

New Qualified Opportunity Zone Guidance Released

Practice Update

October 24, 2018

On October 19, 2018, much-awaited guidance was released by the IRS and Treasury Department on the application of the opportunity zone program. The guidance came in the form of Proposed Regulations and a Revenue Ruling (Rev. Rul. 2018-29). The IRS also released a draft IRS Form 8996 (Qualified Opportunity Fund) and Instructions. The newly released guidance addresses several critical issues involved in the opportunity zone program.

Background on the Opportunity Zone Program

Under the opportunity zone program, investors may defer the recognition of capital gains to the extent such gains are reinvested into the equity of a qualified opportunity fund (a “QOF”) within 180 days. Additional federal income tax incentives are available provided the investors meet the 5, 7 and/or 10-year holding period requirements. At least 90% of

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the assets of a QOF must be comprised of qualified opportunity zone property (the “90% Investment Standard”). See our prior analysis for more background on the basics of the opportunity zone program.

New Guidance

The new guidance addresses several important topics and answers numerous open questions concerning the rules that apply under the opportunity zone program. The highlights of the new guidance are summarized below.

Gain Deferral Rules

- Only “capital” gains from sales or exchanges to unrelated persons are eligible for deferral under the opportunity zone program.
- Individuals, C corporations (including REITs and RICs), S corporations, partnerships, trusts, and estates are each eligible to make the deferral election to rollover capital gains into a QOF within 180 days of the date of the sale or exchange.
- A partnership may elect to defer capital gain on its own behalf. If, however, a partnership does not make the deferral election, then a partner may make the deferral election with respect to the partner’s distributive share of such capital gain. Analogous rules apply with respect to S corporations, trusts, and estates.
- In order to properly elect to defer capital gain, the gain must be reinvested in a QOF in exchange for equity (which can include preferred stock or partnership interests with special allocations), but not debt.

Qualified Opportunity Fund Rules

- A QOF must be an entity classified as a corporation or partnership for federal tax purposes, and must be organized in one of the 50 states, the District of Columbia, or a U.S.

possession. Thus, a limited liability company classified as a partnership or corporation for federal tax purposes can qualify as a QOF.

- A QOF self-certifies as such on IRS Form 8996. This form must be filed annually and must include information to compute the QOF's 90% Investment Standard.
- The term "substantially all" when used in the definition of a "qualified opportunity zone business" is defined to mean 70%, meaning that at least 70% of the tangible property owned or leased must be qualified opportunity zone business property. However, the term "substantially all" when used elsewhere in the statute is not yet defined.
- Land and preexisting buildings situated thereon (which are located within a qualified opportunity zone) cannot satisfy the "original use" test, but with respect to the "substantial improvement" test, when land and preexisting buildings thereon are purchased together, the QOF is only required to substantially improve the buildings (not the land) in order to meet the requirement of holding "qualified opportunity zone business property."
- A qualified opportunity zone business is permitted to hold a reasonable amount of working capital (such as cash and cash equivalents). A safe harbor provides that amounts shall be considered reasonable if the amounts are designated in writing for use in the acquisition, construction or improvement of tangible property, a written schedule provides for the deployment of such working capital under which the working capital must be spent within 31 months, and the working capital is actually used consistently with the foregoing.
- After a 10-year holding period, the ability to make the election to cause the basis in a QOF equity interest to equal the fair market value when sold is preserved until December 31, 2047.

Overall, the new guidance answers a number of open questions and clarifies a number of ambiguities in the statute which commentators and industry professionals have thus far identified; however, numerous vital questions and issues remain unanswered and unclear. Additional proposed regulations will be issued in the near future addressing many of these remaining open questions.

Proposed regulations are generally not binding until they become final regulations. However, these Proposed Regulations state that they may be relied upon in certain circumstances before they are finalized provided that taxpayers and QOFs apply the rules in their entirety and in a consistent manner.

The foregoing is merely a general summary of the new guidance. It is not a complete or comprehensive analysis of every aspect or provision of the new guidance. Investors, property owners and developers who own property in a qualified opportunity zone or are considering an investment in a qualified opportunity zone should consult with qualified tax and real estate counsel in order to determine their eligibility for these federal income tax benefits.

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