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Memorandum

TO: Jaffe Friends

FROM: Marko J. Belej (248-727-1384)

RE: The Five Best Provisions in the Proposed Opportunity Zone Regulations

DATE: October 22, 2018

The Tax Cuts and Jobs Act of 2017 provided certain benefits to taxpayers who invest in "qualified opportunity funds" (QOFs). Principally, these include the deferral of capital gain and, if a 10-year holding period in the QOF investment is met, the exclusion of all additional appreciation in the QOF investment. A QOF is any entity treated as a partnership or corporation for tax purposes that has elected QOF status and has made certain investments in areas that have been designated as "opportunity zones."

The opportunity zone provision was hastily added to the Act and contained many open issues. The IRS proposed regulations on October 19, 2018 that left some of these issues open, clarified some others and gave surprisingly favorable rules for others.[1] This memorandum reviews the five provisions that are the most taxpayer friendly.

- ***The original use requirement does not apply to land.*** Under the statute, property will not be "qualified opportunity zone business property" (QOZBP) unless either its original use begins with the QOF or the QOF "substantially improves" the property. In order to "substantially improve" a property, a QOF must make capital improvements to the property that double its tax basis within a 30-month period. The regulations provide that this requirement does not apply to acquired land at all.

  Example: a QOF acquires real estate that was previously placed in service, for a purchase price of $100, of which $70 is attributable to a building and $30 is attributable to land. The QOF would be required to make capital improvements to the building of at least $70 (not $100) within a 30-month period. The QOF would not be required to make any improvements to the land (as a corollary, any expenditures for land improvements would not count toward the building).

- ***The treatment of flow-throughs provides opportunities for managing the 180-day investment rule.*** In order to defer gain under the opportunity zone legislation, a taxpayer

[1] The IRS indicated that these regulations were only the first round and that a second round is "expected to be published in the near future."

must invest the amount of gain in a QOF within 180 days of recognizing the gain. If a partnership or S corporation is the taxpayer that recognizes the gain, then such entity may invest the amount of gain in a QOF itself. If the entity does not invest the gain in a QOF, then its owners may invest their respective allocable shares of the gain in a QOF. For purposes of the 180-day rule, the regulations treat each owner as recognizing gain on the last day of the year in which the entity recognizes the gain, unless the owner elects to recognize the gain on the actual day on which the entity recognizes it. This rule gives partners and S corporation shareholders added flexibility to comply with the 180-day rule.

Example: The ABC LLC recognizes $100 capital gain on January 31, 2019. A, B and C are equal members. Assuming that ABC LLC does not invest in a QOF, then member A could elect to be treated as either (i) recognizing the gain on December 31, 2019, in which case he would have to invest the gain in a QOF between December 31, 2019 and June 28, 2020, or (ii) recognizing the gain on January 31, 2019, in which case he would have to invest the gain in a QOF between January 31, 2019 and July 30, 2019.

- ***The working capital safe harbor under the 90% test.*** For a fund to qualify as a QOF under the statute, 90% of its assets must be "qualified opportunity zone property" (QOZP).[2] This test generally is applied every six months.

  The proposed regulations will treat cash that has been contributed to the QOF but not deployed at a testing date as QOZP, if the following requirements are satisfied: (i) there is a written plan that identifies the cash as property held for the acquisition, construction, or substantial improvement of tangible property in an opportunity zone, (ii) there is a written schedule that the cash will be used within 31 months, and (iii) the QOF substantially complies with the schedule.

- ***70% counts as "substantially all" for testing the assets of a partnership or corporation.*** In order for a QOF's investment in a partnership or corporation to count as QOZP, the partnership or corporation must be a "qualified opportunity zone business" (QOZB). Under the statute, a business will be a QOZB only if "substantially all" of its assets are "qualified opportunity zone business property" (QOZBP).

  The regulations provide that a business will meet this requirement if at least 70% of its assets are QOZBP.[3] As a result, there is an opportunity for QOFs to invest through such entities, rather than directly in QOZBP. This ownership offers greater flexibility, For example, if a QOF invests directly, then 90% of its assets must be QOZBP. If instead the QOF invests in partnerships and corporations that qualify as QOZBs, then only 63% of the total indirect assets need to be QOZBP (i.e., 90% of the QOF's assets can be entities that hold 70% of their respective assets as QOZBP).

- ***Taxpayers can rely on these proposed regulations.*** Even though these regulations are still in proposed form, they explicitly provide that taxpayers and QOFs can rely on them, if they are consistently followed.

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[2] The proposed regulations clarified that this test is based on the book value of the QOF's assets, or, if the QOF does not have financial statements, their cost basis.

[3] Although the term "substantially all" appears elsewhere in the statute, the regulations expressly state that the 70% standard applies only for this purpose.