ALERT

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New Proposed Regulations on Opportunity Zone Reinvestment

October 25, 2018

Since the Qualified Opportunity Zone program was originally announced in 2017 Tax Act, investors, funds, developers, and businesses have been anxiously awaiting the issuance of guidance by the Department of Treasury ("**Treasury**"). On Friday, October 19, 2018, Treasury issued guidance, including Proposed Regulations and a Revenue Ruling. While the Proposed Regulations do not answer all of the substantive questions underlying the program, they do address some of the more significant ones.

Under the program, individuals and companies can

- **defer tax of the gain** from the sale of an asset until 2026, or sale of the investment, if earlier;
- **reduce the gain that is taxed** by up to 15%; and
- **pay no tax on additional appreciation** of the investment if held for 10 years.

As we have previously discussed, in order to qualify for these benefits, a handful of requirements must be met. The Proposed Regulations provide the following guidance:

Gains Eligible for Deferral

While many practitioners anticipated that the legislation applied solely to "capital gains," as opposed to all "gains," the Proposed Regulations make it clear that deferral is limited to "capital gains." The Proposed Regulations also make clear that the attributes of any deferred gain will be retained through recognition. Therefore, if the gain would have been "short-term capital gain" absent deferral under the program, it would remain "short-term capital gain" upon recognition.

Eligible Taxpayers

Eligible taxpayers include: (1) individuals, (2) corporations (*i.e.*, C corporations, S corporations, RICs, and REITs), (3) partnerships, and (4) trusts and estates.

Gains of Pass-Through Entities

A pass-through entity may elect to defer all (or part) of a capital gain. If such an election is made, then the pass-through entity will not include such deferred gain in the partners' distributive shares. If the partnership does not make an election, each partner is independently eligible to elect to defer gain on his or her distributive share. In such case, the partner can either elect within 180-days after the last day of

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the partnership's tax year, or within 180-days after the date the partnership recognizes capital gain.

Qualified Opportunity Funds
A qualifying corporation or partnership, including limited liability company may self-certify that it is a Qualified Opportunity Fund (a "**Fund**") using Form 8996, which is filed with its tax return. The self-certification may specify the first month in which it elects to be treated as a Fund. If a Fund fails to specify, then the default will be the first month of the Fund's initial taxable year. Importantly, any investment prior to the first month of a Fund's initial taxable year will not be eligible for gain deferral.

As noted in our prior article, a Fund must hold at least 90% of its assets (the "**90% Test**") in Qualified Opportunity Zone Property, which can be either: (A) tangible property used in the business of the Fund ("**Qualified Opportunity Zone Business Property**"), or (B) stock in a corporation or an interest in a partnership which is a Qualified Opportunity Zone Business.

This 90% Test is assessed at the end of the first 6 month period and last day of each taxable year. The Proposed Regulations also clarify that, with respect to the first taxable year of a Fund, the phrase "first 6-month period of the taxable year of the fund means the first 6 months each of which is in the taxable year." Therefore, for example, if a partnership becomes a Fund on April 1, the 90% Test takes into account a Fund's assets on September 30 and again on the last day of the taxable year. Finally, for purposes of the 90% Test, a Fund will use the asset values reported on its applicable financial statement for the taxable year. If a Fund has no applicable financial statement, the Fund uses the cost of its assets.

Qualified Opportunity Zone Business Property
Qualified Opportunity Zone Business Property must be (i) acquired by purchase by a Fund, (ii) the original use of the property in the Qualified Opportunity Zone commences with the Fund, or the Fund *substantially improves* the property, and (iii) during substantially all of the property's holding period, substantially all the use of the property is in the Qualified Opportunity Zone.

The Proposed Regulations provide that "substantial improvement" will be measured solely by reference to the addition to the adjusted basis of the building, not the building and land. Therefore, for example, if a building that was acquired had a basis of $100, and the land on which it sat had a basis of $200, then "substantial improvement" would only require $101 in improvements to the building, as opposed to $151 in improvements to the building and land.

Qualified Opportunity Zone Business

Substantially All Requirement
A Qualified Opportunity Zone Business is a business "in which *substantially all* of the tangible property owned or leased" is Qualified Opportunity Zone Property. The Proposed Regulations clarify that the "substantially all" requirement is satisfied if at least 70% of the tangible property is held in the Qualified Opportunity Zone.

5% Limit on Investment Assets
In order to qualify as a Qualified Opportunity Zone Business, less than 5% of the property of the business may constitute debt, stock, partnership interests, options, warrants, or other similar property, but excludes reasonable amounts of working capital held in cash or cash equivalents. The Proposed Regulations provide that working capital is reasonable with respect to the acquisition, construction, or rehabilitation of tangible property if (1) the intended uses are designated in writing, (2) there is a reasonable written schedule for expenditure within 31 months, and (3) the working capital is actually used in a manner substantially

consistent with the designated uses and written schedule.

Other Aspects

Previously, investors were concerned that their investments would need to be made prior to 2019 in order to take full advantage of all of the benefits offered by the program because Qualified Opportunity Zone designations expire on December 31, 2028. In order to allay this concern, Treasury provided that the ability to make the 10-year basis step-up election at sale will extend beyond the termination of a Qualified Opportunity Zone's designation. In particular, this benefit will be preserved until Dec. 31, 2047.

The Revenue Ruling issued with the Proposed Regulations (Rev. Rul. 2018-29) stands for several propositions. First, that the original use of an existing building cannot commence with a Fund, but instead requires substantial improvement. Second, the value of the land is not factored into the determination of substantial improvement. Instead, substantial improvement is measured solely based on a Fund's additions to the adjusted basis of the building. Finally, a Fund is not required to substantially improve the land upon which the building is located.

To learn more about this new tax saving opportunity, please contact James E. Duffy at (612) 977-8626 or jduffy@briggs.com, or Dimitrios C. Lalos at (612) 977-8830 or dlalos@briggs.com, or another member of our tax department. It is important to note that the foregoing summary is provided for general advice; but should not be considered legal advice that can be relied upon by any specific taxpayer without further consultation with their tax attorney or tax accountant.