On October 19, 2018, the U.S. Treasury Department released proposed regulations, and the IRS released Revenue Ruling 2018-29, relating to the operation of Qualified Opportunity Zones (QOZs) and Qualified Opportunity Funds (QOFs) under Code section 1400Z-2. Here are some highlights:

For Taxpayers:

• All types of capital gains – but only capital gains (i.e. not ordinary gains) – are eligible for deferral upon investment of proceeds in a QOF.
• If a partnership does not invest in a QOF (and recognizes gain as a result), the partners still may invest in a QOF and elect deferral individually, so that they do not have to recognize gain on their distributive shares.

For Qualified Opportunity Funds:

• QOFs must be classified as a corporation or partnership for income tax purposes, meaning a limited liability company (LLC) can qualify as a QOF. QOFs must also be created or organized in one of the 50 U.S. states, DC, or a U.S. territory.
• Preexisting entities can qualify as QOFs or Opportunity Zone businesses as long as they satisfy the necessary requirements.
• QOFs will be able to choose the first month in which they will be treated as a QOF. Subsequently, the “first six-month period of the taxable year of the fund” means the first six-month period that falls entirely within the QOF’s taxable year; the last day of the QOF’s taxable year is always a test date for the QOF’s 90-percent asset test.
• A QOF must value its assets for purposes of the 90-percent asset test using values reported on the QOF’s audited or filed financial statements (or using the cost of the assets if it does not have them).
• Though QOZ designations expire at the end of 2028, taxpayers may continue to hold QOF interests invested in those QOZs and still may step up the basis of their QOF investments to fair market value if they hold the investments for ten years. According to the proposed regulations, an investment made as late as June 30, 2027, and sold as late as the end of 2047 still may qualify for a full basis step-up (with the ten-year period ending in 2037). Treasury provided the additional ten-year period (through 2047) to avoid tax-induced sales as soon as the ten-year requirement is met.

For QOZ Businesses:

• For a QOZ business: At least 50 percent of gross income must be derived from the active conduct of a trade or business within a QOZ. Likewise, a substantial portion of intangible property must be used in the active conduct of a trade or business within a QOZ.
• For purposes of determining whether “substantially all” of a business’s tangible property is QOZ Business Property, the proposed rules define “substantially all” to mean 70 percent. Note that...
Treasury considered defining “substantially all” to mean 90 percent, and has specifically requested comments on this definition.

- Treasury is proposing a “working capital safe harbor” under which cash and cash equivalents will not be counted as “nonqualified financial property” for up to 31 months if certain conditions are met, including a written plan on how the working capital will be used to invest in QOZ property, a written schedule covering the 31-month period, and (ultimately) substantial compliance with that schedule by the business.
- A corresponding safe harbor notes that property subject to construction or substantial improvement in accordance with the working capital plan will not fail to qualify as QOZ Business Property solely because the planned expenditures have not been completed (and thus can contribute to meeting the 70-percent “substantially all” test if it otherwise meets the definition of QOZ business property).
- The accompanying revenue ruling proposed that, for purposes of determining whether an existing building on land in a zone has been substantially improved (and therefore “counts” for purposes of an assets test), the improvements need only double the owner’s basis in the building, and not the basis in the land as well. Treasury hopes that this lower threshold will encourage repurposing of vacant buildings in QOZs, but does not address application of the test to vacant land.

For Future Comment:

In addition, Treasury is seeking input on several outstanding issues, including (but not limited to):

- How to determine whether the “original use” of property commences in a QOZ and other questions related to this definition.
- How to define “substantially all” in the other places the phrase appears (e.g., the holding period requirement).
- Statutorily permissible alternatives to provide a reasonable period of time for a QOF to reinvest gains and still meet the 90-percent asset test, and how to treat gains that the QOF reinvests during that period. “Soon-to-be-released” proposed regulations will further address this issue and formally request comments.

Stakeholders have 60 days to submit comments on the proposed regulations and Treasury and the IRS intend to hold a public hearing on January 10, 2019. In addition, Treasury intends to issue additional proposed regulations in the near future.