Duffy Kruspodin, LLP
Certified Public Accountants

San Diego

4225 Executive Square
Suite 900
La Jolla, CA 92037

tel (858) 642-5050
fax (858) 642-5065

4304 Park Blvd.
San Diego, CA 92103

tel (619) 295-2637
fax (619) 299-5549

Los Angeles

21600 Oxnard St.
Suite 2000
Woodland Hills, CA 91367

tel (818) 385-0585
fax (818) 436-7588

tel (805) 379-4487
fax (805) 379-9767

www.dkllpcpa.com

December 13, 2018

On October 19, 2018, the Internal Revenue Service issued proposed regulations for the deferral of gain under Code Sec. 1400Z-2 Qualified Opportunity Zone (QOZ) tax incentives. The purpose of the proposed regulations is to provide expanded clarity for the eligibility for deferral treatment. While the regulations are proposed, taxpayers and tax practitioners may rely on the guidance until final regulations are issued. The following memo is intended to broadly highlight key provisions of the proposed regulations.

Opportunity Zone Defined

An Opportunity Zone is an economically-distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Localities qualify as Opportunity Zones if they have been nominated for that designation by the state and that nomination has been certified by the Secretary of the U.S. Treasury via his delegation of authority to the Internal Revenue Service.

The list of designated Qualified Opportunity Zones can be found at Opportunity Zones Resources and in the Federal Register at IRB Notice 2018-48. A visual map of the census tracts designated as Qualified Opportunity Zones may also be found at Opportunity Zone Interactive Map.

Gains Eligible for Deferral

The proposed regulations have set forth that only capital gains are eligible for gain deferral. Qualifying gains are those that are treated as capital gains for Federal income tax purposes. As such, the capital gains must result from an actual or deemed sale or exchange. Any qualifying capital gains would also need to be recognized before December 31, 2026, if there was a deferral. Additionally, any gain that arises from a sale or exchange from a related person does not qualify for deferral. When determining whether a person is a related party the proposed regulations point to Section 267(b) and 707(b)(1) for definition. However, the proposed regulations substitute 20 percent for 50 percent each place it occurs in those sections.

There are specific rules regarding eligibility and timing for Section 1256 and offsetting-positions transactions.

Types of Taxpayers Eligible to Elect Gain Deferral

Taxpayers that recognize capital gain for Federal income tax purposes are eligible to elect deferral. These include: Individuals, C corporations, partnerships, common trust funds, qualified settlement funds, and other entities taxable under §1.468B.

If a partnership recognizes capital gains, the partners may elect to defer gain, even if the partnership does not elect to do so. For partners that elect to defer, the 180-day period for investment begins on the last day of the partnership's taxable year -or- the date the partnership recognized the gain. These rules also apply for other passthrough entities, S-Corporations, common trust funds, etc.

Deferral Reporting

Per the proposed regulations taxpayers are anticipated to make deferral elections on Form 8949.

Investment in a QOF (Qualified Opportunity Fund)

Eligible interest in a Qualified Opportunity Fund (QOF) is an equity interest issued by the QOF. Included in the definition are partnership interests with special allocations and preferred stock.

QOF are required to be corporations or partnerships for Federal income tax purposes and must be organized in the US, or in certain cases US possessions.

Debt instruments and deemed contributions of money as a result of a partner's assumption of liabilities or increase in share of partnership liabilities do not qualify as eligible investment. However, debt incurred by a qualified opportunity fund will NOT impact the portion of a partner's investment that qualifies for deferral.

Qualified investment interest may be used as collateral for a loan.

180-Day Rule for Deferring Gain by Investing in a QOF

The 180-Day period begins on the date of the sale or exchange giving rise to the gain.

For a deemed sale, the 180-day period begins on the date on which the gain would be recognized for Federal income tax purposes.

Election for Investments Held at Least 10 Years

The proposed regulations establish that a taxpayer holding a QOF investment for at least ten years may elect to step-up the basis of their investment in order to avoid recognizing gain on any appreciation.

For investments held at least 10 years, the taxpayer may elect to increase the basis to the Fair Market Value (FMV) of the investment on the date sold or exchanged, if a deferral election was originally made. The election to step up the basis can be made after the zone designation expires, which per the proposed regulations is available until December 31, 2047.

Self-Certification Reporting

Qualified Opportunity Funds will self-certify and necessary information will be reported on Form 8996.

Qualified Opportunity Zone Property

<u>90% of a fund's assets must be invested in qualified opportunity zone property</u>. For shares or interests in a corporation or partnership to qualify as qualified property, "substantially all" of the assets must be comprised of Qualified Opportunity Zone Business Property. The proposed regulations state that <u>"substantially all" means 70% of tangible property</u> owned or leased must be qualified property.

When valuing assets to see if a fund meets the 90% asset test, the proposed regulations require the QOF to use values reported on an applicable financial statement. If no financial statement is prepared then the QOF is required to use cost.

Cash and working capital held for over 30 months will qualify as Qualified Opportunity Zone Business Property if:

- Held for acquisition, construction or substantial improvement of tangible property in an Opportunity Zone
- Written plan that identifies the cash and working capital held for such purposes
- Cash and working capital are used in a manner consistent with the written plan

Revenue Ruling 2018-29

Revenue Ruling 2018-29, which was released subsequently to the proposed regulations, discusses the rules related to original use and substantial improvement.

- To be considered QOZ business property, generally the tangible property must commence with an eligible entity, QOF or QOZ business. However, in the case that the property is substantially improved, then it will qualify as QOZ property.
  - E.g. Newly erected building vs pre-existing building.
- The revenue ruling establishes that unimproved land and land with an existing building on it would not qualify unless the property is substantially improved. Substantial improvement in this sense means that the basis increase in the property must exceed the adjusted basis at the time of acquisition
  - E.g. Building costing $500,000 must have improvements worth at least $500,000 to qualify.
- When purchasing land with a building on it, the value of the land is not considered part of the value of the building for the substantial improvement testing. The land does not need to be improved to qualify for QOZ business property treatment.
  - E.g. Purchase land and building for $1mil. Land is worth $400k and building is worth $600k
    - The amount of improvements to be considered substantial improvement is $600k, not $1mil.

Conclusion

While the proposed regulations have helped to clear up several key issues and items there are substantial open questions which require additional guidance. A public hearing is set for January 10, 2019. From this, we hope to have a more definite guide.