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IRS PROVIDES MUCH NEEDED GUIDANCE ON OPPORTUNITY ZONES THROUGH ISSUANCE OF PROPOSED REGULATIONS TITLE

To Our Clients and Friends:

On October 19, 2018, the Internal Revenue Service (the "**IRS**") and the Treasury Department issued proposed regulations (the "**Proposed Regulations**") providing rules regarding the establishment and operation of "qualified opportunity funds" and their investment in "opportunity zones."[1] The Proposed Regulations address many open questions with respect to qualified opportunity funds, while expressly providing in the preamble that additional guidance will be forthcoming to address issues not resolved by the Proposed Regulations. The Proposed Regulations should provide investors, sponsors and developers with the answers needed to move forward with projects in opportunity zones.

Opportunity Zones

Qualified opportunity funds were created as part of the tax law signed into law in December 2017 (commonly known as the Tax Cuts and Jobs Act ("**TCJA**")) to incentivize private investment in economically underperforming areas by providing tax benefits for investments through qualified opportunity funds in opportunity zones. Opportunity zones are low-income communities that were designated by each of the States as qualified opportunity zones – as of this writing, all opportunity zones have been designated, and each designation remains in effect from the date of designation until the end of the tenth year after such designation.

Investments in qualified opportunity funds can qualify for three principal tax benefits: (i) a temporary deferral of capital gains that are reinvested in a qualified opportunity fund, (ii) a partial exclusion of those reinvested capital gains on a sliding scale and (iii) a permanent exclusion of all gains realized on an investment in a qualified opportunity fund that is held for a ten-year period.

- In general, all capital gains realized by a person that are reinvested within 180 days of the recognition of such gain in a qualified opportunity fund for which an election is made are deferred for U.S. federal income tax purposes until the earlier of (i) the date on which such investment is sold or exchanged and (ii) December 31, 2026.

- In addition, an investor's tax basis in a qualified opportunity fund for purposes of determining gain or loss, is increased by 10 percent of the amount of gain deferred if the investment is held for five years prior to December 31, 2026 and is increased by an additional 5 percent (for a total increase of 15 percent) of the amount of gain deferred if the investment is held for seven years prior to December 31, 2026.

- Finally, for investments in a qualified opportunity fund that are attributable to reinvested capital gains and held for at least 10 years, the basis of such investment is increased to the fair market value of the investment on the date of the sale or exchange of such investment, effectively eliminating any gain (other than the deferred gain that was reinvested in the qualified opportunity fund and taxable or excluded as described above) in the investment for U.S. federal income tax purposes (such benefit, the "**Ten Year Benefit**").

A qualified opportunity fund, in general terms, is a corporation or partnership that invests at least 90 percent of its assets in "qualified opportunity zone property," which is defined under the TCJA as "qualified opportunity zone business property," "qualified opportunity zone stock" and "qualified opportunity zone partnership interests." Qualified opportunity zone business property is tangible property used in a trade or business within an opportunity zone if, among other requirements, (i) the property is acquired by the qualified opportunity fund by purchase, after December 31, 2017, from an unrelated person, (ii) either the original use of the property in the opportunity zone commences with the qualified opportunity fund or the qualified opportunity fund "substantially improves" the property by doubling the basis of the property over any 30 month period after the property is acquired and (iii) substantially all of the use of the property is within an opportunity zone. Essentially, qualified opportunity zone stock and qualified opportunity zone partnership interests are stock or interests in a corporation or partnership acquired in a primary issuance for cash after December 31, 2017 and where "substantially all" of the tangible property, whether leased or owned, of the corporation or partnership is qualified opportunity zone business property.

The Proposed Regulations – Summary and Observations

The powerful tax incentives provided by opportunity zones attracted substantial interest from investors and the real estate community, but many unresolved questions have prevented some taxpayers from availing themselves of the benefits of the law. A few highlights from the Proposed Regulations, as well as certain issues that were not resolved, are outlined below.

Capital Gains

The language of the TCJA left open the possibility that both capital gains and ordinary gains (e.g., dealer income) could qualify for deferral if invested in a qualified opportunity fund. The Proposed Regulations provide that only capital gains, whether short-term or long-term, qualify for deferral if invested in a qualified opportunity fund and further provide that when recognized, any deferred gain will retain its original character as short-term or long-term.

Taxpayer Entitled to Deferral

The Proposed Regulations make clear that if a partnership recognizes capital gains, then the partnership, and if the partnership does not so elect, the partners, may elect to defer such capital gains. In addition, the Proposed Regulations provide that in measuring the 180-day period by which capital gains need to be invested in a qualified opportunity fund, the 180-day period for a partner begins on the last day of the partnership's taxable year in which the gain is recognized, or if a partner elects, the date the partnership recognized the gain. The Proposed Regulations also state that rules analogous to the partnership rules apply to other pass-through entities, such as S corporations.

Ten Year Benefit

The Ten Year Benefit attributable to investments in qualified opportunity funds will be realized only if the investment is held for 10 years. Because all designations of qualified opportunity zones under the TCJA automatically expire no later than December 31, 2028, there was some uncertainly as to whether the Ten Year Benefit applied to investments disposed of after that date. The Proposed Regulations expressly provide that the Ten Year Benefit rule applies to investments disposed of prior to January 1, 2048.

Qualified Opportunity Funds

The Proposed Regulations generally provide that a qualified opportunity fund is required to be classified as a corporation or partnership for U.S. federal income tax purposes, must be created or organized in one of the 50 States, the District of Columbia, or, in certain cases a U.S. possession, and will be entitled to self-certify its qualification to be a qualified opportunity fund on an IRS Form 8996, a draft form of which was issued contemporaneously with the issuance of the Proposed Regulations.

Substantial Improvements

Existing buildings in qualified opportunity zones generally will qualify as qualified opportunity zone business property only if the building is substantially improved, which requires the tax basis of the building to be doubled in any 30-month period after the property is acquired. In very helpful rule for the real estate community, the Proposed Regulations provide that, in determining whether a building has been substantially improved, any basis attributable to land will not be taken into account. This rule will allow major renovation projects to qualify for qualified opportunity zone tax benefits, rather than just ground up development. This rule will also place a premium on taxpayers' ability to sustain a challenge to an allocation of purchase price to land versus improvements.

Ownership of Qualified Opportunity Zone Business Property

In order for a fund to qualify as a qualified opportunity fund, at least 90 percent of the fund's assets must be invested in qualified opportunity zone property, which includes qualified opportunity zone business property. For shares or interests in a corporation or partnership to qualify as qualified opportunity zone stock or a qualified opportunity zone partnership interest, "substantially all" of the corporation's or partnership's assets must be comprised of qualified opportunity zone business property.

In a very helpful rule, the Proposed Regulations provide that cash and other working capital assets held for up to 31 months will count as qualified opportunity zone business property, so long as (i) the cash and other working capital assets are held for the acquisition, construction and/or or substantial improvement of tangible property in an opportunity zone, (ii) there is a written plan that identifies the cash and other working capital as held for such purposes, and (iii) the cash and other working capital assets are expended in a manner substantially consistent with that plan.

In addition, the Proposed Regulations provide that for purposes of determining whether "substantially all" of a corporation's or partnership's tangible property is qualified opportunity zone business property, only 70 percent of the tangible property owned or leased by the corporation or partnership in its trade or business must be qualified opportunity zone business property.

Qualified Opportunity Funds Organized as Tax Partnerships

Under general partnership tax principles, when a partnership borrows money, the partners are treated as contributing money to the partnership for purposes of determining their tax basis in their partnership interest. As a result of this rule, there was uncertainty regarding whether investments by a qualified opportunity fund that were funded with debt would result in a partner being treated, in respect of the deemed contribution of money attributable to such debt, as making a contribution to the partnership that was not in respect of reinvested capital gains and, thus, resulting in a portion of such partner's investment in the qualified opportunity fund failing to qualify for the Ten Year Benefit. The Proposed Regulations expressly provide that debt incurred by a qualified opportunity fund will not impact the portion of a partner's investment in the qualified opportunity fund that qualifies for the Ten Year Benefit.

The Proposed Regulations did not address many of the other open issues with respect to qualified opportunity funds organized as partnerships, including whether investors are treated as having sold a portion of their interest in a qualified opportunity fund and thus can enjoy the Ten Year Benefit if a qualified opportunity fund treated as a partnership and holding multiple investments disposes of one or more (but not all) of its investments. Accordingly, until further guidance is issued, we expect to see most qualified opportunity funds organized as single asset corporations or partnerships.

Effective Date

In general, taxpayers are permitted to rely upon the Proposed Regulations so long as they apply the Proposed Regulations in their entirety and in a consistent manner.

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[1] Prop. Treas. Reg. §1.1400Z-2 (REG-115420-18).

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the Tax Practice Group, or the following authors:

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