GIBSON DUNN

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IRS ISSUES ADDITIONAL GUIDANCE ON INVESTING IN OPPORTUNITY ZONES

To Our Clients and Friends:

On April 17, 2019, the Internal Revenue Service (the "**IRS**") and the Treasury Department released proposed regulations (the "**Proposed Regulations**") that provide additional guidance regarding investing in "qualified opportunity funds" and "opportunity zones."[1] The Proposed Regulations answer many questions that remained open regarding qualified opportunity funds, including by addressing certain areas of uncertainty for which the previously proposed regulations issued on October 19, 2018 (the "**October Proposed Regulations**") reserved or solicited comments. The Proposed Regulations provide many answers needed to move forward with projects in opportunity zones. In general, similar to the October Proposed Regulations, 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.

Among other guidance, the Proposed Regulations address the tax treatment of sales of opportunity zone investments by qualified opportunity funds, the transactions that may trigger the inclusion of deferred gain, and other technical issues with regard to investing in a qualified opportunity fund.

Please refer to Gibson Dunn's October 22, 2018 client alert for further discussion on the October Proposed Regulations.

Qualified Opportunity Funds

Qualified opportunity funds were created as part of the Tax Cuts and Jobs Act (the "**TCJA**") signed into law in December 2017 to incentivize private investment in economically underperforming areas by providing tax benefits for investments through qualified opportunity funds that own property used in "opportunity zones." 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 within 180 days after the recognition of such gains ("**reinvested gain**"), (ii) an exclusion of up to 15% of such reinvested gain, and (iii) a permanent exclusion of all gain, other than reinvested gain, 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 the investment is sold or exchanged and (ii) December 31, 2026. Under the October Proposed Regulations, with respect to any capital gain recognized by a partnership and reinvested by a partner thereof in a qualified opportunity fund, the 180-day investment period would begin on the last day of the partnership's taxable year, though the partner could elect to commence the period on the date the partnership recognized the capital gain.

- 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 reinvested gain if the investment is held for five years by December 31, 2026 and is increased by an additional 5 percent of the amount of reinvested gain (for a total increase of 15 percent) if the investment is held for seven years by December 31, 2026.

- Finally, the tax basis in an investment in a qualified opportunity fund attributable to reinvested gain and held for at least 10 years is increased to the fair market value of such investment on the date of the sale or exchange of such investment, effectively eliminating any gain (other than the reinvested gain) 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 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. Qualified opportunity zone stock and qualified opportunity zone partnership interests are stock in a corporation or interests in a partnership acquired in a primary issuance for cash after December 31, 2017, provided "substantially all" of the tangible property, whether leased or owned, of the corporation or partnership is qualified opportunity zone business property during substantially all of the qualified opportunity fund's holding period for the stock or interest.

The Proposed Regulations – Summary and Observations

A few highlights from the Proposed Regulations are outlined below.

Acquisition of Interests in Qualified Opportunity Funds

The Proposed Regulations make clear that a taxpayer may obtain the tax benefits of investing in a qualified opportunity fund though the investment of cash or property in the qualified opportunity fund or by purchasing an interest in the qualified opportunity fund from another investor in the qualified opportunity fund. In the latter case, the investing taxpayer is treated as making an investment in a qualified opportunity fund in an amount equal to the amount invested or paid for the interest. In the case of a contribution of property to a qualified opportunity fund in a carryover basis transaction, the Proposed Regulations provide that the amount invested equals the lesser of the taxpayer's adjusted basis in the equity received in the transaction (in the case of a transfer to a partnership, without regard to any partnership liabilities allocated to the taxpayer) and the fair market value of the equity received in the transaction. In all cases, the amount treated as invested is limited to the amount of gain that may be deferred.

Debt-Financed Distributions From Partnerships

To prevent investors from taking advantage of the gain exclusion and deferral rules by investing in a qualified opportunity fund that is classified as a partnership and then reducing that investment with a debt-financed or other distribution from the qualified opportunity fund, the Proposed Regulations provide that, to the extent a distribution to an investor in a qualified opportunity fund would be treated as a disguised sale of property to the partnership under existing partnership tax rules, with certain modifications, such as assuming for such purpose that any cash invested was property, the investor's investment in the qualified opportunity fund that is entitled to the benefits of investing in a qualified opportunity fund will be reduced to the extent re-characterized as a sale.

Section 1231 Gain and 180-Day Rule

With certain exceptions, gain or loss from the sale or exchange of real property or depreciable property used in a trade or business and held for more than one year is treated as "section 1231 gain" or "section 1231 loss," as applicable. If a taxpayer's section 1231 losses exceed its section 1231 gains for a taxable year, then such losses and gains are treated as ordinary losses and gains, and if a taxpayer's section 1231 gains exceed its section 1231 losses for a taxable year, subject to a recapture rule that applies if the taxpayer had net section 1231 losses in prior taxable years, such gains and losses are treated as capital gains and losses. The Proposed Regulations provide that the 180-day period by which gain must be reinvested in a qualified opportunity fund with respect to any section 1231 capital gain begins on the last day of the taxpayer's taxable year, not when the section 1231 gain is recognized. In addition, the only Section 1231 gain eligible for deferral is a taxpayer's net Section 1231 gain for the year.

Inclusion of Deferred Gains

As mentioned above, 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. The Proposed Regulations expand on the "sold or exchanged" language of the statute by requiring the inclusion of deferred gain upon the occurrence of an "inclusion event." For this purpose, an "inclusion event" generally means a taxpayer's transfer of a qualifying investment in a qualified opportunity fund in a transaction that (1) reduces the taxpayer's equity interest in the qualified opportunity fund or (2) except as otherwise provided under the Proposed Regulations, involves the receipt of property (including cash) in a transaction that is treated as a distribution for U.S. federal income tax purposes (without regard to whether the distribution reduces the taxpayer's ownership of the qualified opportunity fund).

A tax-free contribution to an entity classified as a partnership of an interest in a qualified opportunity fund that is also classified as a partnership for U.S. federal income tax purposes will not result in an inclusion event (and the taxpayer's holding period for purposes of the Ten Year Benefit will not reset), although the reinvested gain associated with the contributed interest must ultimately be allocated to the contributing partner. Distributions from a partnership generally are not inclusion events unless the amount distributed exceeds the taxpayer's basis (including allocable debt) in its partnership interest (although the modified disguised sale rule noted above could apply).

Similarly, distributions treated as dividends or as returns of capital from qualified opportunity funds that are C corporations generally are not inclusion events, although distributions in excess of a shareholder's basis (and most stock redemptions) are inclusion events. An inclusion event also occurs when the percentage of the stock of an S corporation holding an investment in a qualified opportunity fund that is owned directly by the shareholders who owned the S corporation at the time of its deferral election has decreased by more than 25 percent. In such an instance, the S corporation is treated as having disposed of its entire qualifying investment in the qualified opportunity fund.

A transfer of an interest in a qualified opportunity fund by gift generally is an inclusion event, but a transfer of an interest in a qualified opportunity fund by reason of the taxpayer's death generally is not an inclusion event.

Special Rules for Qualified Opportunity Funds Classified as Partnerships, S Corporations and REITs

The Proposed Regulations clarify that sales or dispositions of assets by a qualified opportunity fund will not impact investors' holding periods in their qualifying investments. A taxpayer that is the direct holder of an interest in a qualified opportunity fund classified as a partnership or stock of a qualified opportunity fund treated as an S corporation may elect to exclude from gross income some or all of the taxpayer's distributive share of certain capital gain arising from the disposition of qualified opportunity zone property reported on such partner's or shareholder's Schedule K-1 (provided the disposition occurs after the 10-year anniversary of the taxpayer's acquisition of its interest in the qualified opportunity fund). Even with this election, an investor in a qualified opportunity fund may still want to consider selling interests in the qualified opportunity fund rather than relying upon this election as this election by its terms only applies to capital gains and not gains from the sale that are taxed as ordinary income.

A similar rule permits qualified opportunity funds that are REITs to designate capital gain dividends attributable to long-term gains from the sale of qualified opportunity zone property and to allow qualifying shareholders who have held the stock in the REIT for the applicable ten-year period to exclude the gain from income.

Original Use and Substantial Improvement

As noted, qualified opportunity zone business property is tangible property used in a trade or business within an opportunity zone if, among other requirements, 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. The October Proposed Regulations reserved on the meaning of original use of tangible property.

The Proposed Regulations provide that the original use of tangible property in an opportunity zone commences on the date any person first places the property in service in the qualified opportunity zone for purposes of depreciation or amortization. If, however, property has been unused or vacant for an uninterrupted period of at least 5 years, original use in the qualified opportunity zone commences on the date after that period when any person first uses or places the property in service in the qualified opportunity zone. Leasehold improvements made to leased property by a lessee are treated as purchased property and thus will satisfy the original use requirement if made by the qualified opportunity fund or qualified opportunity zone business.

The October Proposed Regulations reserved on whether or not unimproved land needed to be substantially improved in order to be treated as qualified opportunity zone business property. The Proposed Regulations make clear that unimproved land within a qualified opportunity zone acquired by purchase generally is not required to be substantially improved. There are two limitations on this favorable rule. First, a qualified opportunity fund may not rely on the foregoing proposed rule if unimproved land is purchased with intent not to improve the land by more than an insubstantial amount within 30 months after the date of purchase. Second, if a qualified opportunity fund does not invest new capital into, or increase any economic activity or output of, that unimproved land, a general anti-abuse rule set forth in the Proposed Regulations (discussed below) could be applied to treat the acquisition of the unimproved land as an acquisition of non-qualifying property for purposes of the qualified opportunity zone rules. This would apply, for example, to farm land that is purchased by a qualified opportunity fund and which is continued to be operated as farm land.

Leases of Tangible Property

The Proposed Regulations contain certain specific requirements applicable to leased tangible property intended to qualify as qualified opportunity zone business property. Each lease must be entered into after December 31, 2017, and the terms of the lease must be market rate, measured at the time the lease was entered into. In the case of leased real property, upon entering into the lease, there may not be a plan for the qualified opportunity fund to purchase the real property, other than for the fair market value of the real property at the time of purchase without regard to any prior lease payments.

As a general matter, leased property need not be substantially improved, nor does its original use need to commence with the lessee. If, however, tangible property is leased from a related party, the lessee may not make any prepayment in connection with the lease relating to a period of the property's use that exceeds 12 months, if the original use of leased tangible personal property in the qualified opportunity zone does not commence with the lessee, the lessee must become the owner of tangible property that is qualified opportunity zone business property at least equal to the value of the leased tangible personal property within 30 months of taking possession of the leased property, and there must be substantial overlap of the opportunity zones in which the acquired and leased property are used.

90 Percent Asset Test

As mentioned above, 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. For purposes of the 90 percent asset test, the Proposed Regulations permit a qualified opportunity fund to exclude for 6 months any capital contributions received by the qualified opportunity fund, provided that those capital contributions must be held in cash, cash equivalents, or debt instruments with a term of 18 months or less. The Proposed Regulations also permit proceeds from a qualified opportunity fund's sale or disposition of qualified opportunity zone property to be treated as qualified opportunity zone property for purposes of the 90 percent asset test so long as the qualified opportunity fund reinvests the proceeds within the 12-month period following the sale or disposition, and the proceeds are held in cash, cash equivalents, or debt instruments with a term of 18 months or less. If reinvestment of the proceeds is delayed by waiting for governmental action, the application for which is complete, that delay will not cause a failure of the 12-month requirement.

For purposes of the 90 percent asset test, unless a qualified opportunity fund elects to use the leased asset's financial statement value – which it may use only if the fund has an "applicable financial statement" that is prepared in accordance with U.S. generally accepted accounting principles and requires an assignment of value to the lease of the property – the value of each leased asset will be equal for all testing dates to the sum of the present values of each payment under the lease (discounted at the applicable federal rate used for debt instruments). For this purpose, the term of the lease includes lessee options to extend if the option includes pre-defined rent.

The valuation method selected for a taxable year must be applied consistently to all tangible property valued with respect to that year.

Active Conduct of a Trade or Business; Nonqualified Financial Property

At least 50 percent of the gross income of a qualified opportunity zone business (i.e., a partnership or corporation in which a qualified opportunity fund invests) must be derived from the active conduct of a trade or business within a qualified opportunity zone. While the Proposed Regulations generally do not define what is the active conduct of a trade or business, the Proposed Regulations explicitly provide that the ownership and operation (including leasing) of real property is treated as the active conduct of a trade or business for purposes of the opportunity zone rules. Merely entering into a triple-net-lease with respect to real property owned by a taxpayer, however, is not the active conduct of a trade or business.

A qualified opportunity zone business is also limited in its ability to hold "nonqualified financial property" and the October Proposed Regulations excluded reasonable amounts of working capital held in cash, cash equivalents, or debt instruments with a term of 18 months or less from such definition, so long as certain conditions were satisfied, including that such amounts be expended within 31 months of receipt. The Proposed Regulations add that if consumption of the working capital assets is delayed by waiting for governmental action the application for which is complete, the delay does not cause a violation of the condition requiring working capital assets to be spent within 31 months of receipt.

Consolidated Return Regime and Qualified Opportunity Funds

The Proposed Regulations acknowledge that the policy goals of the consolidated return regulations and the qualified opportunity fund regime conflict and that, rather than attempt to resolve such conflict, the IRS and Treasury have elected to treat stock in a qualified opportunity fund classified as a corporation for U.S. federal income tax purposes as not stock in a member of a consolidated group for purposes of the consolidated return regulations; accordingly, a qualified opportunity fund may be the common parent of a consolidated group but may not be a subsidiary member of a consolidated group. The Proposed Regulations provide that the same member of a consolidated group must both engage in the sale of a capital asset giving rise to gain and make the corresponding investment in a qualified opportunity fund. The tax benefits recognized by a member of a consolidated group as a result of an investment in a qualified opportunity fund generally will "tier up" to other members of the consolidated group by increasing the basis of the stock in the consolidated group member holding interests in a qualified opportunity fund.

Anti-Abuse Provisions

Under the Proposed Regulations, the government reserves the right to recast a transaction (or series of transactions) such that it would not qualify for the opportunity zone benefits if a significant purpose of the transaction (or series of transactions) is to achieve a tax result that is inconsistent with the statutory purposes of qualified opportunity funds. Any such determination by the IRS will be made on the basis of all the facts and circumstances of a given transaction. These anti-abuse provisions are consistent with the traditional anti-abuse framework applied by the IRS in regulations outside of the opportunity zone regime.

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[1] Prop. Treas. Reg. §1.1400Z-2 (REG-120186-18).

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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