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Treasury Department Releases Proposed Regulations on Opportunity Zones and Attendant Tax Forms

For further information about this *Alert*, please contact:

Richard Shamos, Counsel
212.573.8027 or rshamos@sglawyers.com

Paul Marino, Partner
212.573.8158 or pmarino@sglawyers.com

Alex Gelinas, Partner
212.573.8159 or agelinas@sglawyers.com

Please feel free to discuss any aspect of this *Alert* with your regular Sadis & Goldberg contact or with any of the partners whose names and contact information can be found at the end of the *Alert*.

The Treasury Department on October 19, 2018 released proposed regulations[1] (the "**Proposed Regulations**") related to the investment in qualified opportunity zones ("**Opportunity Zones**"). Designed to spur investment in distressed communities, the 2017 Tax Cuts and Jobs Act created powerful tax incentives for investment in Opportunity Zones, which have now been designated in over 8,000 areas throughout the United States. For information regarding the general aspects of the Opportunity Zone regime, please see our previously released Q&A: The Basics of Qualified Opportunity Funds.

The Proposed Regulations provide guidance on a number of issues related to the Opportunity Zone regime, including:

(1) the scope and treatment of eligible gains;
(2) the treatment of partnerships under the program;
(3) timing considerations for the 10-year step-up in basis; and
(4) the requirements applicable to qualified opportunity funds ("**QOFs**"), including:

(a) the process for certifying as a QOF, and attendant IRS forms;
(b) the valuation of assets for purposes of the 90% Qualifying Asset Test (defined below);
(c) the application of the "substantial improvement" test to real property;
(d) guidance that a qualified opportunity zone business ("**QOZ Business**") will meet the "substantially all" test if 70% of its tangible assets are invested in an Opportunity Zone; and
(e) a safe harbor for working capital that permits cash and cash equivalents held by a QOF to qualify as eligible assets for a period of up to 31 months after launch, subject to certain conditions.

The Treasury will accept comments on the Proposed Regulations for 60 days and has scheduled a public hearing for January 10, 2019 at 10 a.m., after which time the Treasury is expected to release a final version of the regulations. The Proposed Regulations state that they may be applied as proposed to transactions occurring before the finalization of the Proposed Regulations; *provided* that they are applied consistently. In addition, the Treasury has released Revenue Ruling 2018-29 related to the treatment of real estate under the Opportunity Zone program, which is discussed below, and draft Form 8996, on which entities may self-certify as a QOF and provide annual reporting on compliance with the 90% Qualifying Asset Test. Finally, the Treasury has indicated that certain additional guidance regarding the Opportunity Zone regime is expected to be released soon, including the meaning of "substantially all" in the various other instances it appears in the statute, the "reasonable period" for a QOF to reinvest proceeds from the sale of property, the application of the original use provision, and certain other clarifications.

(1) Eligible Gains[2]

The Treasury's Proposed Regulation 1.1400z-2(a)-1(b) includes a number of clarifications related to the treatment and eligibility of gains under the Opportunity Zone program. Notably, the Treasury has taken a restrictive interpretation of the meaning of "gain" as defined in the Internal Revenue Code ("**Code**") section 1400Z-2(a)(1) to mean only income which is treated as a long-term or short-term capital gain under the Code. In reaching its determination that only capital gains would be eligible for deferral under the Opportunity Zone program, the Treasury referred to the legislative history of the statute, stating that the limitation of the benefits to capital gains here was "explicit."[3] This interpretation would preclude ordinary income from sales of inventory and possibly gain recharacterized as ordinary income under various recapture rules in the Code from qualifying. Carried interest which is treated as short-term capital gain under the 2017 tax reform amendments would appear to qualify as eligible gain.

Under Code section 1400Z-2(a)(1)(A), a taxpayer has 180 days to invest in a QOF in order to be eligible to elect a deferral of such capital gain (the "**180-Day Rule**"). Investors are expected to elect to defer an eligible gain on IRS Form 8949 – Sales and Other Dispositions of Capital Assets. For purposes of the 180-Day Rule, the Treasury has clarified that the first day of the period will be the "date on which the gain would be recognized for Federal income tax purposes."[4] The Proposed Regulations include special provisions by which gain recognized by a partnership may flow through to the partners and be reinvested by such partners in a QOF (except to the extent the partnership itself elects to defer such gain by re-investing it in a QOF). In the case of such pass-through gains, the Proposed Regulations permit the partners to measure the 180-day reinvestment period starting on the last day of the partnership's tax year (instead of the date on which the partnership sold the asset). In addition, taxpayers will be permitted to "roll" a deferred gain, by electing to defer the inclusion of a previously deferred capital gain through re-investment of such gain in another QOF. However, where a taxpayer makes multiple investments in a QOF, such investments are required to be realized on a first-in, first-out basis.[5] Finally,

when such gain is realized (after deferral) by the taxpayer, it will retain its previous character (*e.g.*, a deferred short-term capital gain will remain a short-term gain when realized).[6]

The Treasury has also proposed a number of special rules related to section 1256 contracts, which requires taxpayers to aggregate such contracts for reporting purposes and allows only the capital gain net income from such contracts to be deferred.[7] Finally, the Treasury has proposed a rule under which any capital gain which is subject to an offsetting position, such as a straddle, will be ineligible for deferral. "Offsetting-position transaction" is defined in the Proposed Regulations to mean "a transaction in which a taxpayer has substantially diminished the taxpayer's risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (whether or not of the same kind)."[8] As a result, prospective investors in a QOF would need to examine the source of their capital gain (and portfolio as a whole) to assess the risk that such capital gain may be deemed to have arisen in an offsetting-position transaction.

(2) Treatment of Partnerships

The Treasury's Proposed Regulation 1.1400z-2(a)-1(c) includes a number of clarifications on the treatment of partnerships (and their partners) under the Opportunity Zone regime. In particular, where a partnership elects to defer recognition of a gain under the Code, such deferral is deemed to occur at the partnership level, and accordingly, no gain is included in the distributive shares of the partners.[9] Where a partnership does not elect to defer gains, such gains will be included in the partners' distributive shares and subject to tax when realized by the partner.[10] However, if such gain is an eligible gain, the relevant partner would be permitted to make a deferral election with respect to such gain by reinvesting the gain in a QOF.

(3) Investments Held for 10 Years

Under Code section 1400Z-2(c), a taxpayer which makes a deferral election with respect to a gain and holds the relevant Opportunity Zone investment for 10 years receives a step-up in basis of the investment to equal the investment's fair market value (the "**10-Year Rule**"). This provision effectively eliminates any gain which might be realized by an investor upon sale of an interest in a QOF, thereby eliminating any corresponding federal tax liability. Under Proposed Regulation 1.1400z-2(c)-1, the Treasury has made certain clarifications on the availability of the 10-Year Rule. Notably, the Treasury has reiterated that an investor is only eligible with respect to the amount of gain for which a deferral election has been made under Code section 1400Z-2(a)(1).

Since the Opportunity Zone designations currently in effect will expire on December 31, 2028, the Treasury has also provided additional guidance with respect to investments held beyond 2028. In particular, the Treasury regulations permit taxpayers to make a step-up in basis under the 10-Year Rule in respect of an investment in an Opportunity Zone, even if such investment is ultimately sold or disposed of after the Opportunity Zone ceases to exist; *provided* that such sale or disposition occurs prior to December 31, 2047 (i.e., 20½ years after the last date on which an investor may make a deferral election).[11]

(4) Qualified Opportunity Funds ("QOFs")

Proposed Regulation 1.1400Z-2(d)-1 with respect to QOFs includes several significant clarifications on how the Opportunity Zone program will be implemented through investment funds, each of which is discussed below.

(a) Certification as a QOF. The Treasury's Proposed Regulations and guidance notes provide additional clarifications as to the certification process and time considerations for certifying. Notably, an entity may self-certify as a QOF on recently released IRS Form 8996 – Qualified Opportunity Fund, specifying the date of qualification and identifying any penalty applicable to the QOF's assets for each month of the fiscal year.[12] In the event a taxpayer invests in an entity prior to the date on which such entity certifies as a QOF, such investment will not be eligible for deferral, notwithstanding that the investment may otherwise be in compliance with the provisions of the Code.[13]

(b) Valuation of Assets for the 90% Qualifying Asset Test. In order to qualify as a QOF, the Code requires that at least 90% of an entity's assets constitute qualified opportunity zone property (the "**90% Qualifying Asset Test**"),[14] which compliance is required to be reported on IRS Form 8996. Under the Proposed Regulations, QOF assets are required to use the valuations "reported on the QOF's applicable financial statement", or where no financial statement applies, the QOF is required to use the cost of the asset for valuation purposes.[15] Other Proposed Regulations concern specific requirements as to entities qualifying as eligible investments. Notably, corporations will fail to qualify if they have made a repurchase of stock exceeding 5% of the aggregate value at certain times prior to (or after) issuing shares to a QOF, and new entities (both corporations and partnerships) are required to be formed for the purpose of being a qualified opportunity zone business.[16]

(c) "Substantial Improvement" Test. In order for property to constitute qualified opportunity zone business property, such property must meet one of two tests under the Code: either the original use of such property commenced with the QOF (or QOZ Business), or the investment must "substantially improve" such property (the "**Substantial Improvement Test**") among other requirements. Due to uncertainty as to the application of the Substantial Improvement Test to real estate, the Treasury has provided additional guidance that where a QOF purchases a building located on land wholly within an Opportunity Zone, "substantial improvement…is measured by the QOF's additions to the adjusted basis of the building", and the test "does not require the QOF to separately substantially improve the land upon which the building is located."[17] The Treasury has provided further clarification on this issue in Revenue Ruling 2018-29, noting that "given the permanence of land, land can never have its original use in a QOZ commencing with a QOF," but likewise providing that no substantial improvement to the land is required to be made in order for the land to qualify as qualified opportunity zone business property.[18] For financial examples of how this is implemented in practice, taxpayers should consult the Revenue Ruling.

(d) "Substantially All" Tangible Property. In order for a business to qualify as a QOZ Business, substantially all of its tangible property must be qualified opportunity zone business property, as such term is defined in the Code.[19] Pursuant to the Proposed Regulations, the Treasury has clarified that a trade or business will be treated as satisfying the "substantially all" requirement where at least 70% of the tangible property owned or leased by the business is qualified opportunity zone business property.[20]

(e) Working Capital Safe Harbor. A previously unsettled issue for investment funds which invest in Opportunity Zones concerned the treatment of cash held by the QOF for investment during the period

between launch and full deployment of capital, which, particularly in real estate transactions, may require a time period of several years. In the Proposed Regulations, the Treasury has provided a vital safe harbor for working capital that permits a QOF to hold un-invested subscription monies for up to 31 months from launch. In particular, the Proposed Regulations provide that cash, cash equivalents and debt securities with a maturity of less than 18 months that are held by a QOF will to qualify as working capital under the safe harbor, provided that three conditions are met.[21] The three conditions for the safe harbor are as follows:

(i) Designated in writing: the amounts of working capital are designated in writing for the acquisition, construction, and/or substantial improvement of tangible property;

(ii) Reasonable written schedule: there is a written schedule under which the working capital must be spent within 31 months of the QOF's receipt of such assets; and

(iii) Property consumption consistent: the working capital is actually used in a manner consistent with the above.[22]

In addition to the foregoing, income received by the QOF from working capital which qualifies for the safe harbor will count as gross income derived from the active conduct of a business within an Opportunity Zone, for purposes of meeting the 50% requirement under Code section 1397(c)(b)(2) (which is incorporated by reference in the definition of QOZ Business).[23] Accordingly, fund managers seeking to launch a QOF should familiarize themselves with the working capital safe harbor requirements and ensure that written plans for the deployment of capital are drafted at or prior to the time that offering documents are distributed to investors.

With decades of experience in structuring private fund vehicles and experts in fund structuring, real estate and international taxation, the financial services team at Sadis stands ready to guide you through any concerns relating to structuring of a QOF, executing an Opportunity Zone investment strategy, and handling any tax and commercial considerations. For more information regarding Opportunity Zones, please reach out to one of our practice contacts.

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[1] A copy of the proposed guidelines may be obtained at https://www.irs.gov/pub/irs-drop/reg-115420-18.pdf

[2] Proposed Regulation 1.1400z-2(a)-1(b).

[3] Proposed Regulation, Section I.A.

[4] Proposed Regulation 1.1400z-2(a)-1 (b)(5).

[5] *Id.*, (b)(6).

[6] *Id.*, (b)(5)

[7] *Id.*, (b)(2)(iii).

[8] *Id.*, (b)(2)(iv).

[9] *Id.*, (c)(1)(i).

[10] *Id.*, (c)(1)(ii).

[11] Proposed Regulation 1.1400z-2(c)-1(b).

[12] 1.1400Z-2(d)-1(a). The Treasury expects to issue proposed regulations regarding the application of penalties in the near future.

[13] Proposed Regulation 1.1400z-2(d)-1 (a)(iii)(B)

[14] Section 1400Z-2(d)(1).
[15] Proposed Regulation 1.1400Z-2(d)-1 (b)(1) and (2).
[16] *Id.*, (c)(2) and (3).
[17] *Id.*, (c)(8).
[18] Revenue Ruling 2018-29, pp. 3-4.
[19] Section 1400Z-2(d)(3)(A).
[20] Proposed Regulation 1.1400Z-2(d)-1 (d)(3).
[21] *Id.*, (d)(5)(iv).
[22] *Id.*
[23] *Id.*, (d)(5)(v).

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Please feel free to discuss any aspect of this *Alert* with your regular Sadis & Goldberg contact whose names and contact information are provided below.

Alex Gelinas, 212.573.8159, agelinas@sglawyers.com
Daniel G. Viola, 212.573.8038, dviola@sglawyers.com
Danielle Epstein-Day, 212.573.8416, depstein@sglawyers.com
Douglas Hirsch, 212.573.6670, dhirsch@sglawyers.com
Eliott Frank, 212.573.8148, efrank@sglawyers.com
Erika Winkler, 212.573.8022, ewinkler@sglawyers.com
Greg Hartmann, 212.573.8030, ghartmann@sglawyers.com
Jeffrey Goldberg, 212.573.6666, jgoldberg@sglawyers.com
Jennifer Rossan, 212.573.8783, jrossan@sglawyers.com
Mitchell Taras, 212.5738417, mtaras@sglawyers.com
Paul Fasciano, 212.573.8025, pfasciano@sglawyers.com
Paul Marino, 212.573.8158, pmarino@sglawyers.com
Richard L. Shamos, 212.573.8027, rshamos@sglawyers.com
Robert Cromwell, 212.573.8034, rcromwell@sglawyers.com
Ron S. Geffner, 212.573.6660, rgeffner@sglawyers.com
Sam Lieberman, 212.573.8164, slieberman@sglawyers.com
Steven Huttler, 212.573.8424, shuttler@sglawyers.com
Yehuda Braunstein, 212.573.8029, ybraunstein@sglawyers.com
Yelena Maltser, 212.573.8429, ymaltser@sglawyers.com

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