



# MIDWEST **Opportunity Zone** FORUM

Nurtured by MCM CPAs & Advisors and Frost Brown Todd LLC

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Location: Midwest Opportunity Zone Forum Webinar

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# Agenda

- Treasury's New Guidance
  - Gains Eligible for Deferral
  - Types of Taxpayers Eligible to Elect Gain Deferral
  - Gains of Partnerships and Other Pass-Through Entities
  - Rules for a Qualified Opportunity Fund
  - Qualified Opportunity Zone Business
- Issues Not Addressed
- Next Steps
- Q & A

# Treasury Released First Round of Guidance

- October 19, 2018, the IRS and U.S. Department of the Treasury released the first round of proposed regulations regarding the implementation and application of the opportunity zone development incentive.
- IRS also issued Revenue Ruling 2018-29 to provide clarity regarding the “original use” and “substantial improvement” requirements and the application of those requirements to real property.
- IRS released draft Form 8996 and draft instructions for the form.
- IRS updated its FAQ document related to opportunity zones.

# Proposed Regulations?

- The proposed regulations are intended to provide guidance and clarity regarding Treasury's interpretation of IRC 1400Z-2. However, they are not final.
- There is a public comment period (60 days after publication in the Federal Register) and public hearing.
- Final regulations may differ from the proposed regulations.
- Taxpayers are permitted to rely on the rules outlined in the proposed regulations as long they apply the rules in their entirety and in a consistent manner.

# Treasury's Guidance is Incomplete

- While helpful, the proposed regulations and the Revenue Ruling leave several questions unanswered.
- The proposed regulations make it clear that Treasury and the IRS are working on additional guidance “expected to be published in the near future” that will address other issues under IRC 1400Z-2 that are not addressed in the first round of proposed regulations.
- Time frame of additional guidance?

# The Proposed Regulations

# Gains Eligible for Deferral

- Only capital gains are eligible for deferral.
  - Gain is eligible for deferral if it is treated as a capital gain for Federal income tax purposes.
  - Generally includes capital gain from an actual or deemed sale/exchange.
  - Any other gain that is required to be included in a taxpayer's computation of capital gain.
  - Taxpayer can defer previously deferred gain recognized from the sale of a QOF interest if the taxpayer makes a qualifying new investment in a QOF – complete disposition required.
- Deferred gain must be gain that would be recognized before January 1, 2027 absent deferral – investment in QOF by late June, 2027 (180-day period)

# Gains Eligible for Deferral

- No deferral election can be made with respect to a sale or exchange if a previously made election made with respect to the sale/exchange is in effect.
- However, multiple elections can be made with respect to various parts of gain from a single sale or exchange of property.
- The gain itself can only be deferred once.
- All elections with respect to portions of the same gain from a single source would be subject to the same 180-day period.



# Gains Eligible for Deferral

- Section 1256 contracts – “mark-to-market”
  - Brokers required to report taxpayer’s net recognized gain or loss from all 1256 contracts held during the taxable year. Some taxpayers report gain or loss on a per contract basis.
  - Deferral only permitted for a taxpayer’s net capital gain income from section 1256 contracts for a taxable year.
  - Determined as of the last day of the taxable year.
  - 180-day period for investing net 1256 gains in a QOF begins on the last day of the taxable year.
- Gains from offsetting-positions transactions such as straddles do not qualify for deferral.

# Taxpayers Eligible to Elect Gain Deferral

- Any taxpayer that recognize capital gain for Federal income tax purposes:
  - Individuals
  - C Corporation
  - Regulated Investment Company (RICs)
  - Real Estate Investment Trusts (REITs)
  - Partnerships
  - S Corporations
  - Trusts and Estates

# Attributes of Income When Deferral Ends

- All of the deferred gain's tax attributes are preserved through the deferral period and are taken into account when the gain is included.
- The preserved tax attributes include those taken into account under the following IRC sections:
  - Section 1(h) – maximum capital gains rate
  - Section 1222 – term of capital gain – long-term, short-term
  - Section 1256 – mark-to-market contracts
  - Any other applicable provisions of the IRC

# Attributes Related to QOF Interest Sold

- Confusion where Taxpayer makes investment in QOF using separate deferred gains with different attributes.
- Where taxpayer makes a partial sale of its interests in a QOF that were the result of investments on different days, the proposed regulations provide that QOF interests must be identified using FIFO method.
  - Addresses “mixed fund” investments – what portion of investment not entitled to deferral.
  - Partial basis step-ups for gains with different holding periods.
- Where FIFO method doesn’t provide complete answer – gains with different attributes invested on the same day – pro-rata method must be used to determine character and attributes of gain recognized.

# 180-Day Rule

- 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.
- What about capital gains from a deemed sale? No specific date for the deemed sale.
  - Except as specifically provided in the proposed regulations, the first day of the 180-day period is the date on which the gain would be recognized for Federal income tax purposes, without regard to deferral.

# 180-Day Rule (Partnerships and Other PTEs)

- Partnership and other pass-through entities (including S Corporations, estates and trusts) can elect to defer capital gains at the entity level to the extent that the entity makes an eligible investment in a QOF.
  - No part of the deferred gain is required to be included in the distributive share of the partners.
- Where partnership or other pass-through entity does not elect to defer capital gain at the entity level, a partner/owner can elect to defer all or any portion of their distributive share of the gain.
  - Partner/owner's 180-day period generally begins on the last day of the partnership's taxable year.
  - Partner/owner may choose to begin 180-day period on the same day as the start of the PTE's 180-day period – planning flexibility/pitfalls.

# How To Elect Deferral

- Currently anticipated that taxpayers will elect deferral on Form 8949.
  - Taxpayers will attach Form 8949 to their Federal income tax returns for the taxable year in which the gain would have been recognized if it had not been deferred.
  - Currently used to report sales/dispositions of capital assets.
  - Treasury is expected to release updated form instructions related to deferral election.

# Permanent Exclusion – 10-Year Hold Period

- Taxpayer that holds QOF investment for at least 10 years may elect to increase the basis of the investment to the FMV of the investment on the date it is sold/exchanged – permanent exclusion.
- Under IRC Section 1400Z-1(f), the designations of all existing QO Zones expires on December 31, 2028.
- Ability to elect permanent exclusion based on 10-year hold is not impaired by expiration of QO Zone designation.
- Eligible taxpayer may make an election until December 31, 2047.
- Taxpayer would need to dispose of the QOF investment in order to elect the basis step-up – Proposed Regulations discuss possible presumed basis step-up.



# Investments in a QOF

- In order to be an eligible investment in a QOF, the investment must be an **equity interest** in the QOF.
- Includes preferred stock or a partnership interest with special allocations.
- An eligible interest **cannot** be a debt instrument.
- Status as an eligible interest is not impaired by the taxpayer's use of the equity interest in the QOF as collateral for a loan.

# Deemed Contributions Under IRC Section 752(a)

- IRC Section 752(a) provides that “[a]ny increase in a partner’s share of the liabilities of a partnership, or any increase in a partner’s individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.”
- Any “deemed contributions” of money under IRC Section 752(a) do not result in the creation of an investment in a QOF.
- As a result, a deemed contribution does not result in the partner having a separate “mixed funds” investment.
- A partner’s increase in outside basis is not taken into account in determining what portion of the partner’s interest is subject to or not subject to a deferral election.

# Rules for a Qualified Opportunity Fund

# General Considerations

- Any entity treated as a partnership or corporation for federal income tax purposes is eligible to be a QOF. Includes an LLC.
- A pre-existing entity can qualify as a QOF as long as the entity satisfies all of the requirements of a QOF. Any property acquired by the pre-existing entity prior to 2018 would not qualify as QOZ Property. Additionally, any investment in the pre-existing entity prior to the month in which the entity chooses to become a QOF would not be entitled to deferral.

# General Considerations

- A QOF must be organized in one of the 50 states, the District of Columbia, or U.S. possession.
- Where a QOF is organized in a U.S. possession, the QOF must be organized for the purpose of investing in QOZ Property that relates to a trade or business operating in the U.S. possession in which the QOF is organized.

# Certification of an Entity as a QOF

- Any entity that is eligible to do so can self-certify as a QOF.
- Entity will self-certify using IRS Form 8996, *Qualified Opportunity Fund*.
  - IRS has issued draft IRS Form 8996 and instructions for comment.
  - Form 8996 will also be used for annual reporting of compliance with 90-Percent Asset Test.
  - Expected that IRS Form 8996 will be attached to the taxpayer's Federal income tax return for the relevant tax years.

# Certification of an Entity as a QOF

- Entity will be able to identify:
  - The first taxable year in which the entity wants to become a QOF.
  - The first month in that year that the entity wants to be treated as a QOF.
  - **CAUTION:** Because a deferral election can only be made for an investment in a QOF, a deferral election will not be permitted for an otherwise qualifying investment made in an eligible entity before the date the entity has elected to become a QOF.
- 90% Test calculated as the average of % of QOZ Property held by the QOF on the last day of the first 6-month period of the QOF's taxable year and on the last day of the QOF's taxable year.
  - First 6-month period means the first 6-month period consisting entirely of months in a taxable year during which the entity is a QOF – QOF chooses April 2019 then the first 6-month test takes place on September 30, 2019.
  - If calendar-year QOF chooses a month after June for its first month, the only testing date for the first taxable year would be December 31.

# Certification of an Entity as a QOF

- Penalty for noncompliance with the 90% test does not apply to months prior to the month in which the entity chooses to be treated as a QOF.
- Proposed regulations do not provide any additional discussion of how the penalty is applied or what conduct could lead to decertification of a QOF.
- IRC Section 1400Z-2(e)(4)(B) authorizes regulations to ensure that a QOF has a “reasonable period of time” to reinvest the return of capital or sale proceeds from QOZ Property. Specific importance in the context of property sold prior to a 90% Asset testing date.
- Proposed regulations offer no guidance but promise “soon-to-be-released proposed regulations” addressing these issues.



# Valuation Method for Applying the 90% Test

- Proposed regulations require the QOF to use asset values that are reported on the QOF's "applicable financial statement" as defined in Treasury regulations Section 1.475(a)-4(h).
  - Financial statement prepared in accordance with U.S. GAAP and required to be filed with the SEC (10-k or Annual Statement to Shareholders)
  - Financial statement prepared in accordance with U.S. GAAP that is required to be filed with a federal agency other than the IRS
  - A certified audited financial statement that is prepared in accordance with U.S. GAAP that is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment in the eligible taxpayer, or provided for other substantial non-tax purposes.
- If the QOF does not have an applicable financial statement the QOF is required to use the cost of its assets for determining the value.

# Proposed Regulations Provide Special Rules for Land and Improvements on Land

- If a QOF purchases a building located on land wholly within a QOZ, whether the QOZ substantially improves the purchased tangible property is measured by the QOF's additions to the adjusted basis of the building.
- Measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

# Special Rules for Land and Improvements on Land

## Revenue Ruling 2018-29

- The requirement that the “original use” of the tangible property in the QO Zone commence with the QOF does not apply to land on which a building that the QOF has acquired is located.
- The original use of the acquired building, however, does not commence with the QOF.
- If a QOF purchases a building wholly within a QOZ, a substantial improvement to the building is measured by the QOF’s additions to the adjusted basis of the building.
- QOF is not required to separately substantially improve the land upon which the building is located.

# Qualified Opportunity Zone Business

# Qualified Opportunity Zone Business – “Substantially All”

- One requirement for a trade or business to qualify as a qualified opportunity zone business is that **substantially all** of the tangible property owned or leased by the taxpayer is qualified opportunity zone business property.
- Proposed regulations provide a threshold to determine whether a trade or business satisfies the “substantially all” requirement:
  - If at least **70 percent** of the tangible property owned or leased by the trade or business is qualified opportunity zone business property, the trade or business is treated as satisfying the “substantially all” test.
- “Substantially All” is used throughout IRC Section 1400Z-2. Proposed regulations 70 percent threshold does not apply in those other contexts.

# Application of 70% Test

- Similar to 90% Test for QOF.
- If the qualified opportunity zone business has a an applicable financial statement under Treasury Regulations Section 1.475(a)-4(h), the value of each asset for purposes of evaluating the 70% test is value of the asset reported on the statement for the appropriate reporting period.
- If the business does not have an applicable financial statement then a special rule applies.
  - May use cost provided no other owner of the business is a Five-Percent Zone Taxpayer (another QOF that holds at least a 5% interest).
    - For corporation – at least 5% in voting rights or value
    - For partnership – at least 5% in profits and capital
  - Value calculated using Compliance Methodology used by a Five-Percent Zone Taxpayer which produces the highest percentage.

# Active Conduct of a Trade or Business

- At least 50% of the gross income of a qualified opportunity zone business must be derived from the active conduct of a trade or business **within the qualified opportunity zone**.
- A substantial portion of the intangible property of a qualified opportunity zone business must be used in the active conduct of a trade or business **within the qualified opportunity zone**.
- These requirements will be deemed satisfied during the 31-month start-up period if the only income of the business during that period is from working capital.

# Reasonable Working Capital Safe Harbor

- Safe harbor allows qualified opportunity zone businesses to apply a reasonable working capital safe harbor to property held by the business for a period of up to 31 months if:
  - 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.
- Business is required to retain any written plan in their records.



# Safe Harbor for Property on which Working Capital will be Expended

- Planned expenditures of reasonable working capital assets that are expected to satisfy the requirements for qualified opportunity zone businesses are not treated as failing to satisfy the requirements because the expenditure of working capital is not yet complete.

# Conclusion

- Issues not addressed in the Proposed Regulations?
- Q&A

# Presenters



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