HAWKINS ADVISORY

Qualified Opportunity Funds - Initial Proposed Regulations

The Tax Cuts and Jobs Act of 2017 introduced Opportunity Zones, which are intended to encourage economic growth and investment in designated distressed communities ("qualified opportunity zones" or "QOZs") by providing federal income tax benefits to taxpayers who invest in businesses located within these zones:

1) certain gains (or other amounts equal to such gains) that are reinvested in a qualified opportunity fund ("QOF") are deferred from being included in gross income, as provided in section 1400Z-2; such gains may be reduced by 10 percent if the QOF investment is held for 5 year; and by an additional 5 percent if the QOF investment is held for 7 years,

2) post-acquisition gains on investments in QOFs that are held for at least 10 years may be excluded from a taxpayer's gross income.

Treasury Secretary Steven Mnuchin projected that there could be a $100 billion investment opportunity for real estate and businesses in distressed areas. See, Bloomberg Law News, October 19, 2018.

The Department of the Treasury and the Internal Revenue Service ("IRS") released proposed regulations on October 19, 2018, which provide guidance under section 1400Z-2 of the Internal Revenue Code of 1986 (the "Code") relating to gains that may be deferred as a result of a taxpayer's investment in a QOF.

Contemporaneously with the proposed regulations, the IRS and Treasury also issued **Rev. Rul. 2018-29**, which establishes that the cost of land is exempt from the substantial rehabilitation (100 percent) requirement of section 1400Z-2(d)(2)(D), and addresses the application of the "original use" requirement to real property. This is guidance is expected to facilitate repurposing vacant buildings and vacant or otherwise unutilized land in QOZs.

The Service also released, in draft form, **Form 8996 Qualified Opportunity Fund**, including instructions, which purports to be the form with which a QOF may self-certify as to its status.

The proposed regulations address the type of gains that may be deferred by investors, the time by which corresponding amounts must be invested in QOFs, and the manner in which investors may elect to defer specified gains. The release also contains proposed regulations applicable to QOFs, including rules for self-certification, valuation of QOF assets, and guidance on qualified opportunity zone businesses, as well as notice of a public hearing on these proposed regulations. Further guidance, including additional proposed regulations, is expected to be released in the near future. While these regulations are still proposed, taxpayers may rely on them, provided the regulations are applied in their entirety and in a consistent manner.

Proposed Regulations

I. Deferring Tax on Capital Gains

A. Only Capital Gains are Eligible for Deferral

The proposed regulations clarify that only capital gains are eligible for deferral under section 1400Z-2(a)(1), including capital gains from an actual, or deemed, sale or exchange, or gain that is otherwise required to be included in a taxpayer's computation of capital gain. In addition, the proposed regulations provide that the gain to be deferred must be gain that would be recognized, if deferral under section 1400Z-2(a)(1) were not permitted, not later than December 31, 2026. The gain must not arise from a sale or exchange with a related person, where a person is "related" by virtue of more than 20 percent ownership.

B. Types of Taxpayers Eligible to Elect Gain Deferral

Taxpayers eligible to elect deferral under section 1400Z-2 include individuals, C corporations (including regulated investment companies (RICs) and real estate investment trusts (REITs)), partnerships, and certain other pass-through entities, including common trust funds described in section 584, as well as qualified settlement funds, disputed ownership funds, and other entities taxable under §1.468B of the Income Tax Regulations.

These rules may be amplified by more detailed rules which are expected to provide additional certainty for investors in pass-through entities that are not partnerships.

C. Eligible Investments in a QOF

The proposed regulations clarify that an eligible interest in a QOF must be an equity interest in the QOF, including preferred stock or a partnership interest with special allocations. A debt instrument will not qualify.

Deemed contributions of money to a partnership under section 752(a) also do not result in the creation of an investment in a QOF.

D. 180-Day Rule for Deferring Gain by Investing in a QOF

In order to defer a gain under these provisions, a taxpayer must generally invest in a QOF during the 180-day period beginning on the date of the sale or exchange giving rise to the gain. The first day of the 180-day period is the date on which the gain would be recognized for federal income tax purposes.

The proposed regulations also explain that a taxpayer who made an initial qualifying investment may continue to defer its tax liability when a subsequent sale or exchange of

that initial investment triggers an inclusion of the deferred gain, if the taxpayer makes a qualifying new investment in a QOF. The taxpayer may make a second election to defer the inclusion of the deferred gain, but only if the taxpayer has disposed of the entire initial QOF investment; complete disposition is needed because a second deferral election with respect to a single sale or exchange, while the initial election is still in effect, is not allowed under section 1400Z-2(a)(2)(A). The 180-day period for the second investment in a QOF starts on the date that the taxpayer disposed of its entire investment in the initial QOF.

For pass-through entities such as partnerships, the start of the 180-day period in respect of an election to defer gain is made at the partnership level, based on the general rules described above. If the election to defer gain is not made by the partnership, the partner may make such election, in which case the start of the 180-day period for the partner would generally begin on the last day of the partnership taxable year in which the partner's allocable share of the eligible gain is taken into account. Alternatively, the partner could elect to use the date that would have applied in respect of a partnership-level election as the start of the 180-day period.

Rules similar to the rules provided for partnerships and partners apply to other pass-through entities (including S corporations, decedents' estates, and trusts) and to their shareholders and beneficiaries. Exceptions to and illustrations of the 180-day rule are expected to be included in future guidance.

E. Attributes of Included Income When Gain Deferral Ends

The proposed regulations provide that all of the deferred gain's tax attributes (e.g., tax attributes under sections 1(h), 1222, 1256, and any other applicable provisions of the Code) are preserved through the deferral period and are taken into account when the gain is included. Furthermore, the proposed regulations address situations in which separate investments providing indistinguishable property rights (such as serial purchases of common stock in a corporation that is a QOF) are made at different times or are made at the same time with separate gains possessing different attributes (such as different holding periods). In addition, the proposed regulations speak to situations in which a taxpayer disposes of some of its fungible interests in a QOF, and apply a first-in, first-out (FIFO) method of accounting for purposes of identifying which interests have been disposed of and the attributes of such interests. Where the FIFO method is not sufficient to identify the investments, such as where gains with different attributes are invested in indistinguishable interests at the same time, the proposed regulations apply a pro rata accounting method to determine the character, and any other attributes, of the gain recognized.

Alternative methods may be considered in future guidance; such methods should a) result in certainty as to which fungible interest is being disposed of and b) allow taxpayers to easily comply with the requirements that cause deferred gain from certain dispositions of an interest in a QOF to be included in a taxpayer's income.

II. Gain Not Already Subject to an Election

In the case of a taxpayer who has made an election with respect to some but not all of an eligible gain, the term "eligible gain" includes the portion of that eligible gain as to which no election has been made. All elections with respect to portions of the same gain would, of course, be subject to the same 180 -day period.

Specific guidance is included for Section 1256 contracts* and offsetting-positions transactions.

III. How to Elect Deferral

The proposed regulations require deferral elections to be made at the time and in the manner provided by the Commissioner of Internal Revenue. It is currently anticipated that taxpayers will make deferral elections on Form 8949, Sales and Other Dispositions of Capital Assets, which taxpayers are instructed to attach to their federal income tax returns for the taxable year in which the gain would have been recognized if it had not been deferred. Form instructions to this effect are expected to be released soon. Additional proposed regulations or other guidance may be needed to clarify the required procedures.

IV. Section 1400Z-2(c) Election for Investments Held At Least 10 Years

A. In General

A taxpayer is required to make an election to defer gain under section 1400Z-2(a) and the taxpayer is required to hold the investment for at least ten years in order for such taxpayer to elect to step-up the basis of a QOF investment under section 1400Z-2(c). If a QOF investment is made in part with eligible gains and in part with other monies, the two types of investments are treated as separate investments and subject to different treatment under the Code.

B. QOF Investments and the 10-Year Zone Designation Period

Under the current provisions, the designations of all qualified opportunity zones now in existence will expire on December 31, 2028; this raises concerns for investors who may seek to make basis step-up elections for QOF investments in 2019 and later.

The proposed regulations attempt to address this concern by permitting taxpayers to make the basis step-up election under section 1400Z-2(c) no later than December 31, 2047, 20-1/2 years after the latest date that an eligible taxpayer may properly make an investment and an election to defer gain under section 1400Z-2(a). The last day of the 180-day period for an eligible gain to be invested in a QOF would be in late June 2027; a taxpayer deferring such a gain would achieve a 10-year holding period in a QOF investment only in late June 2037. The proposed rule would permit an investor in a QOF that makes an investment as late as the end of June 2027 to hold the investment in the QOF for the entire 10-year holding period, plus another ten years.

It is uncertain whether 20-1/2 year period or some other time period would better align with taxpayers' economic interests and the purposes of the statute. One suggestion has been put forward to provide for a deemed basis step-up election, based on an appropriate valuation assumption, which would be made immediately before the ability to elect a step-up upon disposition expires.

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* Generally, any regulated futures contract, foreign currency contract, non-equity option, dealer equity option or dealer securities future option.

V. Rules for a Qualified Opportunity Fund

A. Certification of an Entity as a QOF

The proposed regulations generally permit any taxpayer that is a corporation or partnership for tax purposes to self-certify as a QOF, provided that the entity has the statutory authority to self-certify. It is expected that taxpayers will complete Form 8996, Qualified Opportunity Fund (currently in draft from) and attach such Form to their federal income tax return for the relevant tax years. This Form would serve to provide both the initial self-certification, as well as the annual reporting of compliance with the 90-Percent Test set forth in section 1400Z-2(d)(1) and described below.

B. Designating When a QOF Begins

A deferral election under section 1400Z-2(a) may only be made for investments in a QOF. Investments made prior to the first day of an entity's first month as a QOF will not qualify for the deferral election. The proposed regulations allow a QOF to identify both the taxable year in which the entity becomes a QOF and to choose the first month in that year to be treated as a QOF. If an eligible entity fails to specify the first month it is a QOF, then the first month of its initial taxable year as a QOF is treated as the first month that the eligible entity is a QOF.

C. Becoming a QOF in a Month Other Than the First Month of the Taxable Year

A QOF is required to hold at least 90 percent of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held in the fund as measured on the last day of the first 6-month period of the fund's taxable year, and on the last day of the fund's taxable year (the "90-Percent Test"). If an entity chooses as the first month during which to be a QOF a month that is not the first month of its taxable year, the proposed regulations apply the 90-Percent Test by treating first 6-month period composed entirely of months which are within the taxable year and during which the entity is a QOF as the "first 6-month period of the taxable year of the fund". Furthermore, the proposed regulations provide that if an eligible entity becomes a QOF in the seventh or later month of a 12-month taxable year, the 90-Percent Test takes into account only the QOF's assets on the last day of the taxable year.

Section 1400Z-2(e)(4)(B) authorizes regulations to ensure that a QOF has "a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and to reinvest proceeds received from the sale or disposition of qualified opportunity zone business property". For example, if a QOF shortly before a testing date sells qualified opportunity zone property, that QOF should have a reasonable amount of time in which to bring itself into compliance with the 90-Percent Test. Additional guidance on these reinvestments by QOFs is expected to be released shortly.

D. Pre-Existing Entities

The proposed regulations clarify that a pre-existing entity may qualify as a QOF or as a subsidiary entity operating a qualified opportunity business, provided that such pre-existing entity otherwise satisfies the applicable requirements under section 1400Z-2(d), e.g. the 90-Percent Test. For a pre-existing entity, the only assets that are considered relevant in respect of this test are tangible assets acquired after December 31, 2017 by purchase from an unrelated person, determined based on the more than 20 percent ownership definition of "related person".

E. Valuation Method for Applying the 90-Percent Test

For purposes of the calculation of the 90-Percent Test by the QOF, the proposed regulations require an entity to use the asset values that are reported on an applicable financial statement for the taxable year, as defined in §1.475(a)-4(h) of the Income Tax Regulations. If a QOF does not have an applicable financial statement, the proposed regulations require the QOF to use the cost of its assets. The Treasury Department and the IRS are contemplating whether another method, such as tax adjusted basis, would be more appropriate given the need for certainty and administration.

F. Working Capital Safe Harbor

Development of a new business or construction or rehabilitation of real estate requires time, generally more than six months. During such time, a QOF may have significant amounts of cash on hand in anticipation of investing such cash in qualified opportunity zone property. The proposed regulations provide 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 an opportunity zone. This safe harbor will allow qualified opportunity zone businesses to apply the definition of working capital provided in section 1397C(e)(1) to property held by the business for a period of up to 31 months, if 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, there is a written schedule consistent with the ordinary business operations of the business that the property will be used within 31-months, and the business substantially complies with the schedule. Taxpayers would be required to retain any such written plan in their records.

This working capital safe harbor may be expanded, assuming there is a statutory basis for additional relief.

G. Qualified Opportunity Zone Business - "Substantially All"

Under section 1400Z-2(d)(1), a QOF is any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property (other than another QOF). Qualified opportunity zone property may also include certain equity interests in an operating subsidiary entity (either a corporation or a partnership) that qualifies as a qualified opportunity zone business.

The definition of qualified opportunity zone business property requires property to be used in a QOZ and also requires new capital to be employed in a QOZ. "Qualified opportunity zone business property" means tangible property used in a trade or business of a QOF, but only if (1) the property was acquired by purchase after December 31, 2017; (2) the original use of the property in the QOZ commences with the QOF, or the QOF substantially improves the property; and (3) during substantially all of the QOF's holding period for the property, substantially all of the use of the property was in a QOZ. See section 1400Z-2(d)(B)(A)(i).

The proposed regulations establish that if at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property, the trade or business is treated as satisfying the "substantially all" requirement of section 1400Z-2(d)(B)(A)(i) set forth in the immediately preceding paragraph. The 70 percent threshold is intended to apply only to the term "substantially all" as it is used in this section.

The Treasury Department and the IRS have requested comments regarding the other instances in which the phrase "substantially all" is used.

H. 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. If an entity is organized in a U.S. possession, its purpose must be to be a QOF in the possession in which the entity is organized. A possession may include the following U.S. territories: American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands. A QOF created in a possession may only invest in QOZ property relating to a trade or business operated in the possession in which the entity is organized.

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