Federal Opportunity Zones: new IRS guidance

A discussion about the newly released IRS guidance addressing Opportunity Zone tax benefits

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Building a better working world

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Opportunity Zones introduction

- Background:
  - Opportunity Zones were created through the Tax Cuts and Jobs Act and codified in Internal Revenue Code (IRC) Sections 1400Z-1 and 1400Z-2.
  - Opportunity Zones are designed to incentivize long-term investments in economically distressed communities.
  - Taxpayers receive preferential tax treatment in return for investing capital gain in Opportunity Zones through investment vehicles called Opportunity Funds.
  - Many potential Opportunity Zone investors and Opportunity Fund managers have been waiting for guidance before transacting.
- Update:
  - On October 19, 2018, the IRS published proposed regulations (REG-115420-18), a revenue ruling (Revenue Ruling 2018-29) and an update to its FAQ page clarifying certain key aspects of Opportunity Zone tax benefits.
- Animated video: https://go.ey.com/OZ

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Capital gain

- Receiving any Opportunity Zone tax benefits begins with investing capital gain into an Opportunity Fund.
- The capital gain must stem from a sale or exchange with an unrelated party that occurred within the previous 180 days.
- Investing other money alongside capital gain is permissible, but only the capital gain portion of the investment will give rise to tax benefits.

Step 1: Realize capital gain

Taxpayer realizes capital gain from a capital gain triggering event (e.g., taxpayer sells corporate stock).

Step 2: Invest capital gain

Taxpayer creates (or finds) an Opportunity Fund and invests capital gain into the Opportunity Fund within 180 days.

Opportunity Funds

- Opportunity Funds are investment vehicles organized as corporations or partnerships, created for the purpose of investing in Opportunity Zones.
- Opportunity Funds must be self-certified.
- Opportunity Funds must hold at least 90% of their assets in Opportunity Zone property, calculated by averaging the percentage invested at the midpoint and endpoint of the Opportunity Fund’s fiscal year.

Step 3: Opportunity Fund invests in Opportunity Zone property

Taxpayer cannot invest in Opportunity Zone property directly. All investments must be through Opportunity Funds.

Opportunity Zone property (part 1)

- Opportunity Funds can acquire two types of Opportunity Zone property:
  - Opportunity Zone business property
  - Opportunity Zone stock or partnership interest
- Opportunity Zone business property:
  - It must be tangible property, such as real estate or equipment, acquired from an unrelated party after December 31, 2017.
  - During "substantially all" of the Opportunity Fund's holding period of the property, the property must be used within an Opportunity Zone.
    - The Community Development Financial Institutions (CDFI) Fund provides a mapping tool for identifying designated Opportunity Zones: https://www.cims.cdfifund.gov/preparation/?config=config_nmtc.xml
  - Either the "original use" of the property in the Opportunity Zone must be with the Opportunity Fund or the Opportunity Fund must "substantially improve" the property within 30 months.

Opportunity Zone property (part 2)

- Opportunity Zone stock or partnership interest:
  - It must be stock or a partnership interest in a domestic company, acquired with cash after December 31, 2017.
  - Upon acquisition and during “substantially all” of the Opportunity Fund’s holding period of the investment, the company must be considered an Opportunity Zone business.
- Opportunity Zone businesses:
  - “Substantially all” of the business’s owned or leased tangible property must meet the requirements for Opportunity Zone business property.
  - At least 50% of the business’s total gross income must be derived from the “active conduct” of the business.
  - A “substantial portion” of the business’s intangible property must be used in the “active conduct” of the business.
  - Less than 5% of the average bases of the business’s property is attributable to nonqualified financial property (e.g., stocks).
  - The business cannot be a “sin business,” such as a country club, hot tub facility, racetrack or liquor store.

Tax benefits

- Upon investment of capital gain into an Opportunity Fund, the invested gain is deferred from inclusion in the taxpayer's gross income until the earlier of the taxpayer selling the Opportunity Fund investment or December 31, 2026.
- When the deferral period expires, if the Opportunity Fund investment was held for 5+ years, the gain included in gross income is reduced by 10%; if the investment was held for 7+ years, the gain included in gross income is reduced by 15%.

Step 4: Tax deferral

Investment of capital gain → tax bill deferred until December 31, 2026 at the latest.

Step 5: 10% tax reduction

Taxpayer holds fund investment for 5+ years → 10% tax bill reduction.

Step 6: 15% tax reduction

Taxpayer holds fund investment for 7+ years → 15% tax bill reduction.

Tax benefits

- When the taxpayer eventually exits the Opportunity Fund, if the Opportunity Fund investment was held for 10+ years, the taxpayer is permanently exempt from paying capital gains tax on gain realized from the sale of the Opportunity Fund investment.

Step 7: Pay tax deferral bill

In 2026, taxpayer pays for the tax bill in relation to the deferred gain.

Step 8: Tax exemption

Taxpayer holds fund investment for 10+ years → no taxes on capital gain from appreciation of fund investment.

What “gain” is eligible?

IRC Section 1400Z-2

- The title of IRC Section 1400Z-2 is, “Special Rules for Capital Gains Invested in Opportunity Zones,” but the body of IRC Section 1400Z-2 refers to “gain” without the word “capital” or other qualifications.
- The legislative history indicated that eligible gain may have been limited to long-term capital gain.

Ambiguity

- The statute does not specify what types of “gain” a taxpayer can invest into an Opportunity Fund in order to receive tax benefits.

Proposed regulations

- The proposed regulations clarify that gain is eligible if it is “treated as a capital gain for federal income tax purposes.”

IRC Section 1256 contracts and offsetting positions transactions

IRC Section 1400Z-2

- IRC Section 1400Z-2 does not address how to treat gain from when taxpayers “mark to market” positions in Section 1256 contracts.

Proposed regulations

- If at any time during the tax year, the taxpayer was part of an offsetting positions transaction where any of the positions was a Section 1256 contract and any other position was not a Section 1256 contract, then no gain from any Section 1256 contract is eligible for the taxpayer in that year. Additionally, any capital gain resulting from an offsetting positions transaction is not eligible gain, unless all of the positions in the transaction were Section 1256 contracts.

Deferred capital gain

IRC Section 1400Z-2

- IRC Section 1400Z-2 does not address how to determine the attributes of deferred capital gain upon the expiration of the deferral period.
- IRC Section 1400Z-2 does not provide for how taxpayers will make deferral elections.

Proposed regulations

- All tax attributes are preserved through the deferral period and are taken into account when the deferred gain is included in gross income.
- When a taxpayer disposes of a portion of its fungible interests in an Opportunity Fund and cannot readily determine the tax attributes of the gain being recognized, the proposed regulations provide that the taxpayer should apply the first-in, first-out (FIFO) method. To the extent that FIFO does not provide a complete answer, then the taxpayer should apply a pro rata method.
- Taxpayers will make deferral elections on Form 8949.

Who is the “taxpayer”?

IRC Section 1400Z-2

- IRC Section 1400Z-2 states that if a “taxpayer” has gain from the sale or exchange of its property, then the “taxpayer” can defer including the gain by making an election and investing into an Opportunity Fund.

Ambiguity

- The statute does not define “taxpayer.”
- In the context of a partnership having gain from selling property, is the “taxpayer” the partnership or the partners?

Who is the "taxpayer"?

Proposed regulations
▸ The proposed regulations provide that "eligible taxpayers include individuals; C corporations, including regulated investment companies (RICs) and real estate investment trusts (REITs); partnerships; S corporations; trusts and estates."
▸ The regulations further provide that a partnership can elect to defer all or some of the capital gain. The invested/deferred gain is not included in the distributive shares of the partners under Section 702 and is not subject to Section 705(a)(1).
▸ Any gain that the partnership does not elect to defer will be included in the partners' distributive shares under Section 702 and subject to Section 705(a)(1). Each partner may then elect deferral with respect to its distributive share.

How much time do partners have to invest?

IRC Section 1400Z-2

- IRC Section 1400Z-2 states that gain must be invested into an Opportunity Fund "during the 180-day period beginning on the date of such sale or exchange" of the taxpayer's property.

Ambiguity

- The statute does not address whether partners receiving a distributive share of gain from a partnership will be held to the 180-day period beginning on the date of the partnership's sale or exchange.

Proposed regulations

- The proposed regulations provide that a partner's 180-day period begins on the last day of the partnership's tax year, unless the partner elects to begin its own 180-day period on the date of the partnership's sale or exchange.

Expiration of Opportunity Zone designations

IRC Sections 1400Z-1 and 1400Z-2

- IRC Section 1400Z-2 states that gain must be invested into an Opportunity Fund “during the 180-day period beginning on the date of such sale or exchange” of the taxpayer’s property.

Ambiguity

- IRC Section 1400Z-1 states that the Opportunity Zone designations only remain in effect for 10 years.
- IRC Section 1400Z-2 states that when a taxpayer eventually exits an Opportunity Fund, if the Opportunity Fund investment was held for 10+ years, the taxpayer could receive a basis step-up allowing the taxpayer to recognize no gain from the sale of the Opportunity Fund investment.

Proposed regulations

- The proposed regulations provide that a taxpayer exiting an Opportunity Fund after the Opportunity Zone designations expire can still make the basis step-up election, so long as the taxpayer exits the Opportunity Fund and makes the election by December 31, 2047.

Opportunity Funds

IRC Section 1400Z-2 and previous IRS FAQ

- IRC Section 1400Z-2 states that an Opportunity Fund must be "organized as a corporation or a partnership."
- The IRS FAQ states that an Opportunity Fund must self-certify by completing a form and attaching the form to its federal income tax return.

Ambiguity

- Neither the statute nor the previous IRS FAQ specified whether a limited liability company can be an Opportunity Fund.

Opportunity Funds

Proposed regulations

- The proposed regulations provide that any taxpayer classified as a corporation or partnership for federal income tax purposes can self-certify as an Opportunity Fund.
- The updated IRS FAQ specifies that an LLC that chooses to be treated as a corporation or partnership can be an Opportunity Fund.
- Taxpayers will use Form 8996, which was released in draft form, for self-certification.
- If an Opportunity Fund is organized in Washington, DC or a US possession, it must be organized for the purpose of investing in Opportunity Zone property where it is organized.

Debt

IRC Section 1400Z-2

- IRC Section 1400Z-2 does not address debt and how it should be treated in an Opportunity Zone context.

Proposed regulations

- The proposed regulations provide that a debt instrument cannot be an "eligible interest" in an Opportunity Fund. Taxpayers must have an equity interest in an Opportunity Fund in order to receive tax benefits.
- Additionally, a taxpayer with an equity interest in an Opportunity Fund can use that interest as collateral for a loan without impairing its eligible interest in the Opportunity Fund.
- The proposed regulations also state that a partner's share of an Opportunity Fund partnership's liabilities (treated as a deemed contribution under IRC Section 752(a)) will not increase the taxpayer's investment in the fund and will not result in "mixed fund" treatment. Additionally, such deemed contributions will cause a basis increase.

90% asset test

IRC Section 1400Z-2

- IRC Section 1400Z-2 states that an Opportunity Fund must hold “at least 90% of its assets in qualified Opportunity Zone property,” tested by averaging the percentage of Opportunity Zone property held in the Opportunity Fund at the end of the first six-month period and the last day of the tax year.

Ambiguity

- The statute does not address how to apply the 90% asset test in an Opportunity Fund’s first year and how to value the assets.

90% asset test

Proposed regulations

- When an entity self-certifies as an Opportunity Fund, it must decide the month and year when it will be treated as an Opportunity Fund.
- In an Opportunity Fund's first year, the first test date for the 90% asset test will be the end of the first six months in the tax year that the entity is an Opportunity Fund and the second test date will be the last day of the tax year. If an Opportunity Fund is created in the second half of its tax year, the only test date will be the last day of the tax year. The Opportunity Fund will need to annually report its compliance with the 90% asset test.
- If an Opportunity Fund has applicable financial statements, it will use the value of assets reported on those statements for purposes of the 90% asset test. Otherwise, the Opportunity Fund must apply the 90% asset test using the Opportunity Fund's "cost of the asset."

Working capital safe harbor

IRC Sections 1400Z-2 and 1397(b)

- IRC Section 1400Z-2 provides that an Opportunity Fund must have 90% of its assets invested in Opportunity Zone property.
- IRC Sections 1400Z-2 and 1397(b) provide that in order for corporate stock or a partnership interest in a business to constitute Opportunity Zone property, the business is limited in the amount of “nonqualified financing property” that it can hold, with an exception for “reasonable amounts of working capital.”

Ambiguity

- Neither statute defines “reasonable amounts of working capital.”

Proposed regulations

- The proposed regulations provide a “working capital safe harbor,” specifying that a business can hold financial property for up to 31 months if: (1) the business has a written plan that identifies the financial property as held for the acquisition, construction or substantial improvement of tangible property in an Opportunity Zone; (2) the business has a written schedule for expenditures consistent with the ordinary startup of a trade or business; and (3) the business substantially complies with its written schedule.

Preexisting entities

IRC Section 1400Z-2

- IRC Section 1400Z-2 states that an Opportunity Fund must be organized for the purpose of investing in Opportunity Zone property.
- IRC Section 1400Z-2 does not address the organization of an Opportunity Zone business (unless it's a new business).

Ambiguity

- The statute does not address whether preexisting entities can be Opportunity Funds.

Proposed regulations

- The proposed regulations clarify that preexisting entities can be Opportunity Funds and Opportunity Zone businesses.
- In both cases, the entities must still meet all of the requirements to be an Opportunity Fund or an Opportunity Zone business, including the requirement that substantially all tangible property was acquired after 2017.

Substantial improvement

IRC Section 1400Z-2

- IRC Section 1400Z-2 states that tangible property must be substantially improved unless its “original use” in an Opportunity Zone is with the Opportunity Fund or Opportunity Zone business. Substantial improvement requires that during any 30-month period, additions to basis must exceed the adjusted basis of the property at the beginning of the 30-month period.

Ambiguity

- The statute does not address how to apply the requirement in the context of land.

Proposed regulations

- The revenue ruling and proposed regulations provide that land can never have its original use in an Opportunity Zone commence with an Opportunity Fund, but land also does not need to be substantially improved in order to qualify as Opportunity Zone property.
- Thus, if an Opportunity Fund acquires a building located on land in an Opportunity Zone, substantial improvement will be measured based on the adjusted basis of the building alone. The Opportunity Fund should not include the land’s basis in the substantial improvement calculation.

Substantially all

IRC Section 1400Z-2

- IRC Section 1400Z-2 uses the term “substantially all” several times in the context of an Opportunity Fund and Opportunity Zone business holding tangible property in an Opportunity Zone.

Ambiguity

- The statute does not define “substantially all.”

Proposed regulations

- The proposed regulations specify that in the context of an Opportunity Zone business’s owned or leased property, “substantially all” means 70%. Specifically, 70% of the business’s owned or leased tangible property must qualify as Opportunity Zone business property.
- This 70% threshold does not apply to the other uses of “substantially all” in the statute.

Opportunity Zone project investment timeline

Gain is eligible if it is "treated as a capital gain for federal income tax purposes."

Capital gain generated
01/01/20X0

The Opportunity Fund has to be set up and the gain has to be invested into the Opportunity Fund within the 180-day window.

The proposed regulations provide that any taxpayer classified as a corporation or partnership for federal income tax purposes can self-certify as an Opportunity Fund.

Opportunity Fund setup
Before 06/30/20X0

An Opportunity Fund must hold "at least 90% of its assets in qualified Opportunity Zone property," tested by averaging the percentage of Opportunity Zone property held in the Opportunity Fund at the end of the **first six-month period** and **the last day of the tax year**.

90% test
First test date:12/31/20X0 (assuming QOF is set up in 06/30/20XX)

Year 20X0

Jan	Feb	Mar	Apr	May	**Jun**	Jul	Aug	Sep	Oct	Nov	**Dec**

180-day window

90% test is conducted semiannually on June 30 and December 31

20X1	20X2	**20X3**

180-day window
01/01/20X0 until 06/30/20X0

Gain must be invested into an Opportunity Fund "during the 180-day period beginning on the date of such sale or exchange" of the taxpayer's property.

Opportunity Zone business setup
Anytime before 12/31/20X0 (assuming QOF is set up on 06/30/20X0)

Substantially all test

- An entity will qualify as an Opportunity Zone business if it satisfies the "substantially all" requirement, among other things.
- An entity satisfies the "substantially all" requirement if at least **70%** of its owned or leased tangible property is Opportunity Zone business property.
- An entity that qualifies as an Opportunity Zone business must have a written plan and budget that will be completed within 30 months.

Working capital safe harbor

A qualified Opportunity Zone business can hold financial property for up to **31 months** if: (1) the business has a written plan that identifies the financial property as held for the acquisition, construction or substantial improvement of tangible property in an Opportunity Zone; (2) the business has a written schedule for expenditures consistent with the ordinary startup of a trade or business; and (3) the business substantially complies with its written schedule.

Substantial improvement test
01/01/20X3 at the latest

Tangible property must be substantially improved unless its "original use" in an Opportunity Zone is with the Opportunity Fund or Opportunity Zone business. Substantial improvement requires that during any **30-month period**, additions to basis must exceed the adjusted basis of the property at the beginning of the 30-month period.

Outstanding questions

- The newly released IRS guidance addresses many, but not all, questions about Opportunity Zones. The IRS will issue additional guidance.
- There is a comment period for the proposed regulations.
- Taxpayers can rely on the proposed regulations before they are finalized, provided that the rules in each section must be applied in their entirety and in a consistent manner.
- The IRS has said that the next round of regulations will address:
  - Defining “substantially all” outside of Opportunity Zone business context
  - Transactions that may trigger the expiration of the gain deferral period
  - A “reasonable period” for an Opportunity Fund to reinvest assets after selling Opportunity Zone property
  - Rules pertaining to an Opportunity Fund failing the 90% asset test
  - Identification of conduct that may lead to Opportunity Fund decertification
  - Information reporting requirements

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