, partnerships and other pass-through entities are eligible for the benefits provided by QOFs.

Special rules for partners of partnerships

The Proposed Regulations provide that, if a partnership does not elect to defer partnership capital gains, a partner may elect to defer the partner's allocable share of such capital gains. The partner's 180-day period with respect to the partner's allocable share of such capital gains generally begins on the last day of the partnership's taxable year, as this is the day on which such gains are included the partner's distributive share of income.

Tax attributes of gains deferred

The Proposed Regulations provide that all the deferred capital gains' tax attributes are preserved. This includes classification of short-term and long-term holding periods, collectibles, Section 1256 Contracts, unrecaptured Section 1250 gain, etc. The taxpayer will report the gains in the year of disposition of the QOF investment in the same manner they would have reported if no deferral election was made. The investment in the QOF does not extend the holding period for gains classification.

Deferral of gain from sale of QOF

The Proposed Regulations provide that a taxpayer who sells their interest in a QOF prior to December 31, 2026 can invest in another QOF and defer the gains associated with the sale by investing within a 180-day period. The taxpayer is required to dispose of its entire initial investment since a taxpayer cannot make a deferral election with respect to a sale or exchange if an election previously made with respect to the same sale or exchange remains in effect.

Eligible investments in a QOF

The Proposed Regulations state that an eligible investment in a QOF must be an equity interest, which can include preferred stock or a partnership interest with special allocations. The "equity interest" can be a combination of eligible gains from sale within 180 days and/or other cash investments. In these instances, the investment is referred to as "investment with mixed funds," and the taxpayer is treated as having made two separate investments consisting of (a) one investment that includes the amount of the investor's deferral election, and (b) one investment consisting of other amounts where QOF tax benefits do not apply.

The term eligible interest excludes any debt instrument within the meaning of IRC Section 1275(a)(1) and Treasury Regulation §1.1275-1(d).

The Proposed Regulations also clarify that deemed contributions of money under IRC Section 752(a) do not result in the creation of an investment in a QOF.

Making the election

Guidance from the IRS indicates that the taxpayer will make the deferral election on Form 8949 which will need to be included with the taxpayer's federal income tax return in the year in which the gains would have been recognized if no election was made.

Guidance in Relation to the Operation of a Qualified Opportunity Fund

Eligible entities

The Proposed Regulations clarify that a QOF must be an entity classified as a corporation or partnership for Federal income tax purposes. In addition, it must be created or organized in one of the 50 States, the District of Columbia, or a U.S. possession. In addition, if an entity is organized in a U.S. possession, but not in one of the 50 States or in the District of Columbia, then it may be a QOF only if it is organized for the purpose of investing in qualified opportunity zone property that relates to a trade or business operated in the possession in which the entity is organized.

Frequently Asked Questions issued by the IRS provide that entities that are formed as Limited Liability Companies can be QOFs.

Valuation and compliance in relation to the 90% asset test

One of the requirements for a qualified opportunity fund is that 90% of its assets must be qualified opportunity zone property. This 90% threshold is calculated by taking the average percentage of QOZ property held in the fund as measured on the last day of the first six-month period of the taxable year of the fund and on the last day of the taxable year of the fund.

The Proposed Regulations provide that for a QOF that has GAAP financials or other financial statements filed with a federal agency, the QOF will use the asset values on those financial statements to determine if the 90% threshold is met. If the QOF does not have financial statements that meets those requirements, the value of its assets for the 90% test is determined based on the costs of the assets.

Purchase of existing building, substantial improvement requirement and land

The Proposed Regulations provide that if a QOF purchased a building on land within a QOZ, the substantial improvement requirement is only measured on the QOF's basis in the building and not the land. To meet the substantial improvement requirement, the QOF will need to make investments with costs that are at least equal to the original allocated basis to the building within any 30-month period beginning after the date of acquisition of the property.

The QOF is not required to make any improvements to the land upon which the building is located.

Working capital safe harbor

The Proposed Regulations, in response to concerns regarding the 90% assets threshold, provide flexibility by creating a working capital safe harbor for QOF investments in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in a QOZ. The safe harbor allows QOZ businesses to maintain reasonable amounts of working capital in cash, cash equivalents or debt instruments with a term of 18 months or less for a period of up to 31 months, if:

1. There is a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone;
2. There is a written schedule consistent with the ordinary business operations of the business, that the property will be used within 31 months; and
3. The business substantially complies with the schedule.

Taxpayers would be required to retain any written plan in their records.

In addition to the above, please see the Mazars Quick Reference Guide on Opportunity Zones for further details.

Many questions remain unanswered and the Treasury Department has already announced that a second set of Proposed Regulations is expected to be issued before year end. For a more in-depth conversation on the Proposed Regulations and the opportunities available through these funds, please contact your Mazars USA LLP professional for additional information.

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