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IRS Releases Proposed Regulations on Qualified Opportunity Zones

On October 19, the Internal Revenue Service (IRS) issued proposed regulations providing much-needed guidance regarding "Qualified Opportunity Zones," a new tax incentive introduced by the Tax Cuts and Jobs Act. The IRS also issued a revenue ruling and a new form in connection with this regime.

Qualified Opportunity Zones serve as part of a new tax incentive to spur long-term investment in economically distressed communities throughout the United States. All 50 states and certain territories were eligible to nominate communities to be designated as Qualified Opportunity Zones, with such nominations subject to approval by the secretary of the Treasury. Under these new rules, a taxpayer that invests in a designated Qualified Opportunity Zone through a Qualified Opportunity Fund (a QO Fund) is eligible for a range of significant tax benefits, more fully discussed below.

Despite these benefits, which can include deferral of tax on certain taxable gains and a potentially tax-free exit upon selling one's investment in a QO Fund, the rules governing Qualified Opportunity Zones contained enough uncertainties when enacted to prevent many fund managers and investors from taking advantage of the program. Fortunately, the proposed regulations clarify many of these questions, while leaving others unanswered. Day Pitney LLP previously published an article discussing some of these uncertainties, which can be found here, as well as an alert providing an overview of the tax incentive regime, which can be found here.

Highlights of the Proposed Regulations:

1. *Only capital gains are deferrable.* The legislative history behind new Section 1400Z of the Internal Revenue Code consistently suggested that taxpayers could only defer tax on capital gains, but the word "capital" was omitted from key portions of the final statute. This begged the question of whether investors could defer tax on ordinary gains, which are taxed at a materially higher rate than capital gains and would therefore be more advantageous to defer from tax. The proposed regulations confirm that only capital gains are eligible for deferral under Section 1400Z.

2. *Any taxpayer that recognizes capital gain for federal income tax purposes is eligible to elect deferral*. This election for deferral includes not only individuals but also C corporations, S corporations, partnerships and trusts. To the extent that the taxpayer is a pass-through entity, the proposed regulations provide special rules for such deferral, some of which are described below (See item 5).

3. *To qualify for deferral, an investment in a QO Fund must be an equity interest in such fund.* For these purposes, an equity interest includes preferred stock and partnership interests with special allocations, but does not include debt instruments or deemed contributions due to an increase in a partner's share of partnership liabilities. The proposed regulations do not clarify whether a capital commitment is an eligible interest or the investor must contribute actual capital to be eligible for QO Fund benefits.

4. *Investors can defer the same gain in multiple QO Funds, just not at the same time.* If a taxpayer defers a particular gain by investing in a QO Fund and later sells or exchanges its interest in the QO Fund, it will trigger tax on the deferred gain. The taxpayer can defer such resulting gain by reinvesting that gain in another QO Fund. That being said, the taxpayer must completely dispose of the first QO Fund investment to take full advantage of this opportunity, since Section 1400Z makes it clear that an investor can make only one deferral election per gain.

5. *Owners of pass-through entities can elect to defer tax on capital gains as well.* If a pass-through entity, such as a partnership, elects to defer a gain under Section 1400Z, the deferred gain is not included in its partners' distributive shares of income and does not increase its partners' bases in their partnership interests. If the partnership itself does not elect to defer gain, the gain is allocated to its partners as a capital gain would normally be allocated. However, if the partnership does not make such an election, the partners—acting independently—can then make their own election to defer their share of the gain.

6. *The IRS released a new form.* Taxpayers who wish to defer capital gains under these rules will be able to do so on Form 8949, *Sales and Other Disposition of Capital Assets*, which is the form that taxpayers currently use to report capital gains. The IRS also released a new form, Form 8996, *Qualified Opportunity Fund*, which is the form that partnerships and corporations will use to self-certify their status as QO Funds.

7. *Land is not a factor under the "substantial improvement" or "original use" tests.* In conjunction with the proposed regulations and Form 8996, the IRS released Revenue Ruling 2018-29, which clarified key issues surrounding how land is treated in the rules governing Qualified Opportunity Zone Business Property. Among other things, this ruling provides that land is not factored into the calculation of whether a QO Fund has substantially improved a building. Rather, the calculation is based on how much the QO Fund has improved the building as measured by the increase in the QO Fund's basis in the building.

What's Next:

The IRS will release a second set of proposed regulations in the near future addressing some key topics that are still without clarification, including the definition of "substantially all" as used in various tests under Section 1400Z, the "reasonable period" in which a QO Fund can reinvest proceeds from the sale of qualifying assets without incurring a penalty under the 90 percent asset test, and whether certain transactions will trigger deferred gain. It is important to bear in mind that these regulations are proposed and are subject to change prior to becoming final.

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