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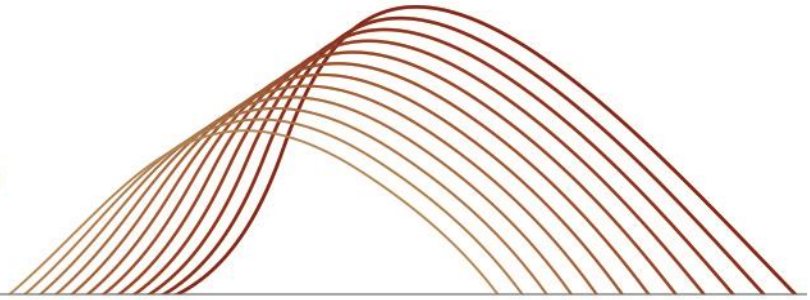

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IRS Provides Guidance on Qualified Opportunity Zones

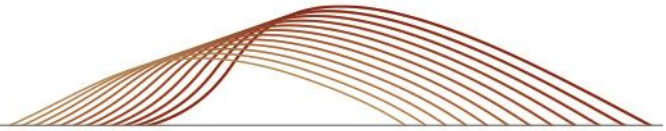
By Michael D. Haun, Anna Twardy, Amy Lawrence & Kami LaBerge

The Internal Revenue Service ("IRS") released proposed Treasury Regulations and a Revenue Ruling on October 19, 2018, providing guidance on the new tax incentive for "qualified opportunity zones," or "QOZs," under Section 1400Z-2 of the Internal Revenue Code (the "Code"). This new tax incentive, introduced as part of the Tax Cuts and Jobs Act, is designed to spur investment in designated low-income communities across the country by allowing taxpayers who invest in "qualified opportunity funds," or "QOFs," which in turn invest in these low-income communities, to defer and, in some cases, eliminate federal income taxes on certain gains. The new guidance addresses 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 guidance also addresses how QOFs will self-certify their status to the IRS, how QOF assets will be valued, and certain requirements for QOZ businesses. Although the proposed guidance leaves many unanswered questions, it should provide sufficient clarity to allow investments to move forward.

Overview of QOZs

The QOZ program incentivizes taxpayers to invest in underdeveloped areas designated as QOZs by the Treasury, which include areas in all 50 states, the District of Columbia, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the Virgin Islands.

To qualify for the incentive, the taxpayer must invest gains from a sale of capital assets in a QOF within 180 days after the sale of the asset that generated the gains. Any such gains timely invested into a QOF will be deferred for tax purposes until the taxpayer sells his or her interest in the QOF or December 31, 2026, whichever occurs earlier. Depending on how long the investment in the QOF is held, the taxpayer may also be able to eliminate taxation on some of those proceeds. Specifically, a taxpayer who holds its interest in the QOF for at least five years will eliminate 10% of the deferred gains from taxation, and if the taxpayer holds its investment in the QOF for at least seven years, that gain elimination is increased to 15%. If the taxpayer has not yet sold the investment by December 31, 2026, any deferred gain that hasn't been eliminated will have to be included in taxable income for that year. If the taxpayer then sells or exchanges its investment in the QOF after holding it for more than ten years, any appreciation in the interest in the QOF is never taxed.



A QOF must hold at least 90% of its assets in QOZ property, which is defined to include QOZ business property or equity interests in an operating subsidiary (either a corporation or partnership) that qualifies as a QOZ business. If a QOF operates a trade or business directly and does not hold any equity in a QOZ business, the QOF must hold 90% of its assets in QOZ business property. If a QOF operates a trade or business indirectly through one or more entities, the QOF can satisfy the 90% asset test if each of the entities it owns qualifies as a QOZ business.

Gains Eligible for Deferral

The proposed regulations confirm that only capital gains arising from a sale or exchange with an unrelated person (which generally means less than 20% common ownership) are eligible for deferral under the statute.

Gain Can Be Divided with Different Elections

The proposed regulations clarify that a taxpayer can make separate deferral elections for portions of the gain arising from a single sale or exchange, allowing the taxpayer to invest the gain in more than one QOF.

180-Day Rule for Deferring Gain

In order to elect to defer gain, a taxpayer must invest in a QOF prior to the end of the 180-day period beginning on the date of the sale or exchange giving rise to the gain. The proposed regulations provide a general rule that the first day of this 180-day period is the date on which the gain would have been recognized for federal income tax purposes if not for the deferral available under the statute. The proposed regulations also allow a taxpayer to continue to defer gain if it sells its entire original interest in a QOF and reinvests in another QOF within 180 days.

Taxpayers Eligible to Elect Gain Deferral

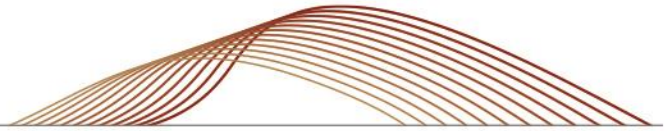
Taxpayers eligible to elect gain deferral are those that recognize capital gain for federal income tax purposes, including individuals, both C and S corporations (including regulated investment companies ("RICs") and real estate investment companies ("REITs")), partnerships, and other pass-through entities, including common trust funds, qualified settlements funds, disputed ownership funds, and other entities taxable under Treasury Regulations Section 1.468B.

Gains of Partnerships and Other Pass-Through Entities

A partnership, S corporation, or other pass-through entity can elect gain deferral under the statute and to the extent it does not, its partner or shareholder can. The partner's 180-day period begins on the last day of the partnership's taxable year in which the gain was realized; however, a partner may choose to begin its 180-day period on the same date as the start of the partnership's 180-day period if the partner knows both the date the partnership's gain was realized and that the partnership has decided not to make the deferral election.

How to Elect Deferral

Taxpayers are anticipated to make deferral elections on IRS Form 8949 (Sales and Other Dispositions of Capital Assets), which will be attached to their federal income tax returns for the taxable year in which the capital gain would have been recognized if it had not been deferred. An updated IRS Form 8949 and instructions are expected to be released shortly.



Attributes of Income Recognized When Gain Deferral Ends

The tax attributes of the deferred gain are maintained throughout the deferral period and will be taken into account when the gain is recognized for tax purposes. For example, if a gain is short-term capital gain at the time of the deferral election, it will continue to be treated as short-term capital gain when taken into income at the end of the deferral period. The proposed regulations also provide that a taxpayer that sells less than all of its interests in a QOF must use the first-in, first-out ("FIFO") method to identify which QOF interests were disposed. In cases where the FIFO method does not provide a definitive answer, such as where gains with different attributes are invested in indistinguishable interests at the same time, a pro rata method must be used to determine the character of the gain recognized.

Eligible Interest in a QOF

An investment in a QOF must be an equity interest, including preferred stock or a partnership interest with special allocations. An eligible interest cannot be a debt instrument, but an otherwise eligible interest will not be disqualified if a taxpayer uses its interest as collateral for a loan. The proposed regulations also clarify that deemed contributions of money under Section 752(a) of the Code do not result in a "mixed" investment in a QOF.

Investments Held at Least 10 Years

A taxpayer that holds a QOF investment for at least 10 years may elect to increase the basis of the investment to the fair market value of the investment on the date that the investment is sold or exchanged, eliminating from taxation any appreciation in the QOF investment after the required recognition of the deferred gain on December 31, 2026. This election to step-up basis can only be made if there was a proper gain deferral election for the original investment in the QOF. The designations of all QOZs will expire on December 31, 2028, but the proposed regulations allow taxpayers to continue to make the 10-year basis step-up election until December 31, 2047, allowing for the potential to eliminate almost 30 years of investment appreciation.

Certification of an Entity as a QOF

A QOF must be structured as a corporation or partnership for tax purposes. Any eligible investment fund can self-certify as a QOF using new IRS Form 8996 (Qualified Opportunity Fund) and attaching it to the taxpayer's federal income tax return for the relevant tax years that the taxpayer is a QOF. The IRS made clear in its QOZ frequently asked questions page that a limited liability company treated as a corporation or partnership for tax purposes will also qualify as a QOF. The proposed regulations clarify that pre-existing entities can qualify as a QOF as long as they undergo the same self-certification process and meet the 90% asset requirements. IRS Form 8996 will be used both for initial self-certification and for annual reporting of compliance with the 90% asset test requirement. The IRS has released a draft of IRS Form 8996 with instructions.

Designating When a QOF Begins

A QOF may identify the taxable year in which it becomes a QOF and 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 on IRS Form 8996, 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. The 90% asset test must be met by averaging the QOF's assets at the end of the first 6 months of the taxable year and at the end of the taxable year. However, if a calendar-year QOF chooses a month after June as its first month as a QOF, then the only testing date will be the last day of the QOF's taxable year.

Valuation Methods for the 90% Asset Test

If a QOF has audited financial statements, it must use the asset values shown on those financial statements for purposes of the 90% asset test. If a QOF does not have audited financial statements, it must use the cost of its assets for purposes of the 90% asset test.

QOZ Business - "Substantially All" Test

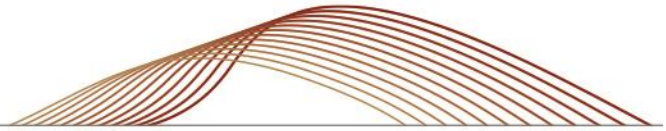
The statute requires that "substantially all" of the tangible property owned or leased by the QOF be QOZ business property. The proposed regulations state that this "substantially all" requirement is satisfied if 70% of the tangible property owned or leased by a trade or business is QOZ business property. Therefore, a QOF that operates a trade or business indirectly through one or more entities can meet the asset test requirement with as little as a 63% indirect investment (90% ownership of entities that meet the 70% threshold for QOZ business property) in QOZ business property.

Working Capital Safe Harbor

The proposed regulations provide a working capital safe harbor for QOF investments in QOZ businesses that acquire, construct, or rehabilitate tangible business property for purposes of the "non-qualified financial property" test. The working capital safe harbor permits QOZ businesses to apply the definition of working capital in Section 1397C(e)(1) of the Code (defined as cash, cash equivalents, and debt instruments with a term of 18 months or less) to property held by the business for up to 31 months. In order to qualify for this safe harbor, the QOZ business must (1) have a written plan that identifies the financial property as property held for acquisition, construction, or substantial improvement of tangible property in the QOZ, (2) develop a written schedule consistent with the ordinary business operations of the business that the property will be used within 31 months, and (3) substantially comply with the schedule. Taxpayers are required to keep any written plan in their records.

Treatment of Land

In addition to the proposed regulations, the IRS released Revenue Ruling 2018-29, which illustrates rules related to a QOF purchasing both a building and land. QOZ property is tangible property used in a trade or business of the QOF if (1) such property is purchased by the QOF after December 31, 2017, (2) the original use of such tangible property commences with the QOF or the QOF substantially improves the tangible property, and (3) during substantially all of the QOF's holding period for such tangible property, substantially all of the use of such tangible property is in a QOZ. Revenue Ruling 2018-29 clarifies the second prong of this test (which requires that use of the property commences with the QOF or the QOF substantially improves the property). If a QOF purchases an existing building, the original use of the building is not considered to commence with the QOF. Given the permanence of land, the original use of land can never commence with the QOF. However, where a building and land are purchased together, the cost of land is not included in the QOF's adjusted basis in the building, and the QOF is not required to substantially improve such land for its investment in the land to qualify as QOZ property. Tangible property is "substantially improved" by the QOF if, during any 30-month period beginning after the date of acquisition, additions to basis with respect to such tangible property exceed the original adjusted basis of such tangible property at the beginning of the 30-month period.



Conclusion

This first round of guidance from the Treasury is helpful in clarifying the QOZ statute in order for taxpayers to move forward with investments in QOFs. The Treasury is expected to soon release more regulations on issues that were not covered in this first release. This second round of guidance is expected to address the meaning of "substantially all" each time that phrase is used in the statute (other than the 70% rule provided in these proposed regulations for QOZ businesses); the type of transactions producing gain eligible for deferral under the statute; the "reasonable period" for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty; administrative rules when a QOF fails to maintain the required 90% investment standard; and information reporting requirements.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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