

# Tax Update

## Treasury Issues Proposed Regulations on Opportunity Zones

October 29, 2018

### I. Introduction

On October 19, 2018, the Internal Revenue Service (the “**IRS**”) and the Treasury Department issued proposed regulations relating to the new Opportunity Zone program.<sup>1</sup> The Opportunity Zone program is intended to encourage investments in economically distressed qualified opportunity zones (“**QOZs**”) by allowing taxpayers to defer and, in some cases, reduce or eliminate tax on capital gains if they reinvest their gains within 180 days in qualified opportunity funds (“**QOFs**”), which, in turn, generally are required to invest at least 90% of their assets in (1) certain business property located in a QOZ (“**QOZ Business Property**”) and/or (2) equity in certain entities that hold QOZ Business Property (“**QOZ Subsidiaries**” and, together with QOZ Business Property, “**QOZ Property**”).

The proposed regulations offer helpful guidance on several issues relating to the Opportunity Zone program. However, a number of questions remain unanswered, and the preamble to the proposed regulations indicates that the IRS and the Treasury Department intend to issue additional guidance, including additional proposed regulations, in the near future.

Part II of this memorandum provides an overview of the Opportunity Zone program, as modified by the proposed regulations. Part III summarizes some of the most important aspects of the proposed regulations.

### II. Overview of the Opportunity Zone Program

#### A. In General

Under the Opportunity Zone program, if a taxpayer realizes capital gain on a sale of appreciated assets to an unrelated person and reinvests the capital gain in a QOF within 180 days of the date

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<sup>1</sup> The Opportunity Zone program appears in sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code (the “**Code**”), and was codified as part of the Tax Cuts and Jobs Act of 2017.

that the taxpayer would otherwise recognize the gain for U.S. tax purposes,<sup>2</sup> then the following tax incentives are available to the taxpayer:

- **Tax deferral.** The taxpayer may elect to defer tax on the gain until the earlier of (1) the date that the taxpayer disposes of the QOF and (2) December 31, 2026 (collectively, the “**First Recognition Date**”).<sup>3</sup>
- **Tax reduction.** The amount of gain that the taxpayer is required to recognize on the First Recognition Date is reduced by:
  - 10% if the taxpayer has, at that time, held the QOF for at least five years, or
  - 15% if the taxpayer has, at that time, held the QOF for at least seven years.<sup>4</sup>

In addition, the amount of any gain that the taxpayer is required to recognize if the taxpayer disposes of the QOF after December 31, 2026 (the “**Second Recognition Date**”) is reduced by:

- any gain that the taxpayer recognized on the First Recognition Date, and
- (x) 10% of the originally deferred gain if the taxpayer has, as of the Second Recognition Date, held the QOF for at least five years, or (y) 15% of the originally deferred gain if the taxpayer has, as of the Second Recognition Date, held the QOF for at least seven years.<sup>5</sup>
- **Tax-free appreciation.** Finally, if the taxpayer has held the QOF for at least 10 years on the Second Recognition Date, then the taxpayer is not required to recognize any gain in respect of the QOF.<sup>6</sup>

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<sup>2</sup> As discussed in Part III of this memorandum, the proposed regulations modify the 180-day period for partners in a partnership. In addition, the proposed regulations provide that the 180-day period for regulated futures contracts and other “section 1256 contracts” begins on the last day of a taxpayer’s taxable year. Taxpayers generally may defer only the capital gain net income from section 1256 contracts on an aggregate basis (and not on a per-contract basis) for each taxable year. Taxpayers also generally may not defer gain from any position that is or has been part of an offsetting-positions transaction (generally, a transaction in which a taxpayer has substantially diminished its risk of loss from holding one position by holding one or more other positions). Proposed Treasury regulations section 1.1400Z-2(a)-1(b)(2).

<sup>3</sup> Section 1400Z-2(b)(1). The preamble to the proposed regulations provides that the taxpayer makes the deferral election on IRS Form 8949, which the taxpayer attaches to its U.S. federal income tax return for the taxable year in which the taxpayer would have recognized the gain in the absence of Section 1400Z-2(b)(1).

<sup>4</sup> Section 1400Z-2(b)(2)(A). The proposed regulations provide that any gain recognized on the First Recognition Date has the same “attributes” as the deferred gain would have had. Proposed Treasury regulations section 1.1400Z-2(a)-1(b)(5). The proposed regulations also adopt a first-in, first-out (“**FIFO**”) approach to gain recognition if a taxpayer sells less than all of its interest in a QOF before December 31, 2026.

<sup>5</sup> Section 1400Z-2(b)(2)(B).

<sup>6</sup> Section 1400Z-2(c). Under section 1400Z-1(f), a census tract’s designation as a QOZ terminates no later than December 31, 2028. The proposed regulations would clarify that, notwithstanding this termination, tax-free appreciation under section

For example, assume that a taxpayer recognizes \$100 of capital gain on a sale of appreciated securities on December 31, 2018. If the taxpayer invests the \$100 in a QOF on or before June 1, 2019, then the taxpayer may elect to defer paying tax on the \$100. If the taxpayer holds the QOF until December 31, 2026, then, at that time, the taxpayer must recognize \$85 of gain (*i.e.*, \$100 deferred gain less 15% of \$100). If the taxpayer sells the QOF for \$200 in 2027, then the taxpayer is required to recognize only \$100 of additional gain (*i.e.*, \$200 amount realized, less \$85 gain recognized on the First Recognition Date, less \$15 basis step-up). If, instead, the taxpayer sells the QOF for \$200 in 2030 (*i.e.*, at least 10 years after its investment in the QOF), then the taxpayer is not required to recognize any additional gain on the sale.

## B. Qualified Opportunity Funds

### 1. In General

At the heart of the Opportunity Zone program is the concept of QOZs, which are low-income census tracts nominated by governors and certified by the Treasury Department.<sup>7</sup> There are currently over 8,700 QOZs in all 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands.

An entity that is organized in the United States or a U.S. possession and is treated as a corporation or partnership for U.S. tax purposes generally is eligible to be a QOF if at least 90% of its assets consist of QOZ Property.<sup>8</sup>

Under the proposed regulations, an entity self-certifies as a QOF by filing IRS Form 8996 with its U.S. tax return.<sup>9</sup> In connection with issuing the proposed regulations, the IRS and the Treasury Department published a draft of IRS Form 8996.<sup>10</sup>

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1400Z-2(c) continues to be available until December 31, 2047. A taxpayer is eligible for tax-free appreciation only with respect to an investment in a QOF that it made with deferred capital gains. Proposed Treasury regulations section 1.1400Z-2(c)-1(a).

- <sup>7</sup> The Economic Innovation Group has published a helpful interactive map of opportunity zones, which is available at <https://eig.org/opportunityzones>. For further opportunity zone resources, see <https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx>.
- <sup>8</sup> Section 1400Z-2(d). Under the proposed regulations, a QOF may be organized in a U.S. possession only if its purpose is to invest in QOZ Property that relates to a trade or business operated in that U.S. possession. Proposed Treasury regulations section 1.1400Z-2(d)-1(e).
- <sup>9</sup> Proposed Treasury regulations section 1.1400Z-2(d)-1(a). Under the proposed regulations, a pre-existing entity may become a QOF; however, taxpayers that invested their capital gains in the entity before it became a QOF are not eligible to defer any taxes with respect to those capital gains. Proposed Treasury regulations section 1.1400Z-2(d)-1(a)(3); Proposed Treasury regulations section 1.1400Z-2(d)-1(a)(1)(iii)(B).
- <sup>10</sup> The draft is available at <https://www.irs.gov/pub/irs-dft/f8996--dft.pdf>.

## 2. 90% Asset Test

The 90% asset test is a semi-annual test based on the average of the percentage of QOZ Property that the QOF holds.<sup>11</sup> In addition, if the QOF fails to satisfy the asset test at the end of any one month, it is subject to a penalty equal to (1) the excess of 90% of its assets over the amount of its QOZ Property, multiplied by (2) the federal short-term rate plus 3%, unless the failure is due to reasonable cause.<sup>12</sup>

Under the proposed regulations, a QOF generally must determine the value of its assets by reference to financial statements that the QOF files with the U.S. Securities and Exchange Commission or another U.S. federal agency, or other audited financial statements that are prepared in accordance with U.S. GAAP. If the QOF does not have any such financial statements, then it must use the cost of its assets.<sup>13</sup>

## 3. QOZ Business Property

As mentioned above, QOZ Property includes QOZ Business Property and equity interests in QOZ Subsidiaries. Tangible property generally qualifies as QOZ Business Property if:

- the property is used in a trade or business;
- the QOF or a QOZ Subsidiary acquires the property from an unrelated person after 2017;
- the property's original use commenced with the QOF or a QOZ Subsidiary, or the QOF or a QOZ Subsidiary substantially improved the property; and
- substantially all of the use of the property is in a QOZ during the QOF's or QOZ Subsidiary's holding period.<sup>14</sup>

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<sup>11</sup> Section 1400-2(d)(1). The proposed regulations would clarify that the first six-month period of a QOF's first taxable year is the first six-month period within that taxable year during which the QOF qualifies as a QOF. Proposed Treasury regulations section 1.1400Z-2(d)-1(b). Accordingly, if (for example) a calendar-year entity chooses a month after June as the first month for which it qualifies as a QOF, then its only testing date for that taxable year is December 31.

<sup>12</sup> Section 1400Z-2(f).

<sup>13</sup> Proposed Treasury regulations section 1.1400Z-2(d)-1(b).

<sup>14</sup> Section 1400Z-2(d)(2)(D). Neither the Code nor the proposed regulations define "substantially all" in this context, although they do define the phrase in an analogous context, as discussed in Part III of this memorandum. The preamble to the proposed regulations notes that the phrase "substantially all" appears several times in section 1400Z-2 of the Code, and requests comments on how the phrase should be interpreted.

For this purpose, a QOF or QOZ Subsidiary generally is treated as having “substantially improved” property if, within 30 months of acquiring the property, its capital expenditures with respect to the property exceed its cost basis in the property.<sup>15</sup>

#### 4. QOZ Subsidiaries

An entity generally qualifies as a QOZ Subsidiary if:

- the entity is treated as a domestic corporation or domestic partnership for U.S. tax purposes;
- the QOF acquired equity interests in the entity from the entity,<sup>16</sup> solely in exchange for cash, after 2017; and
- both at the time that the QOF acquired the equity interests, and for substantially all of the QOF's holding period, the entity was engaged in a qualified opportunity zone business (a “**QOZ Business**”).<sup>17</sup>

A QOZ Subsidiary generally is treated as being engaged in a QOZ Business if:

- “substantially all” of the tangible property that the QOZ Subsidiary owns or leases is QOZ Business Property (and, for this purpose, the proposed regulations define “substantially all” as 70%);<sup>18</sup>
- at least 50% of the QOZ Subsidiary's gross income is from the active conduct of the business;
- a substantial portion of the QOZ Subsidiary's intangible property is used in the active conduct of the business;
- less than 5% of the average of the aggregate unadjusted bases of the QOZ Subsidiary's property is attributable to certain “nonqualified financial property”;<sup>19</sup> and

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<sup>15</sup> Section 1400Z-2(d)(2)(D)(ii). As discussed in Part III of this memorandum, Revenue Ruling 2018-29, which was issued along with the proposed regulations, provides a safe harbor with respect to substantial improvements of existing buildings purchased with land.

<sup>16</sup> In the case of a corporate entity, the QOF must acquire the equity interests at original issue either directly or through an underwriter. Section 1400Z-2(d)(2)(B)(i)(I).

<sup>17</sup> Section 1400Z-2(d)(2)(B)-(C). Under the proposed regulations, a QOZ Subsidiary may be organized in a U.S. possession only if it conducts a QOZ Business in the U.S. possession. Proposed Treasury regulations section 1.1400Z-2(d)-1(e).

<sup>18</sup> Part III of this memorandum discusses the proposed regulations' definition of “substantially all” in this context. Tangible property that ceases to be QOZ Business Property will nevertheless continue to be treated as QOZ Business Property for five years or until the QOZ Subsidiary disposes of the property. Section 1400Z-2(d)(3)(B).

<sup>19</sup> Nonqualified financial property generally means debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities, and other similar property, other than reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less, or accounts receivable acquired in the ordinary course of a trade or business. Section 1397C(e). As discussed in Part III of this memorandum, the proposed regulations provide a safe harbor under which a QOZ Subsidiary may exclude certain working capital from the

- the QOZ Subsidiary's trade or business does not comprise certain "sin businesses."<sup>20</sup>

### III. Summary of Proposed Regulations

Some of the most important aspects of the proposed regulations are:

- **70% asset safe harbor.** An entity qualifies as a QOZ Subsidiary only if, among other things, "substantially all" of the tangible property that it owns or leases constitutes QOZ Business Property.<sup>21</sup> The proposed regulations define "substantially all" in this context to mean at least 70%.<sup>22</sup> Accordingly, if 90% of a QOF's direct holdings constitute equity interests in QOZ Subsidiaries and each QOZ Subsidiary invests 70% of its assets in QOZ Business Property, then the QOF can still satisfy its 90% asset test, even though only 63% of its aggregate direct and indirect holdings constitute QOZ Business Property (*i.e.*, 70% of 90% is 63%).
- **Working capital safe harbor.** As mentioned in Part II of this memorandum, the Code generally limits a QOZ Subsidiary's ability to hold certain "nonqualified financial property." The proposed regulations provide a safe harbor under which a QOZ Subsidiary may exclude working capital (*i.e.*, cash, cash equivalents, and debt instruments with a term of 18 months or less) from the definition of "nonqualified financial assets," so long as (1) the working capital is designated in writing for the acquisition, construction, and/or substantial improvement of tangible property in a QOZ, (2) there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital within 31 months of receipt, and (3) the working capital is actually used in a manner that is substantially consistent with the written designation and schedule.<sup>23</sup> Moreover, under the proposed regulations, any tangible property that is being acquired, constructed, and/or substantially improved with this working capital and that is expected to qualify as QOZ Business Property by the end of the 31-month safe harbor

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definition of "nonqualified financial assets," and treat as QOZ Business Property any tangible property that is being acquired, constructed, and/or substantially improved with that working capital.

<sup>20</sup> Section 1400Z-2(d)(3). "Sin businesses" are private or commercial golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, racetracks or other facilities used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises. Section 144(c)(6)(B).

<sup>21</sup> Section 1400Z-2(d)(3).

<sup>22</sup> Proposed Treasury regulations section 1.1400Z-2(d)-1(d)(3). This percentage must be calculated by reference to financial statements that the QOZ Subsidiary files with the U.S. Securities and Exchange Commission or another U.S. federal agency, or other audited financial statements that are prepared in accordance with U.S. GAAP. If the QOZ Subsidiary does not have any such financial statements, then it generally must use the methodology used by any 5% owner that is a QOF and that produces the highest percentage of QOZ Business Property for the QOZ Subsidiary. Proposed Treasury regulations section 1.1400Z-2(d)-1(d)(3).

<sup>23</sup> Proposed Treasury regulations section 1.1400Z-2(d)(5)(iv). Any income on this working capital also would count toward satisfying the 50% gross income test described above. Proposed Treasury regulations section 1.1400Z-2(d)-1(d)(5)(v).

period generally qualifies as QOZ Business Property that is used in the active conduct of a trade or business during that period.<sup>24</sup>

- **Safe harbor for improved property.** Tangible property qualifies as QOZ Business Property only if (1) its “original use” begins with the QOF or a QOZ Subsidiary or (2) within 30 months of acquiring the property, the QOF’s or QOZ Subsidiary’s capital expenditures with respect to the property exceed its cost basis in the property.<sup>25</sup> Under Revenue Ruling 2018-29, which was issued along with the proposed regulations, if a QOF or QOZ Subsidiary purchases an existing building located on land within a QOZ, then (1) the “substantial improvement” test applies only with respect to the amount of cost basis attributable to the building (and the amount of cost basis attributable to the land is disregarded), and (2) if the “substantial improvement” test is satisfied, then the entire cost basis (including cost basis attributable to the land), as well as the cost of the improvements, qualify as QOZ Business Property. The preamble to the proposed regulations suggests that vacant land is not QOZ Business Property, but requests comments in this regard.
- **Use of QOF equity as collateral.** Under the proposed regulations, only an investment in QOF equity (including preferred stock or a partnership interest with special allocations) may entitle a taxpayer to tax deferral.<sup>26</sup> However, taxpayers may pledge QOF equity as collateral for a loan without jeopardizing their Opportunity Zone tax benefits.<sup>27</sup>
- **Eligible gains.** The proposed regulations clarify that only capital gains (long-term or short-term) are eligible to be deferred under the Opportunity Zone program.<sup>28</sup>
- **Partnership investors.** Under the proposed regulations, a partnership is eligible to elect to defer its capital gain by investing in a QOF.<sup>29</sup> If the partnership does not so elect, then each partner may make its own election to defer its distributable share of the capital gain. For purposes of any partner-level election, the 180-day period to invest in a QOF begins on the last day of the partnership’s taxable year, unless the partner elects for the period to begin on the date that the asset is sold.
- **Effective Date.** The proposed regulations generally are proposed to be effective on or after the date that they are finalized. However, taxpayers and QOFs currently may rely on a number of the

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<sup>24</sup> Proposed Treasury regulations section 1.1400Z-2(d)-1(d)(5)(vii)-(viii).

<sup>25</sup> Section 1400Z-2(d)(2)(D)(ii).

<sup>26</sup> Proposed Treasury regulations section 1.1400Z-2(a)-1(b)(3)(i).

<sup>27</sup> Proposed Treasury regulations section 1.1400Z-2(a)-1(b)(3)(ii).

<sup>28</sup> Proposed Treasury regulations section 1.1400Z-2(a)-1(b)(2)(i)(A).

<sup>29</sup> Proposed Treasury regulations section 1.1400Z-2(a)-1(c).

rules in the proposed regulations, so long as they apply the rules in their entirety and in a consistent manner.

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Please contact any member of Cadwalader's Tax Department with any questions.

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