
1. Opportunity Zones

- The federal Tax Cuts and Jobs Act of 2017 allowed the Governor of each state to nominate certain census tracts as “Opportunity Zones”. Governors were required to submit nominations by March 21, 2018. In Kentucky, 144 sites in 84 counties have been designated as Opportunity Zones. Opportunity Zone designations will be effective for 10 years, until December 31, 2028. Investors in these designated Opportunity Zones are eligible for significant federal tax benefits.

2. Qualified Opportunity Funds

- Investments in Opportunity Zones must be through Qualified Opportunity Funds (“QOF”). Under Section 1400Z-2(d) (1), a QOF is any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property other than another QOF. A QOF must hold at least 90 percent of its assets in qualified opportunity zone property. Compliance with the 90-Percent Asset Test is determined by the average of the percentage of the qualified opportunity zone property held in the QOF as measured on the last day of the first 6-month period of the taxable year of the QOF and on the last day of the taxable year of the QOF.
 - a. **Certification of an Entity as a QOF.** 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. Form 8996 will be attached to the taxpayer’s federal income tax return for the relevant tax years.
 - b. **Designating When a QOF Begins.** A QOF may identify both the taxable year in which the entity becomes a QOF and choose the first month in that year to be treated as a QOF. A proper deferral election under section 1400Z-2(a) may not be made for an otherwise qualifying investment that is made before an eligible entity is a QOF.
 - c. **90-Percent Asset Test testing dates:** Section 1400Z-2(d) (1) requires that a QOF must undergo semi-annual tests to determine whether its assets consist on average of at least 90-Percent qualified opportunity zone property. The phrase “first 6-month period of the taxable year of the fund” means the first 6-month period composed entirely of months which are within the taxable year and during which the entity is a QOF. Regardless of when an entity becomes a QOF, the last day of the taxable year is a testing date. Additional guidance is expected regarding the 90-percent asset test, including how to handle reinvestments by QOFs and decertification of QOFs.
 - i. **Valuation Method for Applying the 90-Percent Asset Test.** For purposes of the calculation of the 90-Percent Asset Test by the QOF, the QOF must use the asset values that are reported on the QOF’s applicable financial statement for the taxable year. If the QOF does not have an applicable financial statement, the proposed regulations require the QOF to use the cost of its assets.

2. Qualified Opportunity Funds (Cont.)

d. **Preexisting Entities May Qualify as QOFs.** There is no prohibition to using a pre-existing entity as a QOF or as a subsidiary entity operating a qualified opportunity zone business, provided that the pre-existing entity satisfies the requirements under section 1400Z-2(d). Section 1400Z-2(d) (1) requires that a QOF must undergo semi-annual tests to determine whether its assets consist on average of at least 90-Percent qualified opportunity zone property. If an entity has self-certified as a QOF or as a subsidiary entity operating a qualified opportunity zone business, a tangible asset can be considered qualified opportunity zone business property only if it was acquired by purchase after 2017.

3. Advantage of Investing in a QOF

- Investments in QOF's allows investors to realize significant federal tax advantages:
 - a. A temporary tax deferral for capital gains reinvested in an Opportunity Fund. The deferred gain must be recognized on the earlier of the date on which the opportunity zone investment is sold or December 31, 2026.
 - b. A step-up in basis for capital gains reinvested in an Opportunity Fund. The basis of the original investment is increased by 10% if the investment in the qualified opportunity zone fund is held by the taxpayer for at least 5 years, and by an additional 5% if held for at least 7 years, excluding up to 15% of the original gain from taxation.
 - c. A permanent exclusion from taxable income of capital gains from the sale or exchange of an investment in a qualified opportunity zone fund, if the investment is held for at least 10 years. (Note: this exclusion applies to the gains accrued from an investment in an Opportunity Fund, not the original gains).
 - i. **Basis Step-up for Investments Held at Least 10 Years.** 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 under section 1400Z-2(a) was made for the investment.
 - ii. **The 10-Year Zone Designation Period.** Taxpayers are permitted to make the basis step-up election under section 1400Z-2(c) after a qualified opportunity zone designation expires on 12/31/2028. The ability to make this election is preserved until 12/31/2047, 20.5 years after the latest date that an eligible taxpayer may properly make an investment that is part of an election to defer gain under section 1400Z-2(a). This permits an investor in a QOF that makes an investment as late as June 2027 to hold the investment in the QOF for the entire 10-year holding period, plus another 10 years.

4. Investments in a QOF

- The investment in a QOF must be an equity investment, which is broadly defined to include stock and/or partnership interests.
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5. Qualified Opportunity Zone Property

- Qualified opportunity zone property includes qualified opportunity zone business property. 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).
 - a. 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.
 - b. **Opportunity zone business property** is property that is used in a QOZ and also requires new capital to be employed in a QOZ. Also, at least 50% of income derived must be from active conduct.
 - c. To qualify as a **QOZ business**, substantially all (70% or more) of the tangible property owned or leased by the trade or business must be qualified opportunity zone business property.
 - i. An entity must be a QOZ business both when (a) a QOF acquires an equity interest in the entity and (b) during substantially all of the QOF's holding period for that interest.
 - d. **Tangible property is qualified opportunity zone business property** if it is used in a trade or business of a QOF and (a) was acquired by purchase after 12/31/2017, (b) the original use of the property in the QOZ commences with the QOF, or the QOF substantially improves the property, and (c) during substantially all of the QOF's holding period for the property, substantially all of the use of the property was in a QOZ.
 - i. A QOF cannot qualify as "**original use**" for the acquisition of an existing building on land that is wholly within a QOZ.
 - ii. If a QOF acquires a building wholly within a QOZ, a "**substantial improvement**" is generally defined as capital expenditures that exceed the initial tax basis of the property within 30 months from acquisition. Under Section 1400Z-2, "substantial improvement" is measured by reference to additions to the adjusted basis of the building. The basis attributable to land on which a building sits is not taken into account in determining whether the building has been substantially improved. Excluding the basis of land from the amount that needs to be doubled under Section 1400Z-2(d) (2) (D) (ii) for a building to be substantially improved facilitates repurposing vacant buildings in qualified opportunity zones. An absence of a requirement to increase the basis of land itself addresses the need to facilitate repurposing vacant or otherwise unutilized land.
 - e. **Nonqualified Financial Property.** There is a working capital safe harbor for QOF investments in qualified opportunity zone businesses that acquire, construct, or rehabilitate tangible business property, which includes both real property and other tangible property used in a business operating in an opportunity zone. The safe harbor allows qualified opportunity zone businesses to apply the definition of working capital provided in section 1397C(e)(1) to property held by the business for a period of up to 31 months if there is: (1) 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; (2) a written schedule consistent with the ordinary business operations of the business that the property will be used within 31-months; and (3) the business substantially complies with the schedule. Taxpayers are required to retain any written plans in their records. Qualified opportunity zone businesses must hold less than 5% of the unadjusted basis of property in non-qualified financial property.

6. Gains Eligible for Deferral

- Only capital gains (not ordinary gains) are eligible for deferral under Section 1400Z-2. Moreover, (1) the capital gain must be gain that would be recognized, if deferral under Section 1400Z-2 were not permitted, not later than December 31, 2026; and (2) the gain must not arise from a sale or exchange with a related person. For purposes of the Proposed Regs, a “related person” is based on the definition provided in Federal Code Sections 267(b) and 707(b) (1), but substituting 20% instead of the typical 50% in those Code Sections.
 - a. **180-Day Rule for Deferral of Gain.** To be able to defer gain, 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. Unless otherwise specifically provided in the regulations, the first day of the 180-day period is the date on which gain would be recognized for federal income tax purposes.
 - b. **Attributes of Included Income When Gain Deferral Ends.** When a taxpayer defers gains under Section 1400Z-2, all of the deferred gain’s tax attributes are preserved through the deferral period and later taken into account when gain is included in the taxpayer’s income. To the extent a taxpayer disposes of less than all of the taxpayer’s interests in a QOF, there is a “first-in, first-out” methodology for determining gain inclusion.
 - c. **Gain Not Already Subject to an Election.** 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. In other words, gains may only achieves one benefit under Section 1400Z-2 in cases in which a taxpayer initially elects for a portion of the gain to benefit, and then later expands the election.

7. Taxpayers Eligible to Elect Gain Deferral

- Any taxpayer that recognizes capital gain for federal income tax purposes is eligible to elect deferral. This includes individuals, C corporations, regulated investment companies, real estate investment trusts, partnerships, and certain other pass-through entities, including common trust funds described in section 584, as well as qualified settlement funds, disputed ownership funds, and other entities taxable under § 1.468B of the Income Tax Regulations.
 - a. **Gains of Pass-Through Entities, such as Partnerships, S corporations, decedents’ estates, and trusts.** Either a partnership or individual partners may elect to defer all or a part of a capital gain to the extent that it makes an eligible investment in a QOF. No part of the deferred gain is required to be included in the distributive shares of the partners. To the extent that a partnership does not elect to defer capital gain, the capital gain is included in the distributive shares of the partners. If all or any portion of a partner’s distributive share satisfies all of the rules of eligibility (including not arising from a sale or exchange with a person that is related either to the partnership or to the partner), then the partner may generally elect its own deferral. The partner’s 180-day period generally begins on the last day of the partnership’s taxable year, because that if the day on which the partner would be required to recognize the gain is the gain is not deferred. However, 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.

7. Taxpayers Eligible to Elect Gain Deferral Cont.

b. **How to Elect Deferral.** It is anticipated that Form 8949 will be attached to the federal income tax return for the taxable year in which the gain would have been recognized if it had not been deferred.

8. Kentucky Tax Benefits of Investing in Opportunity Zones

- Federal Opportunity Zone deferrals will also be exempt from Kentucky income tax. KRS § 141.010(14) sets the Internal Revenue Code (IRC) conformity date for Kentucky as 12/31/2017; the effective date of the Opportunity Zone legislation (26 USC § 1400Z) was 12/22/2017 as part of the Tax Cuts & Jobs Act. Opportunity Zone rules were not specifically provided for in statute, as other elements of the TCJA were, so the OZ rules were included in the Kentucky update. Accordingly, for Kentucky income tax purposes, the OZ gain deferrals would be treated the same as for federal purposes.
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Taxpayers may rely on the regulations released October 19, 2018 and will not be penalized for relying on those regulations as written while they are in effect. However, these regulations are not final and are subject to a 60-day comment period.

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