Bloomberg Tax

Tax Management
Real Estate Journal™

IRS Guidance Permits Opportunity Zone Transactions to Proceed

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The Opportunity Zone program, contained in new §1400Z-2,[1] has generated widespread interest, but has gotten off to a slow start due to overly restrictive statutory rules on timing and holding funds for the improvement of property, and the lack of defined terms and ambiguities in the statute.[2] Generally, the Opportunity Zone program encourages investment in low-income communities by allowing individual and corporate taxpayers to defer paying tax on gains from the sale of stock, business assets, or any other property by investing the proceeds into a ''qualified opportunity fund,'' as defined in §1400Z-2(d)(1) (O Fund), which in turn must invest at least 90% of its assets, directly or indirectly, in businesses located in certain low-income communities designated as ''qualified opportunity zones,'' as defined in §1400Z-1(a) (O Zone). Partial forgiveness of tax on deferred gains and on future appreciation is possible for O Fund investments held for five, seven, and 10 years.

Proposed regulations released on October 19, 2018, provide critical guidance that should permit O Fund investments to proceed. For the most part, the proposed regulations are favorable and provide the flexibility needed to structure an O Fund investment without undue risk.

Among other things, the proposed regulations:

- provide a safe harbor that allows an O Zone Business (defined below) to hold funds for up to 31 months for the acquisition, construction, or improvement of real and other tangible property;
- calculate the substantial improvement test by reference to the basis of the building, excluding the basis of the land;
- require that an O Zone Business have only 70% of its assets invested in O Zone Business Property (defined below);
- allow gains recognized by a partnership to be invested in an O Fund by either the partnership or its partners;
- allow all of the benefits of the program to be claimed by taxpayers through December 31, 2047, despite the earlier expiration of the O Zone designations;
- allow an O Fund to specify the first year and month in which it will be classified as an O Fund; and
- limit the eligible gains that can be deferred under the program to capital gains, arguably contrary to the statute.

The proposed regulations will be effective on the date published as final regulations in the Federal Register, but special rules permit taxpayers to rely on them if they are applied consistently and in their entirety.[3]

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[1] As added by §13823 of Pub. L. No. 115-97. All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

[2] A detailed description of the benefits and requirements of the Opportunity Zone program is contained in two articles by the author published in the Bloomberg Tax Real Estate Journal: *New Program Allows Deferral and Possible Forgiveness of Capital Gains Invested in Low-Income Community Businesses*, 34 Real Est. J. 23 (Feb. 7, 2018) and *Moving Onward with the Opportunity Zone Program*, 34 Real Est. J. 129 (July 4, 2018).

[3] Prop. Reg. §1.1400Z-2(a)-1(e); Prop. Reg. §1.1400Z-2(c)-1(d); Prop. Reg. §1.1400Z-2(d)-1(f); Prop. Reg. §1.1400Z-2(e)-1(c).

The various provisions of the proposed regulations are explained in more detail below.[4]

SAFE HARBOR FOR 'REASONABLE WORKING CAPITAL' AND RELATED PROVISIONS

The most favorable rule in the proposed regulations is a generous safe harbor that allows a ''qualified opportunity zone business''[5] (O Zone Business) to hold funds for up to 31 months for the acquisition, construction, or improvement of real and other tangible property.[6]

There is no similar rule in the proposed regulations with respect to investments made by the O Fund directly. Direct O Fund investments will therefore continue to be subject to the statutory requirement that 90% of the O Fund's assets be invested in tangible property in six months or less following receipt. This will force many investments in real property to be done indirectly through an O Zone Business,[7]and will require O Funds formed as multi-asset funds or blind pools to coordinate drawdowns from investors and investments in property carefully.

An O Zone Business may take advantage of the safe harbor if all of the following requirements are satisfied: (1) the amount of funds intended to be within the safe harbor is designated in writing (presumably at the time such funds are received) as being for the acquisition, construction, and/or substantial improvement of tangible property in an O Zone; (2) there is a written schedule for the expenditure of the funds within 31 months of receipt consistent with the ordinary start-up of a trade or business; and (3) the funds are actually used in a manner that is substantially consistent with the preceding two requirements. Although this third requirement is not further explained, the use of the qualifier ''substantially'' presumably would allow some leeway for construction delays resulting from weather and other force majeure events.

The proposed regulations also helpfully modify three other rules applicable to an O Zone Business that might have prevented use of the safe harbor: (1) the 50% gross income requirement; (2) the limitation on holding intangible property; and (3) the minimum tangible property requirement.

One of the requirements to be an O Zone Business is that at least 50% of its gross income be derived from the active conduct of a trade or business in an O Zone.[8] The proposed regulations provide that for this purpose income earned on funds qualifying for the safe harbor is treated as income satisfying this test.[9]

A second requirement to be an O Zone Business is that a substantial portion of the intangible property held by the business be used in the active conduct of its business.[10] The proposed regulations provide that this requirement will be treated as being satisfied during any period that the business is proceeding in a manner substantially consistent with the safe harbor.[11]

Third, substantially all of the tangible property owned or leased by the O Zone Business must be ''qualified opportunity zone business property,''[12] (O Zone Business Property). The proposed regulations provide that if the property designated pursuant to the safe harbor is expected to satisfy the requirement as a result of the expenditure of funds pursuant to the safe harbor, then this requirement will be deemed satisfied during the construction period.[13]

An example in the proposed regulations illustrates all three of the above rules.[14] In the example, a taxpayer realized a $w million capital gain and timely invested the same amount in an O Fund, which immediately invested the entire amount in a partnership intended to be an O Zone Business. The O Zone Business complied with the three requirements of the safe harbor, including designating the entire $w million as for land acquisition, construction of a building,

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[4] The IRS also issued contemporaneously with the proposed regulations Rev. Rul. 2018-29, a draft IRS Form 8996 and instructions, and updated Q&As, which provide additional guidance.

[5] §1400Z-2(d)(3).

[6] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(iv). The safe harbor characterizes such funds as reasonable working capital, and thus as an exception to the restrictive rules on holding nonqualified financial property. *See* §1400Z-2(d)(3)(A)(ii), §1397C(b)(8), and §1397C(e)(1).

[7] This will require compliance with the additional requirements that apply to an O Zone Business but not an O Fund, such as the gross income test, limitations on intangible property and the prohibition on investment in certain ''sin'' businesses and property subject to a triple net lease.

[8] §1400Z-2(d)(3)(A)(ii), by cross reference to §1397C(b)(2). Note that the requirement that the gross income be derived from the O Zone is not technically contained within the cited statutory provisions. This change could matter in some cases, e.g., a catering business that prepares food at a facility located in an O Zone but serves the food at locations both within and without an O Zone.

[9] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(v).

[10] §1400Z-2(d)(3)(A)(ii), by cross reference to §1397C(b)(4).

[11] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(vi).

[12] §1400Z-2(d)(2)(D); generally O Zone Business Property is tangible property used in a trade or business (1) acquired by purchase from an unrelated party after December 31, 2017, (2) the original use of which by the O Fund or O Zone Business is in an O Zone, or the property is substantially improved, and (3) during substantially all of the holding period for such property, substantially all of such property is used in an O Zone.

[13] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(vii). Note, the prospective satisfaction of this requirement only applies when construction of property is being funded with working capital held as part of the safe harbor.

[14] Prop. Reg. §1.1400Z-2(d)-1(d)(5)(viii).

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and ancillary but necessary expenditures for the project. Although not mentioned in the example, the working capital would have been treated as intangible property under general tax principles.[15] The O Zone Business acquired land within a month, and proceeded to construct the building and to incur the ancillary but necessary expenditures over the next 30 months. The example held that the O Zone Business was deemed to satisfy the 50% gross income test, the requirement concerning holding intangible property, and the tangible property test during the 31-month period following receipt of the cash. In addition, the example contained the odd statement that the building would not fail the substantial improvement test (discussed below) despite the fact that the basis in the building had not yet doubled, even though the example illustrates new construction.

SUBSTANTIAL IMPROVEMENT TEST

The proposed regulations also contain a very favorable definition of ''substantial improvement.''[16] One of the requirements for property to qualify under the program, whether acquired directly by the O Fund or indirectly by an O Zone Business, is that either the original use of the property by the O Fund or O Fund Business commence with the O Fund or O Fund Business, **or** that the O Fund or O Fund Business ''substantially improve'' the property.[17] For this purpose, the statute defines ''substantial improvement'' as the addition to basis of the property during any 30-month period that exceeds the adjusted basis of such property at the start of the 30-month period.[18]

Rev. Rul. 2018-29 confirms that, given the permanence of land, the original use of land can never commence with the O Fund or O Fund Business.[19] The proposed regulations, however, contain a favorable definition of ''substantial improvement'' that makes this statement unimportant in many cases.[20]

A property consisting of land and an existing building will satisfy the substantial improvement test if the basis of the **building** is doubled in a 30-month period, without regard to the basis of the land. In addition, if additions to the basis of the building satisfy the substantial improvement test, there is no additional requirement that such test be separately satisfied with respect to the land. This will permit the test to be satisfied in areas where land is expensive compared to the costs of the improvement.

Rev. Rul. 2018-29, which contains the identical substantial improvement test as the proposed regulations, provides the following example: An O Fund purchases land and an existing factory building for $800, and allocates $480 to the land and $320 to the building. Within a 30-month period, the O Fund invests an additional $400 converting the building to residential rental property.[21] The example finds that the substantial improvement test is satisfied with respect to the building and that no separate substantial improvement requirement applies with respect to the land.

This example may seem to invite taxpayers to allocate an amount to land to assure that the substantial improvement test will be satisfied with respect to the building. However, if the allocation to the land exceeds its fair value, the IRS could challenge the allocation under general tax principles. In addition, the taxpayer would deprive itself of depreciation deductions to the extent it under-allocated the purchase price to the building.

The substantial improvement test (in the proposed regulations and in Rev. Rul. 2018-29) does not address the acquisition of vacant land followed by new construction on the land.[22] The example illustrating the working capital safe harbor for O Zone Businesses (described above) involved new construction, and contained the statement suggesting that the substantial improvement test was satisfied, but the example did not indicate the allocation of costs among land, building and other costs, and did not indicate how the substantial improvement test was being applied. New construction should satisfy the original use requirement, and if the cost of the new construction (over a 30-month period) exceeds the purchase price of the land, it would seem that the substantial improvement test would be satisfied with respect to the land, but further clarification by the IRS on this point would be desirable.

SUBSTANTIALLY ALL TEST

The term ''substantially all'' is used five times but not defined in §1400Z-2. In three instances it refers to

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[15] *See IT&S of Iowa v. Commissioner*, 97 T.C. 496 (1991); *but see Blodgett v. Silberman*, 277 U.S. 1, 48 S. Ct. 410 (1928), which treated currency as tangible property for certain gift tax purposes.

[16] The identical substantial improvement test is also contained in Rev. Rul. 2018-29, issued contemporaneously with the proposed regulations.

[17] §1400Z-2(d)(2)(D)(i)(II).

[18] §1400Z-2(d)(2)(D)(ii).

[19] The preamble to the proposed regulations solicits comments on whether a special rule should be promulgated that would treat land or a building acquired by an O Fund or O Fund Business that had been vacant for a certain period of time as originally used by the O Fund or O Fund Business.

[20] Prop. Reg. §1.1400Z-2(d)-1(c)(8)(ii).

[21] Note that this statement seems to dispense with a concern raised by some commentators as to whether residential rental property qualified for the program, although technically the concern is that an O Zone Business (as opposed to an O Fund) could not hold such property.

[22] This is one case where the special rule described in footnote 20 could be helpful.

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a time period and the other two refer to an amount of property (or use thereof).

The proposed regulations define the term as 70%, but only for purposes of determining whether substantially all of the property owned or leased by an O Zone Business is O Zone Business Property.[23]

The required percentage is determined differently depending on whether the O Zone Business does or does not have an ''applicable financial statement,'' as defined in Reg. §1.475(a)-4(h).[24] If it has an applicable financial statement, then the values reported in such statement are used to determine the percentage. If the O Zone Business does not have an applicable financial statement, then it may use the method (discussed below) used by its O Fund owner to satisfy the 90% test in §1400Z-2(d)(1). Where the O Zone Business has only one O Fund owner (regardless of the percentage interest held by such O Fund), the method used by that O Fund applies. If there is more than one O Fund owner, and two or more of such owners hold at least 5% in voting rights and value (for a corporation) or capital and profits (for a partnership) in the O Zone Business, then the O Zone Business may use the methodology used by the O Fund holding at least 5% that results in the highest percentage. The proposed regulations do not address how an O Zone Business that does not have an applicable financial statement would value its assets for purposes of the substantially all test for periods before it had an O Fund owner.

It is unclear why the IRS chose a standard that uses accounting values rather than tax values, and that requires subjective determinations as to whether a financial statement of an O Fund or O Zone Business is an ''applicable financial statement.''

It seems likely that many O Funds or O Zone Businesses will not have an applicable financial statement. In this case, they will default to cost both to determine if the O Zone Business satisfies the substantially all test and for purposes of applying the 90% test to the O Fund. This actually may be preferable, because the relative value of the assets would not change, whereas on an applicable financial statement the aggregate value of the depreciable assets would decline compared to cash and other non-depreciable assets.

The preamble to the proposed regulations solicits comments as to how the term ''substantially all'' should be defined for its other four occurrences. The preamble mentions that the IRS has considered a percentage as high as 90% for defining the term.

DEFINITION OF ELIGIBLE TAXPAYER AND SPECIAL RULE FOR PARTNERSHIPS

The statute provides that a ''taxpayer''[25] that has a gain from the sale or exchange of property to or with an unrelated person can defer tax on the gain by timely investing in an O Fund if the various requirements of §1400Z-2 are satisfied. The proposed regulations expand on this requirement by coining the term ''eligible taxpayer.''[26] Consistent with the broad scope of the statute, the proposed regulations define eligible taxpayer as a person who may recognize gains for federal income tax accounting, including individuals, C corporations, regulated investment companies (mutual funds), real estate investment trusts (REITs), partnerships, S corporations, trusts and estates.[27]

A special rule for partnerships allows **either** the partnership or the partners to invest in an O Fund with respect to a gain recognized by the partnership.[28] In the first instance, the partnership can elect to defer the gain and invest in an O Fund. In such case, the gain is not passed through to the partners and there is no step-up in the partners' basis in the partnership with respect to such gain.[29] If the partnership does not elect to defer the gain, then each partner may so elect with respect to their share of the gain if the gain did not arise from a sale or exchange with a person related to such partner.[30]

The proposed regulations provide a favorable timing rule for the partners to invest, allowing them to do

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[23] Prop. Reg. §1.1400Z-2(d)-1(d)(3).

[24] An ''applicable financial statement'' is defined as a financial statement that is the taxpayer's primary financial statement for the year if (1) it is prepared in accordance with U.S. GAAP and is filed with the Securities and Exchange Commission, or (2) the taxpayer makes significant business use of the financial statement (as described in detail in Reg. §1.475(a)-4(j)) and it is either prepared in accordance with U.S. GAAP and required to be provided to a federal government agency other than the IRS, or is a certified audited financial statement prepared in accordance with U.S. GAAP and given to creditors, equity holders, or provided for other substantial non-tax purposes and the taxpayer reasonably anticipates that it will be relied upon for the purposes for which it was given. The preamble to the proposed regulations solicits comments as to whether another standard, such as tax adjusted basis, would be better for purposes of assurance and administration.

[25] ''Taxpayer'' is defined in §7701(a)(14) as any person subject to any internal revenue tax.

[26] Prop. Reg. §1.1400Z-2(a)-1(b)(1).

[27] In addition to the persons listed in the proposed regulations, the preamble adds common trust funds described in §584, qualified settlement funds, disputed ownership funds, and other entities taxable under Reg. §1.468B. Although not listed, it seems clear that a non-U.S. person can be an eligible taxpayer if it has gains subject to U.S. tax.

[28] Prop. Reg. §1.1400Z-2(a)-1(c).

[29] Prop. Reg. §1.1400Z-2(a)-1(c)(1).

[30] Prop. Reg. §1.1400Z-2(a)-1(c)(2)(i), §1.1400Z-2(a)-1(c)(2)(ii).

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so up to 180 days beginning with the last day of the taxable year of the partnership that recognized the gain, or within the 180 days beginning with the sale or exchange, if the partnership does not make the deferral election.[31] For partners to take advantage of these timing rules, partnerships will need to report currently to partners concerning the recognition and amount of a gain and the date of the sale or exchange, and whether or not the partnership will make the deferral election.

Analogous rules apply to S Corporations, trusts, and estates.[32]

TREATMENT FOLLOWING EXPIRATION OF O ZONE DESIGNATIONS

The designations of low-income census tracts as O Zones expire on December 31, 2028.[33] The statute is unclear as to the treatment of O Fund investments held on such date and disposed of afterwards.

The proposed regulations provide that, despite the expiration of the O Zone designations, a taxpayer will be entitled to step up the basis in their O Fund interest to fair market value on disposition, thus permanently avoiding tax on the appreciation in their O Fund interest, if such O Fund interest is disposed of on or prior to December 31, 2047.[34]

O FUND CERTIFICATION REQUIREMENTS AND CALCULATION OF 90% TEST

The proposed regulations provide favorable rules concerning certification of an O Fund and define how the 90% test is to be calculated. Generally, an O Fund must have at least 90% of its assets invested in O Zone Property, on average, as of two dates each year, generally June 30 and December 31 for each year after the first year.[35] For purposes of calculating the 90% test, the O Fund must use values shown on its applicable financial statement,[36] if it has one, or otherwise use cost.[37]

Pursuant to the proposed regulations, an O Fund can specify the first taxable year and the month in the taxable year in which it will first be treated as an O Fund.[38] This will allow it to time the first six-month period, the end of which is one of the measuring dates for the 90% test. The proposed regulations clarify that if the first six-month period begins on or after July 1, it does not extend into the next taxable year, but instead December 31 will be the only measuring date for the first year.[39]

The proposed regulations refer to an entity ''classified as a corporation or partnership for Federal tax purposes''[40] as eligible to be an O Fund, thus dismissing concerns of over-cautious commentators as to whether an O Fund could be organized as a limited liability company.[41]

There is no prohibition on pre-existing entities electing to be an O Fund (or an O Zone Business), as long as it satisfies all the requirements.[42]

Generally, an O Fund must be organized in one of the 50 states or the District of Columbia, but the proposed regulations permit an O Fund to be organized in Puerto Rico or another possession if it operates solely in such possession.

ELIGIBLE GAINS

The Opportunity Zone program generally allows a taxpayer to defer tax on gain from the sale or exchange of any property with an unrelated person to the extent an amount up to such gain is timely invested in an O Fund, and the other requirements of §1400Z-2 are satisfied. Gain from the sale or disposition of property is defined in §1001(a) as ''the excess of the amount realized [from such sale or other disposition] over the adjusted basis provided in section 1011 for determining gain . . . .'' Other sections of the Code determine whether gains are taxed at ordinary income rates or at preferential rates.

Section 1400Z-2 uses the word ''gain'' ten times, and never uses the term ''capital gain.''[43] Therefore, based on a plain reading of the statute, all gains — and not just capital gains — should be eligible for deferral.

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[31] Prop. Reg. §1.1400Z-2(a)-1(c)(2)(iii).

[32] Prop. Reg. §1.1400Z-2(a)-1(c)(3).

[33] §1400Z-1(f).

[34] Prop. Reg. §1.1400Z-2(c)-1(b).

[35] §1400Z-2(d)(1); ''qualified opportunity zone property'' (O Zone Property) is defined generally in §1400Z-2(d)(2) as an interest in an O Zone Business or in O Zone Business Property.

[36] *See* above n. 25.

[37] Prop. Reg. §1.1400Z-2(d)-1(b).

[38] Prop. Reg. §1.1400Z-2(d)-1(a)(1)(ii), §1.1400Z-2(d)-1(a)(1)(iii).

[39] Prop. Reg. §1.1400Z-2(d)-1(a)(2)(i).

[40] Prop. Reg. §1.1400Z-2(d)-1(a)(1).

[41] The updated Q&As also state explicitly that an O Fund can be a limited liability company.

[42] Prop. Reg. §1.1400Z-2(d)-1(a)(3).

[43] The heading to §1400Z-2 is ''[s]pecial rules for **capital gains** invested in opportunity zones'' (emphasis added), but it is clear that in interpreting a provision of the Code, headings are ignored. §7806(b); *Grapevine Imports, Ltd. v. U.S.*, 71 Fed. Cl. 324 (2006); *Amergen Energy Co. v. U.S.*, 113 Fed. Cl. 52 (2013).

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Despite the lack of ambiguity on this point, the proposed regulations define ''eligible gain'' to be limited to capital gains.[44] The rationale for this limitation, as explained in the preamble, is the legislative history of the provision and the structure and text of the statute. The text of the statute uniformly uses the word ''gain,'' so it is not clear what that reference means. The legislative history[45] does use the phrase ''capital gain'' several times, but it is axiomatic when interpreting a statute that if the statute is clear on its face, a court should not resort to legislative history.[46] However, unless the IRS changes its interpretation or such interpretation is challenged, O Fund investors must limit their investments to capital gains.

Determining which gains are capital gains will be straightforward in many cases, but in other cases it is not as clear. Curiously, the term ''capital gain'' (unlike the word ''gain'') is **not** defined in the Code.[47] Most taxpayers would recognize it as a gain resulting from the sale of a ''capital asset,''[48] which is subject to the rules of §1222 (defining long-term gain, short-term gain, etc.), and eligible for more favorable tax rates provided in §1(h).

Assets used in a business would be wholly or largely excluded from the definition of capital assets, but §1231 treats the net gain from the sale of property used in a trade or business as a long-term capital gain, so presumably such net gain could be invested in an O Fund.[49] Gain from the sale of an interest in a partnership is treated as capital gain under §741, except to the extent that §751 applies (which treats a portion of the gain as ordinary income). Other provisions, such as §1245 (involving depreciation recapture) would characterize amounts otherwise treated as capital gains as ordinary income. Capital gains taxed at different rates in §1(h), such as unrecaptured §1250 gain and collectibles gain, would still be capital gain and thus eligible for investment in an O Fund.

OTHER RULES

The proposed regulations provide other rules of more limited application or of primary interest to particular taxpayers.

The proposed regulations specify that for purposes of §1400Z-2 the deemed contribution of money pursuant to §752(a) is ignored.[50] This is a technical provision that deals with determining the tax basis in a partnership interest related to debt borrowed by the partnership. Some had questioned whether such deemed contribution of money might be treated as an actual contribution under the O Zone program, but the IRS properly rejected that misconstruction. Although this rule is narrow, it should alleviate concerns about using debt financing either at the O Fund or O Zone Business.

The proposed regulations provide rules as to when the 180-day period begins in particular circumstances.[51] For stock sold in a regular-way trade on an exchange, the period begins on the trade date. For capital gain dividends received from a regulated investment company or REIT, the 180-day period begins on the date the dividend is paid. For undistributed capital gains of a regulated investment company or REIT, the period begins on the last date of the taxable year of the regulated investment company or REIT.

A gain deferred under the program retains its attributes when it is later subject to tax.[52] For example, a short-term capital gain retains its character as such and is treated as a short-term capital gain (and thus subject to all of the rules in §1222 applicable to short-term capital gains) when it is eventually taxed. The proposed regulations refer to §1(h), §1222, and §1256 as Code sections where the attributes would be important. It is not clear if the reference to §1(h) includes the tax rates listed in that section, i.e., whether the gain when eventually recognized would be taxed at the same rate as in the year of the sale or exchange.

Rules on how to track attributes of O Fund investments for a taxpayer with multiple investments are

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[44] Prop. Reg. §1.1400Z-2(a)-1(b)(2).

[45] *See* H.R. Rep. No. 115-466, at 537–540 (2017) (Conf. Rep.).

[46] *Chevron U. S. A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984); *Mayo Foundation for Medical Ed. & Research v. U.S.*, 562 U.S. 44 (2011). It is unknown what any particular senator or representative or their staff members believed the program covered, but that is wholly irrelevant, because the statute speaks for itself.

[47] Similar terms, such as ''short-term capital gain,'' ''long-term capital gain,'' ''net capital gain,'' and ''capital gain net income'' are defined in §1222.

[48] ''Capital asset'' is defined in §1221 generally as property held by the taxpayer (whether or not connected with a trade or business), excluding stock in trade or other property held in inventory or primarily for sale to customers in the ordinary course of a trade or business, depreciable assets and real property used in a trade or business, certain patents, inventions, copyrights, etc., certain accounts or notes receivable, and a few other categories of property.

[49] Note that pursuant to §702(a)(3), each partner in a partnership must separately take into account his distributive share of §1231 gains and losses, and then determine the net §1231 gain or loss at the partner level. A possible result is that a partnership cannot invest in an O Fund with respect to gains from the sale of business assets, since it does not determine a net §1231 gain at the partnership level. A partner must also separately take into account short-term and long-term gains and losses (§702(a)(1) and §702(a)(2)), but these do not need to be netted to constitute a capital gain, so it appears that gains from the sale of investment property by a partnership could be invested in an O Fund.

[50] Prop. Reg. §1.1400Z-2(e)-1(a)(2).

[51] Prop. Reg. §1.1400Z-2(a)-1(b)(4).

[52] Prop. Reg. §1.1400Z-2(a)-1(b)(5).

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provided. Generally, the proposed regulations adopt a first-in, first-out approach (FIFO).[53] If, after application of FIFO, a taxpayer is treated as having disposed of less than all of his O Fund interests acquired on one day, and the interests would have different attributes, then a pro rata method is used.[54]

As explained in the preamble to the proposed regulations, if a taxpayer invests in an O Fund and later sells its entire interest at a gain (including the original deferred gain), it can elect to further defer the gain by timely investing in the same or another O Fund.

Special rules are provided for gains from §1256 contracts and gains where there are offsetting positions.[55]

The draft IRS Form 8996 also clarifies two important points. An O Fund has until the end of its first taxable year to amend its organizing documents to add the required purpose of investing in O Zone Property. Also, the form clarifies that the penalty for failure to satisfy the 90% test is the underpayment rate on an annual basis, not a monthly basis, i.e., if the O Fund fails its 90% test by $100,000 for each of six months when the underpayment rate is 5%, the penalty is $100,000 X 5% divided by 2. The statute was unclear on this point.

ADDITIONAL GUIDANCE NEEDED

The proposed regulations provide critical rules that should permit O Fund investments to proceed. However, additional guidance is needed on many other issues. The preamble lists the following issues where the IRS expects to issue additional guidance in the near future:

- the meaning of ''substantially all'' for the four uses not addressed in the proposed regulations;
- transactions that may trigger gain that has been deferred (e.g., based on distributions from the O Fund);
- the reasonable period in which an O Fund can reinvest proceeds from a sale of O Zone Property without penalty;
- administrative rules for imposing a penalty where the O Fund fails to meet the 90% test; and
- information reporting requirements.

In addition to these issues, it would be very helpful to have additional guidance on several other issues, including:

- definition of which gains qualify for the program;
- a safe harbor that allows an O Fund to hold funds for the acquisition, construction or improvement of property for more than six months;
- rules on disposing of an interest in an O Fund indirectly, e.g., by the disposition of property by the O Fund;
- rules describing permissible distributions from an O Fund, including those funded by refinancing proceeds; and
- rules on how to treat leases.

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[53] Prop. Reg. §1.1400Z-2(a)-1(b)(6).

[54] Prop. Reg. §1.1400Z-2(a)-1(b)(7).

[55] Prop. Reg. §1.1400Z-2(a)-1(b)(2)(iii), §1.1400Z-2(a)-1(b)(2)(iv).

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