

# Chapman Client Alert

February 4, 2019

Current Issues Relevant to Our Clients

## Opportunity Zone Funds Receive Some Guidance, But Questions Remain

In December 2017, Congress added a provision to the tax code that allows some taxpayers to defer some capital gain and eliminate other gain if the taxpayer invests in an Opportunity Zone and certain conditions are met.

An Opportunity Zone is an economically-distressed community that is nominated for that designation by the state in which it is located and certified as an Opportunity Zone by the Internal Revenue Service.

Taxpayers eligible for the deferral of gain include individuals, C corporations (including RICs and REITs), partnerships and certain other pass-through entities, including common trust funds, qualified settlement funds, disputed ownership funds, and certain other entities.

In October 2018, the IRS released proposed regulations and a Revenue Ruling providing much needed guidance for Qualified Opportunity Funds. Significant questions still remain, however, and the Treasury has indicated that a second set of proposed regulations should be released early in 2019.

### Background and Basic Rules

Section 1400Z-2 of the Internal Revenue Code of 1986, as amended (the "Code"), was added as part of the Tax Cuts and Jobs Act in December 2017. Section 1400Z-2 allows taxpayers to roll gain that would otherwise be required to be recognized by investing such gain in a Qualified Opportunity Fund ("QOF") within 180 days after the time the gain would otherwise be recognized.

The cost of making the roll-over election is that the basis of the taxpayer in the QOF is initially zero. If the investment is held for 5 years, the basis is increased to 10% of the amount deferred. If the investment is held for 7 years, the basis is increased by another 5% of the amount deferred.

The gain deferred will be recognized on the earlier of the date the investment in the QOF is sold or December 31, 2026. The amount included in income under Section 1400Z-2 is the lesser of the gain deferred or the excess of the fair market value over the basis in the investment at the time of recognition.

If the investment in the QOF is held for at least 10 years, the taxpayer may elect to treat the basis in the investment as equal to the fair market value of the investment at the time the investment is sold.

### Requirements for Qualified Opportunity Funds

A QOF is a partnership or a corporation that holds at least 90% of its assets in qualified opportunity zone property, as measured every 6 months during the life of the fund. Qualified opportunity zone property includes qualified opportunity zone stock, qualified opportunity zone partnership interests or qualified opportunity zone business property.

Qualified opportunity zone stock means stock acquired by the fund from the corporation after 2017 for cash. The corporation must either be a qualified opportunity zone business or be newly formed and intend to be a qualified opportunity zone business.

Qualified opportunity zone partnership interest similarly means a partnership interest acquired by the fund from the partnership after 2017 for cash. Again, the partnership must either be a qualified opportunity zone business or be newly formed and intend to be a qualified opportunity zone business.

A qualified opportunity zone business is a business in respect of which substantially all the property is qualified opportunity zone business property and which is engaged in an active business. Less than 5% of the property of the business may be financial property. To be qualified opportunity zone business property, the property must be acquired by purchase after 2017, the original use must begin with the business, and substantially all of the use of the property must be in the Opportunity Zone.

## Clarifications of the Proposed Regulations

---

One of the issues raised from the face of the statute is what types of gain may be deferred. In a variety of places, the Code recharacterizes gain as ordinary income. The proposed regulations clarify that it is intended that only capital gain is eligible for deferral. In addition, the gain included must otherwise be required to be recognized not later than December 31, 2026. Also, the gain must not arise from a sale with a related person.

Separately, the statute only makes reference to an investment in a QOF. The proposed regulations clarify that the investment must be an equity investment, so either stock in a corporation or a partnership interest.

The statute would appear to create a cliff for recognition: if an investment in an QOF is sold, the gain is recaptured. The proposed regulations allow a second deferral if an interest in a QOF is sold and the proceeds are rolled into another QOF.

If a taxpayer recognizes a large capital gain but rolls the gain into separate funds (or a single fund over time), the taxpayer may make multiple deferral elections, so long as all of the roll-overs are within the 180-day period.

The proposed regulations allow the deferral of gain from the mark to market requirements of Section 1256, generally dealing with regulated futures contracts and certain traded futures and options. However, the proposed regulations would not allow deferral of gains from mixed straddles or straddles, both of which are offsetting positions in financial instruments of the taxpayer that vary inversely with each other.

Revenue Ruling 2018-29 further clarifies that the original use of land cannot begin with the opportunity zone business, so the business must qualify based upon the improvements rather than the value of the land.

## Open Questions

---

The statute contemplates a buy and hold for the entire 10-year period. In other words, the most favorable result for an investor may occur if the investor holds the investment in the QOF for 10 years. If the investment in the QOF is sold before the end of the 10-year period, the statute itself would either cause a recapture of the deferred gain, deny the step-up in basis, or both.

The proposed regulations suggest that a QOF may dispose of property within the 10-year period so long as the proceeds are reinvested in opportunity zone business property within a reasonable time. The next set of regulations should address what constitutes a reasonable time.

The statute requires that 90% of the assets of a QOF be invested in qualified opportunity zone property, measured every six months. This requirement will create challenges to new funds that have received the cash from investors but not yet deployed the cash. The IRS has indicated that it is considering a 31-month working capital safe harbor but may require a written plan and schedule for the use of the funds.

## For More Information

---

If you would like further information concerning the matters discussed in this article, please contact the Chapman attorney with whom you regularly work.

# Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

To the extent that any part of this summary is interpreted to provide tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

© 2019 Chapman and Cutler LLP. All rights reserved. Attorney Advertising Material.