

An Overview of Opportunity Zones and Proposed IRS Regulations Concerning Investments in Qualified Opportunity Funds

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On October 17, 2018, the Internal Revenue Service released proposed regulations and commentary concerning the opportunity zone program, a key component of the 2017 Tax Cuts and Jobs Act (TCJA). The opportunity zone program is intended to encourage long-term capital investments into select low-income communities through the use of a new type of investment vehicle known as a Qualified Opportunity Fund (QOF). This Client Alert presents an overview of the opportunity zone program, QOFs, and the IRS's recently proposed regulations.

What Are Opportunity Zones?

Under the TCJA, eligible opportunity zones must be low-income census tracts with a poverty rate of 20% or a median family income of up to 80% of the area median. There are currently 169 census tracts (located in 75 municipalities) designated as opportunity zones in New Jersey, the maximum number permitted in the state under the TCJA. Accordingly, the opportunity zone program constitutes a significant incentive tool to further encourage redevelopment opportunities throughout the state at eligible locations.

What Constitutes a Qualified Opportunity Fund?

QOFs are investment vehicles organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property (other than another QOF). At least 90% of a QOF's assets must be invested in qualified opportunity zone property. In addition to direct ownership of real estate located in opportunity zones, qualified opportunity zone properties may include other "qualified opportunity zone business property" and equity interests in a "qualified opportunity zone business."

To constitute a "qualified opportunity zone business property," the property must be used in an opportunity zone along with new capital to "substantially improve" same so long as (1) the property was acquired by purchase after December 31, 2017; (2) the original use of the property in the opportunity zone commences with the QOF, or the QOF substantially improves the property; and (3) substantially all of the use of the property occurred in a qualified opportunity zone during the QOF's holding period for the property.

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For a trade or business to qualify as a “qualified opportunity zone business,” substantially all (i.e., 70% per proposed regulations) of the tangible property owned or leased by the business entity must constitute qualified opportunity zone property. Moreover, the entity must be a “qualified opportunity zone business” both (1) when the QOF acquires its equity interest in the entity and (2) during substantially all of the QOF’s holding period for that business.

Under the opportunity zone program, capital gains invested in a QOF are deferred until the sooner of the date the investment is sold or exchanged, or on December 31, 2026. This allows investors to roll their capital gains into a QOF with no up-front tax penalty. Moreover, qualified taxpayers may also exclude (1) 10% of the deferred gain from inclusion in income if the investments are held in a QOF for longer than 5 years, (2) 15% of the deferred gain from inclusion in income if the investments in a QOF are held longer than 7 years, and (3) the entire post-acquisition gain if the qualifying investment is held in the QOF for 10 years or more.

What Do the Proposed IRS Regulations Do?

The proposed opportunity zone regulations provide: (1) taxpayer requirements in order to defer the recognition of gains through QOF investments; (2) rules permitting corporations/ partnerships to self-certify as QOFs and (3) requirements for corporations/partnerships to qualify as a QOF. The proposed regulations also address the “substantial-improvement requirements” with respect to buildings purchased in qualified opportunity zones.

Key opportunity zone issues addressed in the proposed regulations include:

- Only capital gains that would otherwise be recognized under the IRC prior to December 31, 2026 from an actual, or deemed, sale are eligible for deferral under the opportunity zone program. Any such gain must not arise from a sale or exchange with a “related person.”
- Only taxpayers that can recognize a capital gain for Federal income tax purposes (i.e., individuals, C corporations (including regulated investment companies (RICs) and real estate investment trusts (REITs)), partnerships and other qualified pass-through entities) are eligible to participate in the opportunity zone program.
- In order to timely defer a gain, a taxpayer must generally invest in a QOF within 180 days from the date of the sale or exchange giving rise to the gain. Except as specifically set forth in the regulations, the first day of the 180-day period is the date on which the gain would otherwise be recognized under the IRC.
- Taxpayers may not make multiple elections with respect to the same capital gain. Thus, if a taxpayer makes an election under Section 1400Z-2(a) with respect to some, but not all of an eligible gain, the term “eligible gain” includes the portion of the eligible gain to which no election has been made.
- To the extent that a partnership does not elect to defer capital gains under the opportunity zone program, individual partners may do so as long as such partner’s distributive share satisfies all applicable eligibility rules under the regulations.

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- A 31-month working capital safe harbor is provided for QOF investments in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property, including both real property and other tangible property used in a business operating in an opportunity zone. To qualify, there must be (1) a written plan identifying the tangible property as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone, (2) a written schedule showing that the property's working capital will be used within 31 months, and (3) the business must substantially comply with the schedule.
- QOF investments held for at least 10 years from the date of the original investment in the QOF may elect to step-up the basis of the investment to the fair market value of the investment on the date that the investment is sold or exchanged; provided that the initial investment is made in connection with a proper deferral election. If an investment is made, in part, with gains from a deferred election and, in part, with other funds, the QOF investments are to be treated as separate investments and receive separate tax treatment for federal income tax purposes.
- Notwithstanding that the designations of all qualified opportunity zones will expire on December 31, 2028, the proposed regulations permit taxpayers to elect to step-up their property's basis after a qualified opportunity zone designation expires so long as the taxpayer makes the election no later than December 31, 2047.
- The proposed regulations generally permit taxpayers that are eligible corporations or partnerships for tax purposes to self-certify as a QOF.
- QOFs will be given a "reasonable period of time" to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests and to reinvest proceeds received from the sale or disposition of a qualified opportunity zone property. The IRS will be providing further guidance to address this issue.
- There will be no prohibition against using a pre-existing entity as a QOF or as a subsidiary entity operating a qualified opportunity business, provided that the pre-existing entity satisfies statutory requirements under the opportunity zone program.
- To constitute a "qualified opportunity zone business," "substantially all" of the assets of the trade or business must be a qualified opportunity zone property. The proposed regulations provide a 70% threshold to satisfy the "substantially all" requirement.
- If a QOF purchases a building located on land wholly within a qualified opportunity zone, a substantial improvement to the purchased tangible property is measured by the QOF's additions to the adjusted basis of the building. Additional regulations are forthcoming from the IRS concerning the "substantial improvements" requirements under the regulations.

The IRS is currently soliciting comments on the proposed opportunity zone regulations. Moreover, additional proposed regulations will be forthcoming from the IRS in the near future. We will continue to monitor and advise as the IRS promulgates further guidance and finalizes its opportunity zone regulations.

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Please contact the author of this Alert, **Matthew J. Schiller**, with any questions concerning opportunity zones in New Jersey.