ADDITIONAL GUIDANCE ON NEW OPPORTUNITY ZONE FUNDS

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On October 19, 2018, just days after publishing our first article on investing in new Opportunity Zones, the I.R.S. issued proposed regulations.

Many believe that the majority of opportunity zone capital will be invested in real estate, and it seems the I.R.S. shares that view, as simultaneously with the proposed regulations, the I.R.S. published Rev. Rul. 2018-29 addressing the manner in which certain aspects of the new provision apply to real property investments.

This article will focus on the new guidance as it relates to the deferral election, as well as qualification as a Qualified Opportunity Zone Fund. The article will address, among other issues, (i) rules relating to the taxpayers that are eligible to make the deferral election, (ii) the type of gains eligible for deferral, (iii) how the 180-day limitation is measured, (iv) the tax attributes of the deferred gain, and (v) the effect of an expiration of qualifying zone status on an election to step up the basis of opportunity fund investments to fair market value after ten years. For a detailed discussion of the basic tax benefits offered by the provision, and an example of its application, see our first article.[1]

BACKGROUND

Broadly stated, new Code §1400Z-2 provides for an election under which taxpayers may roll over capital gains (and only capital gains) into an equity investment in Qualified Opportunity Zone Funds ("Qualified Funds") and achieve three tax benefits:

- Deferral of tax on the capital gains being reinvested
- Up to a 15% reduction in the recognition of the deferred gain upon (the earlier of) a disposition of the new investment or December 31, 2026
- Tax-free appreciation of the new investment (if held for at least ten years)

This provision appeals to both investors wanting to enjoy these tax benefits and real estate developers and other business owners wishing to raise capital from investors.

This provision does not offer developers the "easy money" they might desire. To enjoy the major tax benefits, investors must hold their investments for ten years. Savvy investors are unlikely to tie up funds for this extended period of time or to take the risk of investing in unfamiliar territory without considerable due diligence. An investment must make economic sense before considering the tax benefits.

Nevertheless, the provision does create an opportunity for investors to rollover their investments for the long term into designated areas of the country that need

1 "The Opportunity Zone Tax Benefit – How Does It Work and Can Foreign Investors Benefit?" *Insights* no. 8 (2018).

economic investment, with considerable tax benefits for investors in successful enterprises. Thus, developers and other business owners in these areas may gain access to more potential investors.

A QUALIFIED OPPORTUNITY ZONE FUND

What Entities Can Qualify as a Qualified Fund?

Any taxpayer classified as a corporation or partnership may qualify. This includes limited liability companies ("L.L.C.'s") that are not taxed as disregarded entities.

Can Foreign Entities Qualify?

Foreign entities cannot be treated as Qualified Funds. Eligible entities include only entities organized in one of the 50 states, the district of Columbia, or one of the U.S. possessions (*e.g.*, Puerto Rico and the U.S. Virgin Islands). An entity organized in a U.S. possession must invest in an Opportunity Zone within its territory in order to be eligible. Other entities are not limited to Opportunity Zones within the state they were formed.

Can Pre-existing Entities Qualify?

An eligible entity must be formed for the purpose of investing in Qualified Opportunity Zone Property ("Eligible Property"). Notwithstanding the aforementioned, the proposed regulations clarify that there is no restriction on pre-existing entities becoming a Qualified Fund, provided that all of the requirements are met – in particular, the entity must acquire the Eligible Property after December 31, 2017.

How Does an Eligible Entity Certify as a Qualified Fund?

Concurrently with publishing the proposed regulations, the I.R.S. published an early draft of the instructions for Form 8996, Qualified Opportunity Fund. This form will be filed together with the electing fund's tax return on an annual basis. The form is expected to be used to certify that the entity is organized to invest in Eligible Property and to report that it meets the investment standard (see below) for a Qualified Fund under the Code or to compute the penalty if it fails to meet the investment standard.

What Is the Effective Date of Qualified Fund Status?

An eligible entity must identify the first taxable year it is to be treated as a Qualified Fund on its first Form 8996 submission. The proposed regulations further provide that a Qualified Fund may designate its first month of qualifying status in that year.

The designation of the first month is of special importance. If an eligible entity fails to designate its first month of qualified fund status, the first month of the first taxable year of the entity will be treated as its effective month.

As discussed below, the Qualified Fund must meet an investment standard confirming that it deployed capital in accordance with the provision and the regulations thereunder. This standard is an average measured at two points during the year. The first is six months after the effective month.

A Qualified Fund may be incentivized to designate a later month than the first month of the first taxable year as its effective date, so as to give itself more time to deploy

capital and achieve higher percentages on the first testing period. However, Qualified Funds must be wary of designating an effective month that is later than the first month it accepts capital from investors, as this would prevent investors from enjoying the tax benefits provided by the provision.

What Is the Required Investment Standard for Qualified Funds?

The investment standard requires that at least 90% of a Qualified Fund's holdings be invested in Eligible Property acquired after December 31, 2017.

The 90% test is based on the average of the percentage of total assets that is Eligible Property, as measured on two dates each year:

- After the first six months of the taxable year
- On the last day of the taxable year

For the first year, if the Qualified Fund's first effective month is on July (or later), the 90% test would take into account only the assets held by the fund on the last day of the taxable year.

How Are Assets Valued for Purposes of the 90% Test?

Generally, the proposed regulations provide that if a Qualified Fund prepares certified audited financial statements for its investors and creditors (or is required to prepare such statements by the S.E.C. or another Federal agency other than the I.R.S.), it must use the value of each asset on its financial statement for the reporting period in order to determine whether the 90% test is satisfied.

A Qualified Fund that does not prepare a certified audited financial statement may use the cost of the assets in measuring the 90% test.

What is an Eligible Property?

Eligible Property is one or more of the following:

- *Qualified Stock*: Stock in a domestic corporation that operates a Qualified Opportunity Zone Business on the day the Qualified Fund purchases its stock and during substantially all of the fund's holding period, provided that the stock is purchased at original issue after December 31, 2017, solely for cash
- *Interest in a Qualified Partnership*: A capital interest or profits interest in a domestic partnership that operates a Qualified Opportunity Zone Business during substantially all of the fund's holding period, provided that such interest is purchased from the partnership after December 31, 2017, solely for cash
- *Qualified Business Property*: A tangible property acquired to be used in a Qualified Opportunity Zone Business and which (i) meets the "original use" test or the "substantial improvement" test and (ii) substantially all of the use of the tangible property was in a qualified zone during substantially all of the Qualified Fund's holding period

In simple terms, the investment standard requires that a Qualified Fund directly operate a business in a qualified zone or invest in entities that operate a qualified business.

What Is the Qualified Business Property "Original Use" Test?

Tangible property purchased after December 31, 2017, to be used in a trade or business in an Opportunity Zone will be a Qualified Business Property (and thus an Eligible Property) if its "original use" commences with the Qualified Fund. While the proposed regulations do not elaborate on the meaning of original use at this time, additional guidance will be published in the future.

It is assumed to mean that the purchased property must not have been used in the Opportunity Zone before it was purchased by the Qualified Fund.

For example, if a fund purchases an existing factory building in an Opportunity Zone, the original use of the property in the Opportunity Zone clearly does not commence with the Qualified Fund. Alternatively, if a fund purchases new manufacturing equipment to be used in its Qualified Business, it is assumed that the manufacturing equipment's original use in the Opportunity Zone commences with the Qualified Fund.

What Is the Qualified Business Property "Substantial Improvement" Test?

Tangible property whose original use does not commence with the Qualified Fund can still qualify as a Qualified Business Property (and thus an Eligible Property) if the Qualified Fund "substantially improves" the property following its purchase. A property is considered substantially improved if, during any 30-month period following the purchase of the property, the Qualified Fund invests at least the same amount as the cost to improve the property, so that at the end of this 30-month period the adjusted basis of the property is more than double the original basis.

In the case of real property, the proposed regulations and the Rev. Rul. 2018-29 provide that substantial improvement to a building is measured by additions to the adjusted basis of the building (as allocated to the building in the purchase price allocation). The substantial improvement test does not require the separate improvement of the land on which the building is located.

Because land is not depreciable, taxpayers have always been incentivized to allocate as large a portion of the purchase price as possible to the building. To some degree, this rule could shift the incentive away from allocating most of the purchase price to the building because the higher the building's portion of the purchase price, the greater the capital investment needed.

What Is a Qualified Business?

A Qualified Business is generally any trade or business operated by an entity in which "substantially all" of the property owned or leased is Qualified Business Property (*i.e.*, generally, tangible property purchased after December 31, 2017, whose original use commences with the entity or that is substantially improved by the entity; substantially all of its use in substantially all of the entity's holding period must be in an Opportunity Zone).

The proposed regulations provide for a 70% threshold for purposes of meeting the requirement that "substantially all" of the property owned or leased by an entity be Qualified Business Property. The 70% threshold applies in this context only and not anywhere else the phrase "substantially all" applies.

<u>What Additional Requirements Must Be Met for a Business to Qualify as a Qualified Business?</u>

In addition to having substantially all (*i.e.*, at least 70%) of its owned or leased assets qualify as Qualified Business Property, a Qualified Business must meet the following tests:

- At least 50% of its gross income must be from the active conduct of the business.
- A substantial portion of its intangible property must be used in the active conduct of the trade or business in the qualified Opportunity Zone.
- Less than 5% of the average unadjusted basis of all of its property may be attributable to nonqualified financial assets.

The term "nonqualified financial asset" is defined to exclude "reasonable amounts of working capital" held in cash, cash equivalent, or debt instruments with a term of no more than 18 months. The proposed regulations provide a safe harbor for determining "reasonable working capital" for purposes of meeting the requirements above.

Therefore, if the safe harbor requirements are met (discussed below), reasonable amounts of working capital will not be counted towards the 5% test, and income derived from such amounts will be counted towards the satisfaction of the 50% test. Likewise, the proposed regulations provide that if the business is proceeding in a manner that is substantially consistent with the safe harbor requirements, the business will be treated as meeting the intangible assets use test.

<u>How Is the Working Capital Safe Harbor Satisfied?</u>

The proposed regulations provide that reasonable amounts of working capital are not treated as nonqualified financial assets. The proposed regulations further provide for a safe harbor to treat working capital as reasonable in amount if the following conditions are met:

- There is a written plan that identifies the working capital assets as assets held for the acquisition, construction, or substantial improvement of tangible property in the Opportunity Zone.
- There is written schedule consistent with the ordinary business operations of the business according to which the property will be used within 31 months.
- The business substantially complies with the written plan and the written schedule in the manner that it employs the assets.

The proposed regulations also provide that if tangible property is expected to be substantially improved as a result of expending the working capital, an entity that meets the working capital safe harbor requirements will not be treated as failing to meet the Qualified Business Property requirements solely because the scheduled consumption of the working capital is not yet complete.

In an example provided in the proposed regulations, a Qualified Fund invested 100% of its capital in a partnership interest, which immediately placed the funds in working capital assets. The example provides that the partnership had a written plan to acquire land in a qualified Opportunity Zone on which it planned to construct

a commercial building. A certain portion of the funds was dedicated to the land purchase, a different amount was dedicated to the construction of the building, and the remainder of the funds was dedicated to ancillary but necessary expenditures for the project. The written plan provided for the purchase of the land within a month of the receipt of the cash from the Qualified Fund and for the remaining amounts to be spent within the next 30 months as per the dedicated plan. All expenditures were made on schedule and, therefore, the safe harbor requirements were met. As a result, the Qualified Fund's investment in the partnership satisfies the 90% investment standard. Lastly, the proposed regulations add that the above conclusion would also apply if the partnership's plans had been to buy and substantially improve a pre-existing commercial building, and the fact that the partnership's basis in the building has not yet doubled does not cause the building to fail to satisfy the requirements for a Qualified Business Property.

Are All Types of Businesses Permitted as Qualified Businesses?

Certain businesses are prohibited *per se* from being a Qualified Business. Those include, *inter alia*, casinos, liquor stores, golf courses, and country clubs.

In Sum, What Are the Requirements for an Entity to Be a Qualified Fund?

To qualify as a Qualified Fund, a U.S. entity taxed as a corporation or a partnership must invest 90% of its assets in Eligible Property, which can take two forms:

- Equity interest in an entity that operates a Qualified Business
- Qualified Business Property

The Qualified Fund must deploy its capital within a short period of time in order to meet the 90% test for the taxable year. The 90% test is based on the average of the fund's total assets that are invested in Eligible Property, as measured at two times during a taxable year: (i) six months after the effective date of the fund's election to be treated as a Qualified Fund and (ii) at the end of the taxable year.

A reasonable working capital safe harbor allows for some flexibility, so that cash held for the acquisition, construction, or substantial improvement of tangible property will not cause the fund to fail the investment standard if it will be used, under a written plan, within 31 months.

The investment standard allows entities to qualify if they invest directly in Qualified Business Properties or if they invest in Qualified Businesses operated by other entities. To be a Qualified Business, 70% of the entity's assets must be Qualified Business Properties. As a result, the proposed regulations, as currently drafted, provide an incentive for funds to invest in other entities operating a Qualified Business rather than to invest directly in Qualified Business Properties. Investing in a Qualified Business allows greater diversification of assets beyond Opportunity Zones. This incentive is the result of the 70% threshold, which means that if the fund invests in equity interests in other entities, only 63% of the fund's assets must be invested in Qualified Business Properties (assume the fund invests 90% of its capital in a Qualified Business that must invest 70% of its assets in Qualified Business Properties). In contrast, if the fund were to operate a Qualified Business directly, 90% of the fund's capital would have to be invested in Qualified Business Properties.

How Does the Tax Deferral Benefit Work?

To be eligible to defer the tax on gain realized, taxpayers must

- sell an appreciated property to an unrelated person before December 31, 2026,[2]
- make an election to defer the gain (or the invested amount, if lower) in the tax return for the year of the sale,
- not have another election to defer the tax in effect, and
- invest the deferred gain in an equity investment in one or more Qualified Funds within 180 days from the day of the disposition.

"Non-U.S. taxpayers, including trusts, may benefit from the provision as long as the invested funds are U.S.-source capital gains that would have been recognized for U.S. Federal tax purposes."

While the tax is deferred, the disposition transaction must be reported in the year it was made on Form 8949, *Sales and Other Dispositions of Capital Assets*, which will also be used to make the election to defer the tax, pending further instructions from the I.R.S. The preamble to the proposed regulations provides that form instructions to this effect are expected to be released shortly, but none have been published so far.

Which Taxpayers Are Eligible to Benefit from the New Provision?

The proposed regulations provide that any person who may recognize gains for Federal income tax accounting is eligible to benefit. This includes individuals; C-corporations, including R.I.C.'s and R.E.I.T.'s; L.L.C.'s; partnerships; S-corporations; trusts; and estates.

Can Non-U.S. Taxpayers Benefit from the Provision?

The Code and the proposed regulations do not limit eligible taxpayers to U.S. taxpayers. Accordingly, non-U.S. taxpayers, including trusts,[3] may benefit from the provision as long as the invested funds are U.S.-source capital gains that would have been recognized for U.S. Federal tax purposes if it were not for the election to defer the tax under this provision.

As mentioned in our earlier article,[4] while non-U.S. persons do not recognize capital gains on the disposition of stocks and securities, non-U.S. persons may recognize capital gains on the disposition of U.S. real property interests ("U.S.R.P.I.") and, following the tax reform, on the disposition of an interest in a partnership. The Code and the proposed regulations do not address the applicability of the provision to non-U.S. taxpayers and the withholding that would apply to any gain they realized under F.I.R.P.T.A. and the new provision applicable to a sale of a partnership

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[2] In determining whether two persons are related, certain modified constructive ownership rules apply. In the case of a partnership, the sale of the property cannot be made to a person related to the partnership or to any of the partners.

[3] Certain U.S. trusts controlled by foreign persons have seen a rise in popularity in recent years, following the implementation of the C.R.S. These trusts are generally taxed as foreign (non-U.S.) trusts for U.S. tax purposes.

[4] "The Opportunity Zone Tax Benefit – How Does It Work and Can Foreign Investors Benefit?"

interest. Since the consideration may be subject to 15% F.I.R.P.T.A. withholding, or to the new 10% withholding on the sale of a partnership interest, foreign taxpayers may find it complicated to utilize the new provision.

Nevertheless, although the proposed regulations remain silent, it is anticipated that non-U.S. taxpayers will be able to apply to the I.R.S. and request a withholding certificate to eliminate the withholding. There is no doubt that this would impose some complications; however, unless future guidance impose limitations, the benefits may be worth it.

The process to obtain an I.R.S. withholding certificate normally takes 90 days and first requires the issuance of a U.S. Tax Identification Number, which may take time. However, well-advised taxpayers who plan in time may be able to invest the proceeds within the required 180 days and reap the benefits of this new provision.

Note, that in addition to the general eligibility of non-U.S. taxpayers, it is common for non-U.S. persons to use U.S. structures, specifically, U.S. domestic trusts, which are used to benefit family members treated as U.S. persons, and these structures can surely benefit from the provision and take the opportunity to cash out on appreciated portfolios.

What Types of Gains Are Eligible for the Benefit?

While the Code did not limit the type of gain to which the provision applies, the proposed regulations follow the legislative history and limit the application to gain that is treated as capital gain for Federal income tax purposes. This includes gain from a deemed sale or exchange, or any other gain that is required to be included in the taxpayer's tax return.

Can Gain from Code §1256 Contracts Be Deferred?

Section 1256 contracts are marked to market on the last day of the taxable year; the taxpayer need not dispose of the contract. As a result, capital gain may be recognized for Federal tax purposes, and the amount recognized may be eligible for deferral.

Since some contracts may result in a loss, the proposed regulations provide that only the net income from all §1256 contract positions is treated as gain eligible for deferral.

Additionally, the proposed regulations disallow the tax deferral of any §1256 contract gain if, at any time during the taxable year, one of the taxpayer's §1256 contracts was part of an offsetting-position transaction in which any of the other positions was not also a §1256 contract. An offsetting-position is defined in the proposed regulations as a transaction that eliminates a taxpayer's risk of loss. With respect to gain from offsetting-position transactions, including straddles, the proposed regulations disallow any tax deferral.

Can Foreign-Source Gains Be Deferred?

There is no limitation relating to foreign-source gain. As long as the foreign-source gain would be subject to Federal tax, the deferral election should be available.

Unlike a §1031 exchange, which only allows deferral on exchanges of real estate and only if the rolled over property is like-kind and which does not treat foreign real

property as like-kind U.S. real property, this provision does not require U.S.-source investment. Therefore, foreign-source capital gain, which would have been recognized for Federal tax purposes if it were not for the deferral election, can be invested in a Qualified Fund and be eligible for the tax benefits described.

Note that if the foreign-source gain is subject to foreign tax at a rate that is equal to or higher than the U.S. rate (as low as 20% for long-term capital gains or as high as 37% for short-term capital gains), no U.S. tax will be due at the time of the disposition as a result of the foreign tax credit. Thus, the deferral may not be desirable.

Is There a Limitation on the Amount of Gain that Can Be Deferred?

There is no limitation on the amount of gain that can be deferred by reinvestment, provided that the amount deferred is invested in accordance with the provision.

Similarly, not all of the gain realized must be deferred. A taxpayer may elect to defer only a part of the eligible gain.

Can a Taxpayer Invest More Than the Gain Realized?

Cash investments from sources other than deferred capital gain do not qualify for the benefits of the provision. Therefore, investments of more than the realized gain will be treated as an investment of "mixed funds." In such circumstances, the Qualified Fund must segregate the total amount of investment to be treated as two separate investments. All potential step-up benefits would only apply to the investment of the deferred gain to which an election applies.

The proposed regulations provide that transactions resulting in a deemed contribution to a partnership (*e.g.*, as a result of an increase in liabilities allocated to a partner) would not be treated as an additional investment in a Qualified Fund and will be ignored (*i.e.*, will not be treated as an eligible investment nor as a mixed fund investment).

Can a Taxpayer Split the Deferral Election with Respect to Gain from a Single Sale?

Under the provision as drafted in the tax reform, it seemed that not utilizing all of the gain at the time of the deferral election would prohibit the taxpayer from making a second election to defer tax on the other portion of the gain. The proposed regulations clarify that this is not the case.

Under the proposed regulations, a taxpayer may elect to defer tax on part of the gain from a sale and later, but still within the 180 days, make a second election to invest, and defer tax on, the unused portion of the gain from the same sale. The taxpayer will not be restricted by the limitation requiring that it not have another election to defer the tax in effect. Likewise, the second investment will not be treated as an investment of unqualified cash nor as a mixed fund investment.

How Can Capital Gain Realized by a Pass-Thru Entity Be Deferred Under the Provision?

Partnerships and other pass-thru entities are eligible taxpayers who can make the election to defer tax on all or part of the gain. If the partnership makes the election to defer the gain, no part of the gain will be included in the partner's distributive share.

To the extent that the partnership does not make the election, each partner or member may elect to defer the gain allocated to him or her, provided that it satisfies the requirements.

What Types of Investments in Qualified Funds Are Eligible?

The proposed regulations provide that the deferral is only available if the rolled-over investment is made in an equity interest in the Qualified Fund. Equity interests include preferred stock or partnership interests with special allocations. An investment in a debt instrument of a Qualified Fund is ineligible as a rollover investment. Notwithstanding the aforementioned, an equity interest in a Qualified Fund may serve as a collateral for a loan.

What Is the Timeframe to Rollover the Gain into an Investment in a Qualified Fund?

The deferred gain must be invested in a Qualified Fund within 180 days of the day of disposition of the property. The proposed regulations provide that this means the day on which the gain would be recognized for Federal income tax purposes.

How Is the 180-Day Period Measured when Gain Is Realized by a Partnership?

With respect to gain realized by a partnership and allocable to a partner, the 180-day period begins on the day on which the partner would be required to recognize the gain (*i.e.*, on the last day of the partnership's taxable year). Nevertheless, if a partner has knowledge as to the partnership's disposition of an asset, and that the partnership does not intend to make a deferral election, the proposed regulations allow the partner to choose to begin its 180-day period on the day that the partnership recognizes the gain rather than the day the partner would.

How Is the 180-Day Period Measured for §1256 Contracts?

Contracts that were not disposed of result in gain recognition at the end of the taxable year. Thus, the proposed regulations provide that the 180-day period begins on the last day of the taxable year.

How Long Does the Tax Deferral Last?

The gain is deferred until the earlier of (i) the time that the rolled-over investment is disposed of or (ii) December 31, 2026.

Can Gain Recognition Be Deferred with a Second Election and Rollover into a Different Qualified Fund?

Under the proposed regulations, gain from a sale of an interest in a Qualified Fund that meets the requirements (*i.e.*, is sold to an unrelated person before December 31, 2026) is eligible for a deferral, provided that the gain is invested in a Qualified Fund within 180 days. The portion of the consideration eligible for a deferral includes both the appreciation in the value of the interest in the Qualified Fund, as well as the portion of the previously deferred gain, which will be eligible for a second deferral.

For the original gain to be eligible for the second deferral, the taxpayer must dispose of the entire interest in the Qualified Fund. Otherwise, the deferral would be disallowed on the basis that the taxpayer may not have another election to defer the tax in effect.

In any event, it seems the deferral cannot be extended beyond December 31, 2026.

This opportunity for a second election gives taxpayers flexibility, enabling them to exchange an investment in a Qualified Fund that they view as underperforming for an investment in a different Qualified Fund. However, the proposed regulations are silent on whether this will reset the holding periods for the partial step-up when gain is recognized (discussed below) and for the fair market value step-up after ten years. A reset in the holding period may disincentivize exchanges.

"In order to benefit from the 15% step-up, taxpayers should invest in Qualified Funds before December 31, 2019."

How Much of the Gain Is Recognized Eventually?

When the investment is disposed of, the taxpayer includes in his or her gross income the full amount of the deferred gain over the taxpayer's basis in the rolled-over investment. The taxpayer's basis in the investment is zero, unless the taxpayer held the investment for at least five years. If the holding period was at least five years, a partial step-up in basis is available, resulting in a lesser amount recognized (see discussion later).

If the investment in the Qualified Fund diminished, the inclusion will be reduced, and instead of recognizing the full amount of deferred gain, only the fair market value of the investment in the Qualified Fund over the basis in the investment will be recognized.

What Are the Tax Attributes of the Recognized Gain?

Capital gains deferred under the provision preserve their tax attributes. This includes the holding period for applying the short- or long-term capital gains tax rates.

The proposed regulations provide ordering rules for cases where a taxpayer disposes of only a part of an interest in a Qualified Fund and the gain invested did not all have the same attributes. Under these rules, the "first-in, first-out" ("F.I.F.O.") method is applied, and if this is insufficient to determine the tax attributes of the disposed portion, a *pro rata* method is applied.

How Does the Partial Step-Up Work?

After five years, the taxpayer is eligible for a step-up in the basis of the investment in the Qualified Fund. This step-up is 10% of the deferred gain. After seven years, the taxpayer is eligible for an additional 5% step-up, resulting in a total step-up of up to 15% of the deferred gain.

Since gain cannot be deferred beyond 2026, in order to benefit from the 15% step-up, taxpayers should invest in Qualified Funds before December 31, 2019. Taxpayers investing in Qualified Funds after January 1, 2020, but before January 31, 2021, can benefit from a 10% reduction in gain recognition. Taxpayers investing in Qualified Funds after January 1, 2022, cannot not enjoy a reduction in gain recognition but can still benefit from tax deferral on the gain (until December 31, 2026) and from tax-free appreciation if they hold the interest in the Qualified Fund for at least ten years.

What Are the Benefits for an Investment Held for Ten Years?

If an investment in a Qualified Fund is held for at least ten years, the taxpayer can elect to step up the basis in the interest to the fair market value of the interest at the time of the disposition, thereby eliminating the tax on post-acquisition gain.

While no more than 15% of the deferred gain can be exempt from tax, the gain derived from the investment in the Qualified Fund may be completely tax-free if the taxpayer elects to step up the basis to the fair market value on the day of the disposition.

The fair market value step-up is only available with respect to appreciation of the portion of the investment made by deferring capital gains under the provision. As mentioned above, investment of mixed funds is treated as two separate investments, so that the portion of the appreciation attributable to ineligible funds would not benefit from this fair market value step-up election.

What Happens if the Ten-Year Period Falls After an Opportunity Zone Has Lost its Designation as Such?

A qualified Opportunity Zone's designation expires on December 31, 2028. Therefore, investments made after December 31, 2018, and for which taxpayers wish to benefit from the ten-year fair market value step-up, will be disposed of after the opportunity zone designation has expired. The proposed regulations clarify that as long as the investment is disposed of before December 31, 2047, the expiration of opportunity zone status will not create a problem for taxpayers electing to step up the basis of their investment to its fair market value.

> ***"The gain derived from the investment in the Qualified Fund may be completely tax-free if the taxpayer elects to step up the basis to the fair market value on the day of the disposition."***

CONCLUSION

The advent of the Opportunity Zone has created a huge commotion. It is viewed by many as one of the biggest tax benefits offered in the history of the U.S.

Yet many have criticized the provision, claiming that, despite the well-intended mission, capital investments in distressed areas could end up benefiting cities that are already experiencing growth. This is already the case in Long Island City, an Opportunity Zone in one of the country's most prosperous cities, New York, where Amazon has chosen to build its HQ2 and which even now offers luxury rentals to professionals working in Manhattan.

Ultimately, though the tax benefits are great, it remains to be seen whether the stir around Opportunity Zones is justified. The holding period requirement is significant; many of the Opportunity Zones are unfamiliar territories; and substantial improvement requirements could double the cost of the property, consuming funds that might otherwise not be spent on improvement and which may ultimately reduce the anticipated yield of a project. With these considerations, are Opportunity Zones worth the hype?

Investors should carefully consider how and where to utilize this benefit.

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