Opportunity Zone Update - IRS Issues Proposed Regulations, Revenue Ruling 2018-29 and Form 8996

On October 19, 2018, the Internal Revenue Service issued (a) highly-anticipated, first set of proposed regulations (REG-115420-18) providing guidance on investing in Qualified Opportunity Funds (QOF), (b) Revenue Ruling 2018-29 providing guidance on the “original use” and “substantial improvement” requirements for buildings located on land that are purchased after 2017 and (c) Form 8996 and instructions to self-certify as a QOF.

The Tax Cuts and Jobs Act, P.L. 115-97, added new Section 1400Z-2 of the Internal Revenue Code which created QOFs. An overview of the Opportunity Zone program was provided in our prior client alert, including an overview of the tax benefits of an investment in a QOF.

Highlights

The proposed regulations answer many questions that have arisen since the Opportunity Zones program was enacted, and this alert highlights 10 select provisions of the proposed regulations. A more detailed summary of the proposed regulations is attached here.

1. Only certain types of capital gains are eligible for deferral.
2. All taxpayers that recognize capital gain for federal income tax purposes are eligible to elect deferral, including individuals, C corporations, Regulated Investment Companies (RICs), Real Estate Investment Trusts (REITs), partnerships (or their partners), and certain other pass-through entities.
3. The investment in a QOF must be an equity investment which includes preferred stock or a “preferred” partnership interest. The investment cannot be debt for federal income tax purposes. However, a taxpayer may use its equity investment in a QOF as collateral for a loan.
4. In general, the investment in a QOF must be made within the 180-day period beginning on the day on which the gain would be recognized for federal income tax purposes if the taxpayer did not elect to defer recognition of the gain. The proposed regulations provide special rules with respect to determine when the 180-day period begins.
5. A taxpayer that holds a QOF investment for at least ten years may elect to increase its basis of the investment to its fair market value on the date that the investment is sold or exchanged regardless of whether the qualified opportunity zone designation for the property has expired. The ability to make this basis step-up election is preserved until December 31, 2047.
6. Any corporation or partnership for federal income tax purposes may self-certify as a QOF using Form 8996. A pre-existing entity may self-certify as a QOF after 2017 as long as it meets the QOF requirements after December 31, 2017.
7. A QOF must hold at least 90% of its assets in “Qualified Opportunity Zone Property.” The proposed regulations require the QOF to use the asset values reported on the QOF’s “applicable financial statement” for the taxable year. If the QOF does not have an applicable financial statement, the QOF must use the QOF’s cost basis.

8. A trade or business is a qualified opportunity zone business if “substantially all” of the tangible property owned or leased by the trade or business meets certain requirements. The proposed regulations provide that the “substantially all” requirement is satisfied if at least 70% of the tangible property owned or leased by the trade of business is qualified opportunity zone business property. In general, satisfaction of the 70% requirement is determined utilizing the same rules to determine compliance with the 90% asset test as described above.

9. For tangible property to qualify as Qualified Opportunity Zone Property, the “original use” of the property must commence with the QOF or the QOF must “substantially improve” the property. With respect to the “original use” and “substantial improvement” requirements, the proposed regulations and Rev. Rul. 2018-29 provide the following:
   - **The Land** - The Revenue Ruling concludes that, given the permanence of land, the original use of land can never commence with a QOF, and the original use requirement is not applicable to the land on which the building is located.
   - **The Building** - Because the original use of an existing building located on land does not commence with the QOF, the QOF must substantially improve the building by at least doubling the QOF’s basis in the building within 30 months after acquisition. The land’s adjusted basis is not included in a building’s adjusted basis, and the land on which a substantially improved building is located does not itself need to be separately substantially improved.

10. The proposed regulations allow qualified opportunity zone businesses to hold reasonable amounts of working capital held in cash, cash equivalents, and/or debt instruments with a term of 18 months or less for a period of up to 31 months if certain requirements are satisfied.

The proposed regulations are effective on or after the date of publication in the Federal Register adopting the regulations as final regulations. However, taxpayers may rely on the rules in the proposed regulations prior to such date as long as the taxpayer applies the proposed rules in their entirety and in a consistent manner.

Additional proposed regulations regarding the Opportunity Zones program are expected in the near future.

As indicated above, our detailed summary of the proposed regulations is linked to this alert.

Please feel free to contact us with any questions regarding the proposed regulations or the Opportunity Zone program.

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