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# A FIRST LOOK AT THE IRS'S PROPOSED REGULATIONS ON OPPORTUNITY ZONES

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We explore how the new Opportunity Zone Proposed Regs and Revenue Ruling 2018-29 affect the how, what, when and who of opportunity zones, as well as a collection of other notable issues.

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## WHAT IS IT?

The [new proposed regulations](#) ("Regs") were posted by Treasury with a summary on Friday, and were issued in coordination with Revenue Ruling 2018-29. The regulation package runs 74 pages, and addresses many (but not all) of the questions being asked by developers, investors and their advisors. We highlight many features below, as well as note some continued outstanding questions.

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The Regs clarify that only gains treated as capital gains for federal income tax purposes are eligible for deferral. So, gains from selling property used in a trade or business (under section 1231) should be eligible, while depreciation recapture and gain from ordinary sales of inventory do not qualify. Special rules are provided for section 1256 gains and straddles.

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## FORMATION BASICS

The regulations plainly state that an Opportunity Zone Fund (“Fund”) must be “taxed as” a corporation or partnership, which should allow them to be set up as appropriately structured limited liability companies. Strangely, instructions for the draft self-certification form (Form 8996) on the IRS’s website STILL refer to entities “organized as” partnerships or corporations, thereby retaining the confusing wording of the Code section. We are writing to the IRS to suggest that the form be corrected to use the same definition as the proposed regulations. A Fund can be organized in any state, or in a U.S. territory, or it can be organized in a territory but only if it is the same as the opportunity zone’s trade or business. Fund interests can be common or preferred, provided they are “equity” under standard tax principles. Debt is ineligible for favorable treatment.

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## HOW MANY FUNDS?

We have generally been recommending one Fund per asset, given the ease of “self-certifying” Funds, and the potential tax consequences of dispositions. The Regs only save taxes on a post-10-year disposition of an interest in the Fund, while a sale of the underlying asset held by the Fund will generally be taxable. Thus, having only one asset in

each Fund will generally facilitate non-taxable sales of the interest to a buyer who might then liquidate the Fund (or continue to hold the property through such an entity). The proposed regulations facilitate this structure by making it clear that an investor can set up multiple Funds from a single capital gain, as long as there is no double counting.

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## WHO CAN DEFER?

Persons or entities that recognize capital gain for federal income tax purposes are eligible for deferral. This includes a long laundry list of entities, including individuals, C corporations, regulated investment companies, REITs and trusts, as well as partnerships and other pass-through entities, such as S corporations. As suggested in a letter we authored to Treasury, in the case of pass-throughs, either the entity or, with a proper election, its partners or shareholders, can invest the entity's gain in a Fund. Special timing rules may help a partner or shareholder of an S corporation get well more than 180 days after the gain occurs to make their investment.

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## LEVERAGE AND LIQUIDITY

An investor in an Opportunity Fund can borrow money to make the investment, even pledging the interest as collateral for the loan. Importantly, the IRS addressed the technical concerns of some tax advisors by providing that borrowing at the entity level by a Fund that is a partnership will not be recharacterized as an additional capital contribution by the investors under Section 752(a).

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## TIMING CONCERNS FOR TESTING THE FUND

Generally, the 180-day period to invest capital gain in an Opportunity Fund begins on the date on which the gain would be recognized for federal income tax purpose. As noted above, a special rule for pass-through entities may extend this significantly longer in certain situations. The Fund must then invest 90 percent of its funds in qualifying assets. Generally, the 90 percent test is assessed six months after the date selected as the start date for the Fund, and also at year end. If the first testing date would arise after the first (e.g., a Fund that starts in July or later), then only the year-end date applies. The 90 percent test is based on financial statements, or actual cost for taxpayers who don't have financials, with a special rule that allows investors to use the method used by other members who own at least a five percent interest.

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## **TIMING CONCERNS FOR NEW CONSTRUCTION AND REHABILITATIONS**

In another place where the IRS adopted a rule like the one we suggested in our letter to Treasury, the proposed Regs provide a safe harbor to build or rehab a project of up to 31 months, provided the Fund has a written plan for the construction or rehabilitation, and it substantially complies with that plan. It should be noted that rather than referring to "rehabilitation" of used property, the applicable Code provision actually uses the words "with respect to" the used property, which (to our thinking) might be different from rehabilitation, and allow for more kinds of capital expenditures. However, the Regs do not provide any additional guidance about this term. We will be asking the IRS to address this issue.

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## **WHAT CAN THE FUND INVEST IN?**

Funds can own opportunity zone businesses directly, or they can own partnership interests or stock in certain opportunity zone business entities. The Code requires that “substantially all” of a business’s assets must meet the requirements to be an Opportunity Zone Business, and the regulations defined this term to be “70 percent.”

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## WHAT ABOUT LAND?

Another important provision in the proposed regs is the exclusion of land when computing the required capital expenditures for used property. For example, if a Fund acquires land for \$1 million and an existing building for \$2 million, it only has to incur capital expenditures of another \$2 million with respect to the used property to pass the substantial improvement requirement. Rev. Rul. 2018-29 provides illustrations.

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## IRS FORMS

There are two IRS forms. Form 8949 is used to report that you are deferring a capital gain. Form 8996 will be used for initial self-certification of the Fund and for annual reporting of compliance with the 90-Percent Asset Test.

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## DISPOSITION BASICS

A taxpayer may sell a Fund investment, but if it sells only a portion, the Proposed Regs generally provide that the Fund interests disposed of must be identified using a first-in, first-out (FIFO) method. A pro rata method will sometimes apply. If a taxpayer sells ALL of its interest at a gain prior to 2027, it can (if it chooses) make a new election and roll over this new gain.

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## HOW TO DISPOSE AND NOT PAY TAXES ON THE FUND INVESTMENT?

The proposed regulations provide that the no-tax-after-10-years rule applies to any Fund investment made on or **before June 30, 2027** (provided the investment meets the other requirements, like the 180-day rule, which may run out before that date). Recognizing that the current designations for opportunity zones will expire in ten years, the proposed regulations somewhat arbitrarily terminate the no-tax rule **on December 31, 2047**.

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## WHAT'S NEXT?

In addition to these proposed regulations, a second round of proposed regulations is anticipated. Issues expected to be addressed include: the meaning of “substantially all,” which also appears in other places in the opportunity zone statute; identifying the transactions that may trigger the inclusion of gain; the “reasonable period” for a Fund to reinvest proceeds from the sale of qualifying assets without paying a penalty; administrative rules applicable to a Fund that fails to maintain the required 90 percent investment standard; and information-reporting requirements.

PDF: PROPOSED REGULATIONS ON OPPORTUNITY ZONES

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