



[Summary of the U.S. Treasury and Internal Revenue Service's guidance for investing in Opportunity Zones](#)

- This is the first of several proposed federal regulations and guidance documents to be released before tax filing begins in 2019.
- These proposed regulations addresses the type of gains that may be deferred by investors, the time by which corresponding amounts must be invested in Qualified Opportunity Funds (QOFs), the manner in which investors may elect to defer specified gains, and other proposed regulations applicable to QOFs.
- The IRS released a Revenue Ruling providing clarification on the substantial improvement of existing buildings purchased by QOFs, which can be found at the end of this document.
- The document also provides notice of a public hearing on these proposed regulations, scheduled for January 10, 2019. Written comments must be received by December 28, 2018. Specific requests for comment are highlighted in the document below.

[Explanation of Provisions](#)

[Deferring Tax on Capital Gains by Investing in Opportunity Zones](#)

- i. **Gains Eligible for Deferral**
 - i. Only available for capital gains, not ordinary gains.
 - ii. Eligible gains include capital gain from an actual, or deemed, sale or exchange, or any other gain that is required to be included in a taxpayer's computation of capital gain.
 - iii. Must be a gain that would be recognized, if OZ deferral was not permitted, not later than Dec. 31, 2026.
 - iv. Must not arise from a sale or exchange with a related person who is no more than 20% interested in the project.
- B. **Types of Taxpayers Eligible to Elect Gain Deferral**



- i. Those that recognize capital gain for Federal income tax purposes.
- ii. Individuals, C Corporations (including regulated investment companies), real estate investment trusts (REITS), partnerships, and certain other pass-through entities, including common trusts (Section 584), qualified settlement funds, disputed ownership funds, and other entities taxable under Section 1.468B of the Income Tax Regulations.
- iii. Pass through entities and taxpayers can invest in a QOF and defer recognition of eligible gain.
- iv. **Requesting comment on whether the rules are sufficient and whether more detailed rules are required to provide additional certainty for investors in pass through entities that are not partnerships.**

C. Investments in a QOF

- i. Must be an equity interest in the QOF (preferred stock or partnership with special allocations) and cannot be a debt instrument.
- ii. As long as the eligible taxpayer is the owner of the equity interest for Federal tax purposes, status as an eligible interest is not impaired by the taxpayer's use of interest as a collateral for a loan.
- iii. Deemed contributions of money do not result in the creation of an investment in a QOF.

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

- i. A taxpayer must generally invest in a QOF during the 180-day period beginning on the date of the sale or exchange giving rise to the gain.
- ii. For capital gains that do not provide a specific date for a deemed sale, the first day of the 180-day period is the date on which the gain would be recognized for Federal income tax purposes.
- iii. If a taxpayer acquires an original interest in a QOF in connection with a gain deferral election, if a later sale or exchange of that interest triggers an inclusion of the deferred gain, or if the taxpayer makes a qualifying new investment in a QOF, then the taxpayer is eligible to defer the inclusion of the previously deferred gain.
- iv. Deferral of inclusions otherwise mandated by section 1400Z-2(a)(1)(B) is permitted only if the taxpayer has disposed of the entire initial investment.
- v. **Requesting comment as to whether the final regulations should contain exceptions to the general 180-day rule and whether it would be helpful for either the final regulation or other guidance to illustrate the application of the general 180-day rule to other circumstances, and what those circumstances are.**

E. Attributes of Included Income When Gain Deferral Ends



- i. Taxpayers are required to include in income previously deferred gains.
- ii. All of the deferred gains' tax attributes are preserved through the deferral period and are taken into account when the gain is included.
- iii. If a taxpayer disposes of less than all of its fungible interests in a QOF, the proposed rule provides that the QOF interests disposed of must be identified using a first-in, first-out (FIFO) method. If the FIFO method doesn't work, the proposed regulations provide that a pro-rata method must be used to determine the character and any other attributes of the gain recognized.
- iv. Requesting comment as to whether different methods should be used. Any such alternatives methods must both provide certainty as to which fungible interest a taxpayer disposes of and allow taxpayers to comply easily with the requirement that certain dispositions of an interest in a QOF cause deferred gain be included in a taxpayer's income.

Special Rules

A. Gain not already subject to an election

- i. In the case of a taxpayer who has made 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 that eligible gain as to which no election has been made.

B. Section 1256 contracts

- i. Deferral allowed only for a taxpayer's capital gain net income from section 1256 contracts for a taxable year.
- ii. The 180-day period for investing capital gain net income from section 1256 contracts in a QOF begins on the last day of the taxable year.
- iii. Does not allow any deferral of gain from a section 1256 contract in a taxable year if, at any time during the taxable year, one of the taxpayer's section 1256 contracts was part of an offsetting-positions transaction in which any of the other positions was not also a section 1256 contract.
- iv. Requesting comment on this limitation and on whether capital gain from a section 1256 contract should be eligible for deferral under section 1400Z-2 on a per contract basis rather than on an aggregate net basis. Comments are requested on how to minimize the burdens and complexity that may be associated with reporting on a per contract basis for section 1256 contracts.

C. Offsetting-positions transactions, including straddles



- i. An offsetting-positions transaction is defined in the proposed regulations as a transaction in which a taxpayer has substantially diminished the taxpayer's risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (whether or not of the same kind).
- ii. Any capital gain from a position that is or has been part of an offsetting-positions transaction (other than an offsetting-positions transaction in which all of the positions are section 1256 contracts) is not eligible for deferral under section 1400Z-2.
- iii. An offsetting-positions transaction includes a straddle as defined in section 1092, which provides rules for positions held by related persons and certain flow-through entities (for example, partnerships).

[Gains of partnerships and other pass-through entities](#)

- i. A partnership may elect to defer all or part of a capital gain to the extent that it makes an eligible investment in a QOF.
- ii. If the election is made, no part of the deferred gain is required to be included in the distributive shares of the partners. If a partnership does not elect to defer capital gain, the capital gain is included in the distributive shares of the partners.
- iii. If all or any portion of a partnership's distributive share satisfies all of the rules for eligibility under section 1400Z-2(a)(1), then the partner generally may elect its own deferral with respect to the partner's distributive share. The partner's deferral is potentially available if the partner makes an eligible investment in a QOF.
- iv. The partner's 180-day period generally begins on the last day of the partnership's taxable year. However, if the partner knows both the date of the partnership's gain and the partnership's decision not to elect deferral under section 1400Z-2, the partner may choose to begin its own 180-day period on the same date as the start of the partnership's 180-day period.
- v. Rules analogous to the rules provided for partnerships and partners apply to other pass-through entities (including S corporations, decedents' estates, and trusts) and to their shareholders and beneficiaries.
- vi. Comments are requested regarding whether taxpayers need additional details regarding analogous treatment for pass-through entities that are not partnerships.



- i. It is anticipated that taxpayers will make deferral elections on Form 8949.
- ii. This form will be attached to Federal income tax returns for the taxable year in which the gain would have been recognized if it had not been deferred.
- iii. The ultimate time and manner in which deferral elections occur will be prescribed by the Commissioner of Internal Revenue.
- iv. **Comments are requested whether additional proposed regulations or other guidance are needed to clarify the required procedures** (www.IRS.gov/DraftForms).

[Elections for investments held for at least 10 years](#)

A. In general:

- i. A taxpayer that holds a QOF investment for at least ten years may elect to increase the basis of the investment to the fair market value of the investment on the date that the investment is sold or exchanged.
- ii. The basis step-up election is available only for gains realized upon investments that were made in connection with a proper deferral election.
- iii. It is possible for a taxpayer to invest in a QOF in part with gains for which a deferral election is made and in part with other funds (for which no deferral election is made or for which no such election is available). These two types of QOF investments must be treated as separate investments, which receive different treatment for Federal income tax purposes.
- iv. A taxpayer may make the election to step-up basis in an investment in a QOF that was held for 10 years or more only if a proper deferral election was made for the investment

B. QOF Investments and the 10-Year Zone Designation Period

- i. Designations of all qualified opportunity zones now in existence will expire on December 31, 2028. The loss of qualified opportunity zone designation raises numerous issues regarding gain deferral elections that are still in effect when the designation expires.
- ii. Proposed regulations permit taxpayers to make the basis step-up election under section 1400Z-2(c) after a qualified opportunity zone designation expires.

[Rules of a Qualified Fund](#)

A. Certification of an Entity as a QOF



- i. Generally permits any taxpayer that is a corporation or partnership for tax purposes to self-certify as a QOF, provided that the entity self-certifying is statutorily eligible to do so.
- ii. It is expected that taxpayers will use Form 8996, Qualified Opportunity Fund, both for initial self-certification and for annual reporting of compliance with the 90-Percent Asset Test.
- iii. Form 8996 would be attached to the taxpayer's Federal income tax return for the relevant tax years.

B. Designating When a QOF Begins

- i. A QOF can identify the taxable year in which the entity becomes a QOF and choose the first month in that year to be treated as a QOF. If an eligible entity fails to specify the first month it is a QOF, then the first month of its initial taxable year as a QOF is treated as the first month that the eligible entity is a QOF.

C. Becoming a QOF in a Month Other Than the First Month of the Taxable Year

- i. May become a QOF in the "first 6-month period of the taxable year of the fund," meaning the first 6-month period composed entirely of months which are within the taxable year and during which the entity is a QOF.
- ii. If the calendar-year QOF chooses a month after June as its first month as a QOF, then the only testing date for the taxable year is the last day of the QOF's taxable year.
- iii. Regardless of when an entity becomes a QOF, the last day of the taxable year is a testing date.
- iv. Soliciting public comments on guidance not only on the length of a "reasonable period of time to reinvest" but also on the Federal income tax treatment of any gains that the QOF reinvests during such a period; the scope of statutorily permissible policy alternatives.

D. Pre-Existing Entities

- i. There is no prohibition to 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 the requirements under section 1400Z-2(d).
- ii. A tangible asset can be qualified opportunity zone business property by an entity that has self-certified as a QOF or an operating subsidiary entity only if it acquired the asset after 2017 by purchase.



- iii. Requesting comment on whether there is a statutory basis for additional flexibilities that might facilitate qualification of a greater number of pre-existing entities across broad categories of industries.

E. Valuation Method for Applying the 90-Percent Asset Test

- i. The QOF must use the asset values that are reported on the QOF’s applicable financial statement for the taxable year.
- ii. If a QOF does not have an applicable financial statement, the proposed regulations require the QOF to use the cost of its assets.
- iii. Request comments on the suitability of both of these valuation methods, and whether another method, such as tax adjusted basis.

F. Nonqualified Financial Property

- i. Cash can be an appropriate QOF property for purposes of the 90-Percent Asset Test, if the cash is held with the intent of investing in qualified opportunity zone property.
- ii. Capital safe harbor for QOF investments in qualified opportunity zone businesses
 - a. Working capital can be applied to property held by the business for a period of up to 31 months where there is a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the opportunity zone, there is a written schedule consistent with the ordinary business operations of the business that the property will be used within 31-months, and the business substantially complies with the schedule.
 - b. Taxpayers required to retain written plans of their records.
 - c. Requesting comment on the adequacy of the working-capital safe harbor and of ancillary safe harbors that protect a business during the working capital period, and on whether there is a statutory basis for any additional relief. Comments are also requested about the appropriateness of any further expansion of the “working capital” concept beyond the acquisition, construction, or rehabilitation of tangible business property to the development of business operations in the opportunity zone.



G. Qualified Opportunity Zone Business

- i. The definition of qualified opportunity zone business property requires property to be used in a QOZ and also requires new capital to be employed in a QOZ.
- ii. Qualified opportunity zone business property means tangible property used in a trade or business of a QOF, but only if (1) the property was acquired by purchase after December 31, 2017; (2) the original use of the property in the QOZ commences with the QOF, or the QOF substantially improves the property; and (3) during substantially all of the QOF's holding period for the property, substantially all of the use of the property was in a QOZ.
- iii. To qualify as a qualified opportunity zone business, an entity must be a qualified opportunity zone business both (a) when the QOF acquires its equity interest in the entity and (b) during substantially all of the QOF's holding period for that interest.
- iv. For a trade or business to qualify as a qualified opportunity zone business, it must (among other requirements) be one in which substantially all of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property.
- v. If an entity qualifies as a qualified opportunity zone business, the value of the QOF's entire interest in the entity counts toward the QOF's satisfaction of the 90 Percent Asset Test.
- vi. If at least 70 percent of the tangible property owned or leased by a trade or business is qualified opportunity zone business property, the trade or business is treated as satisfying the substantially all requirement in section 1400Z-2(d)(3)(A)(i).
- vii. Qualified opportunity zone property may also include certain equity interests in an operating subsidiary entity (either a corporation or a partnership) that qualifies as a qualified opportunity zone business by satisfying certain requirements pursuant to section 1400Z-2(d)(2)(B) and (C).
- viii. If a QOF operates a trade or business directly and does not hold any equity in a qualified opportunity zone business, at least 90 percent of the QOF's assets must be qualified opportunity zone property.
- ix. Requested comments regarding the proposed meaning of the phrase substantially all.



H. Eligible Entities

- i. Qualified opportunity zone property may include:
 - a. A stock or a partnership interest in an entity classified as a corporation or partnership for Federal income tax purposes.
 - b. A corporation or partnership created or organized in, or under the laws of, one of the 50 States, the District of Columbia, or a U.S. possession.
 - c. If an entity is organized in a U.S. possession but not in one of the 50 States or the District of Columbia, an equity interest in the entity may be qualified opportunity zone stock or a qualified opportunity zone partnership interest, as the case may be, only if the entity conducts a qualified opportunity zone business in the U.S. possession in which the entity is organized.
 - d. A U.S. possession is any jurisdiction outside of the 50 States and the District of Columbia in which a designated qualified opportunity zone exists under section 1400Z-1. This definition may include the following U.S. territories: American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands.

[Investments from Mixed Funds](#)

- ii. If only a portion of a taxpayer’s investment in a QOF is subject for deferral election, the investment must be treated as two separate investments for Federal income tax purposes.
- iii. A taxpayer may make the election to step-up basis in an investment in a QOF that was held for 10 years or more only if a proper deferral election was made for the investment.
- iv. Deemed contributions of money do not constitute an investment in a QOF; therefore, such a deemed contribution does not result in the partner having a separate investment. Thus, a partner’s increase in outside basis is not taken into account in determining what portion of the partner’s interest is or is not subject to the deferral election.
- v. Comments are requested on whether other pass-through entities require similar treatment.



- vi. Comments are requested on whether there may be certain circumstances in which not treating the deemed contribution as creating a separate investment may be considered abusive or otherwise problematic.

[Special Rules for Capital Gains Invested in Opportunity Zones](#)

The IRS also released guidance which clarifies the meaning of substantial improvement as it relates to existing tangible property within an Opportunity Zone.

- If a QOF purchases an existing building located on land that is wholly within a QOZ:
 - the original use of the building in the QOZ is not considered to have commenced with the QOF, and the requirement under §1400Z-2(d)(2)(D)(i) that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located.
 - substantial improvement is measured based on the adjusted basis of the building. The cost of the land on which the building is located is not included in this basis.
 - the QOF is not required to separately substantially improve the land on which the building is located.
- For more information, see [Special Rules for Capital Gains Invested in Opportunity Zones](#).