

# Proposed Regulations for Qualified Opportunity Funds: A Summary of New Guidance Interpreting IRC Section 1400Z-2



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On October 19, 2018, the Treasury Department released [proposed regulations](#) regarding certain aspects of the new qualified opportunity funds (“QOF”) and related qualified opportunity zones. In general, the proposed regulations take a liberal reading of the IRC section 1400Z-2 rules regarding (1) the requirements that must be met by a taxpayer in order properly to defer the recognition of gains by investing in a QOF, (2) the rules regarding self-certification as a QOF, and (3) the requirements that must be met by a corporation or partnership in order to qualify as a QOF.

Although only proposed regulations, taxpayers may rely on the new guidance for a variety of important and previously unclear issues. These include determining which gains are eligible for deferral and how deferral elections can be made for investments through pass-through entities.

This alert provides a reference guide for the major new information contained in the proposed regulations.

## **1. Background on QOF and Qualified Opportunity Zones**

IRC section 1400Z-2 is a temporary tax provision designed to encourage private sector investment in certain lower-income communities designated as qualified opportunity zones. Taxpayers may elect to defer the recognition of capital gain to the extent of amounts invested in a QOF, provided the gains are invested during the 180-day period beginning on the date such capital gain would have been recognized by the taxpayer. The deferred capital gain will be taxed on the date the investment in the QOF is sold, or on December 31, 2026, whichever comes first.

For investments in a QOF held longer than five years, taxpayers may exclude 10 percent of the deferred gain, and for investments held longer than seven years, taxpayers may exclude a total of 15 percent of the deferred gain. For investments in a QOF held longer than 10 years, taxpayers may also elect to exclude from income the post-acquisition gain on the qualifying investment in the QOF.

In order to properly qualify, a QOF must hold at least 90 percent of its assets in qualified opportunity zone property. The 90 percent requirement is tested every six months. If a QOF fails the 90 percent test, it must pay a penalty for each month it does not meet the 90 percent asset requirement.

Below is a summary of the particular issues for qualified opportunity zones, the way in which the proposed regulations address the issue, and the citation to the proposed regulations.

## 2. Proposed Regulations

<b>GENERAL RULES FOR DEFERRING TAX ON GAINS BY INVESTING IN OPPORTUNITY ZONES</b>		
<i>Issue</i>	<i>Resolution</i>	<i>Cite</i>
Gains Eligible for Deferral	Capital gain only.	Prop. § 1.1400Z-2(a)-1(b)(2)(i)
Types of Taxpayers Eligible to Elect Gain Deferral	Individuals, C corporations (including REITs), partnerships, and most other pass-through entities.	Prop. § 1.1400Z-2(a)-1(b)(1)
Qualified Investments in a QOF	Investment must be an equity interest in the QOF, including preferred stock or a partnership interest with special allocations; debt does not constitute an investment in a QOF.	Prop. § 1.1400Z-2(a)-1(b)(3)
180-Day Rule for Deferring Gain by Investing in a QOF	The investment in a QOF must be made within 180-days of the sale or exchange giving rise to the gain.	Prop. § 1.1400Z-2(a)-1(b)(4)
Attributes of Included Income When Gain 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.	Prop. § 1.1400Z-2(a)-1(b)(5)
<b>GAINS OF PARTNERSHIPS AND PARTNERS</b>		
<i>Issue</i>	<i>Resolution</i>	<i>Cite</i>
Deferrals for Partnerships and Partners	A partnership may elect deferral of gain and, to the extent that the partnership does not elect deferral, a partner may do so.	Prop. § 1.1400Z-2(a)-1(c)(1)
Application of 180-Day Rule to Partnerships and Partners	A partner's 180-day period generally begins on the last day of the partnership's taxable year. But a partner may also choose to begin her own 180-day period on the same date as the start of the partnership's 180-day period.	Prop. § 1.1400Z-2(a)-1(c)(2)(iii)
<b>ELECTION FOR STEP-UP WHERE INVESTMENTS HELD AT LEAST 10 YEARS</b>		
<i>Issue</i>	<i>Resolution</i>	<i>Cite</i>
Availability of Basis Step-up	Only available for gains realized upon investments made in connection with initial deferral election.	Prop. § 1.1400Z-2(c)-1(a)

Date by which the Election must be Made	December 31, 2047. This is 20½ years after June 2027 - the latest date that an eligible taxpayer may properly defer gain under the qualified opportunity zone rules (the latest gain subject to deferral would be at the end of 2026, so the last day of the 180-day period for that gain would be in late June 2027).	Prop. § 1.1400Z-2(c)-1(b)
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### RULES FOR A QUALIFIED OPPORTUNITY FUND

<i>Issue</i>	<i>Resolution</i>	<i>Cite</i>
Certification of an Entity as a QOF	Taxpayers can use <a href="#">Form 8996</a> both for initial self-certification and for annual reporting of compliance with the 90 percent asset test.	Prop. § 1.1400Z-2(d)-1(a)(1)
Designating When a QOF Begins	A QOF can (1) identify the taxable year in which the entity becomes a QOF, and (2) choose the first month in that year to be treated as a QOF.	Prop. § 1.1400Z-2(d)-1(a)(2)
Pre-Existing Entities	Pre-existing entities can qualify as QOFs.	Prop. § 1.1400Z-2(d)-1(a)(3)
Valuation Method for Applying the 90 Percent Asset Test	QOF must use the asset values that are reported on the QOF's financial statement for the taxable year. If a QOF does not have a financial statement, the QOF must use the cost of its assets.	Prop. § 1.1400Z-2(d)-1(b)
Testing Timeline for 90 Percent Asset Test	The first 6-month period to test must be composed entirely of months which are within the taxable year and during which the entity is a QOF. So if a 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.	Prop. § 1.1400Z-2(d)-1(a)(2)(i)
Penalty for Failure to Maintain 90 Percent of Qualified Opportunity Zone Property	The penalty does not apply before the first month in which the entity qualifies as a QOF.	Prop. § 1.1400Z-2(d)-1(a)(2)(ii)

Working Capital Safe Harbor for QOF Investments	Qualified opportunity zone businesses may hold cash, cash equivalents, or short-term debt for up to 31 months, provided the business (1) has a written plan for use of the working capital in the zone, (2) has a written expenditure schedule consistent with the ordinary business operations showing that the property will be used within 31-months, and (3) substantially complies with that schedule.	Prop. § 1.1400Z-2(d)-1(d)(5)(iv)
Asset Test for QOF Investing directly in Qualified Opportunity Business Property (i.e. direct ownership of tangible property in the zone)	If a QOF operates a trade or business directly using tangible property in the zone, at least 90 percent of the QOF's assets must be qualified opportunity zone business property.	Prop. § 1.1400Z-2(d)-1(c)
Asset Test for QOF Investing in Qualified Opportunity Zone Business (i.e. indirect ownership of tangible property in the zone through a corporation or partnership conducting business in the zone).	If a QOF operates a trade or business through one or more entities, then the QOF can satisfy the 90 percent asset test if each of the entities qualifies as a qualified opportunity zone business and substantially all the assets of those entities are qualified opportunity zone business property.	Prop. § 1.1400Z-2(d)-1(d)(1)
Definition of "Substantially All" for Qualified Opportunity Zone Businesses	A qualified opportunity zone business satisfies the "substantially all" requirement if at least 70 percent of the tangible property owned or leased by that business is qualified opportunity zone business property.	Prop. § 1.1400Z-2(d)-1(d)(3)

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