
1. What are 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* (“OZ”). Governors were required to submit nominations by March 21, 2018. In Kentucky, 144 sites in 84 counties have been designated as OZs. OZ designations will be effective for 10 years, until 12/31/2026. Investors in these designated OZs are eligible for significant federal tax benefits.

2. What are Qualified Opportunity Funds?

- Investments in OZs must be through *Qualified Opportunity Funds* (“QOF”). A QOF is any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified OZ property other than another QOF. A QOF must hold at least 90% of its assets in qualified OZ property.
 - 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% 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 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:** Compliance with the 90% Asset Test is determined by the average of the percentage of the qualified OZ 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. The phrase “first 6-month period of the taxable year” 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.
 - i. For purposes of the calculation of the 90% 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 regulations require the QOF to use the cost of its assets.
 - ii. The QOF does not take into account any investments received within the last 6 months prior to the testing date that are held in cash, cash equivalents, or debt instruments with a term of 18 months. This gives QOFs a minimum of 6 months to make investments without failing the 90% asset test.

2. What are Qualified Opportunity Funds? (Cont.)

iii. Failure to satisfy the 90% test does not disqualify a QOF but only triggers a penalty.

iv. If QOZ property is sold for cash, it is no longer a qualified investment for purposes of meeting the 90% test; however, the QOF has 12 months to reinvest those funds without failing the 90% asset test.

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 OZ business, provided that the pre-existing entity satisfies the requirements. If an entity has self-certified as a QOF or as a subsidiary entity operating a qualified OZ business, a tangible asset can be considered qualified OZ business property only if it was acquired by purchase after 12/31/2017.

3. What are the 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 QOF. The deferred gain must be recognized on the earlier of the date on which the OZ investment is sold or December 31, 2026.
 - b. A **step-up in basis** for capital gains reinvested in an QOF. The basis of the original investment is increased by 10% if the investment in the QOF 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 QOF if the investment is held for at least 10 years. (Note: this exclusion applies only to the gains accrued from the investment in a QOF, 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 OZ designation expires on 12/31/2026. 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.
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4. What Can a Taxpayer Invest in a QOF?

- The investment in a QOF must be an equity investment, which is broadly defined to include stock and/or partnership interests (i.e., an investment cannot be a loan).
 - a. Taxpayers **may** make a qualifying investment in a QOF through the **contribution of cash or cash equivalents**.
 - b. Taxpayers **may** make a qualifying investment in a QOF through the **contribution of property other than cash**.
 - c. Taxpayers **may** obtain a qualifying investment in a QOF by **purchasing the QOF interest from an investor in the QOF**.
 - d. Taxpayers **may not** obtain a qualifying interest in a QOF **in exchange for services**.

5. What Can a QOF Invest In?

- A QOF can operate a trade or business directly or can invest (hold equity) in qualified OZ businesses.
 - a. If a **QOF operates a trade or business directly** and does not hold any equity in a qualified OZ business, at least 90% of the QOF's assets must be qualified OZ property.
 - b. If a QOF invests in a qualified OZ business, the entity must be a QOZ business both when the QOF acquires an equity interest in the entity and during substantially all (90%) of the QOF's holding period for that interest. To be a qualified opportunity zone business:
 - i. **OZ business property is property that is used in a QOZ and also requires new capital to be employed in a QOZ.**
 - ii. **Substantially all (70% or more) of the tangible property owned or leased by the trade or business must be qualified OZ business property.**
 1. **Tangible property is qualified OZ 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 (90%) of the QOF's holding period for the property, substantially all (70%) of the use of the property was in a QOZ.
 - a. A QOF cannot qualify as **"original use"** for the acquisition of an existing building on land that is wholly within a QOZ.
 - b. "Original use" is satisfied if tangible property is placed in service in a QOZ and it has not yet been depreciated by a taxpayer other than a QOF. Original use commences when property is first placed in service in the QOZ.
 - c. If property has been unused or vacant for an uninterrupted period of at least 5 years, use of that property in the QOZ qualifies as "original use".

5. What Can a QOF Invest In? (Cont.)

d. If a QOF acquires a building wholly within a QOZ, a “**substantial improvement**” under Section 1400Z-2 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 OZs. An absence of a requirement to increase the basis of land itself addresses the need to facilitate repurposing vacant or otherwise unutilized land.

e. Each asset must be substantially improved. *However, note that the IRS is considering applying an aggregate standard for the substantial improvement requirement and may do so at a later date.*

f. Inventory and raw materials are still considered to be QOZ business property even when it is in transit from a vendor or to customers.

g. The requirement that the original use of tangible property in the QOZ commence with a QOF is not applicable to land, whether the land is improved or unimproved. Land also does not need to be substantially improved. But land must be used in a trade or business- holding land for investment does not qualify.

h. **Leased Tangible Property.** Leased tangible property can be QOZ Business Property.

i. There is no original use requirement for leased property.

ii. There is no requirement to substantially improve leased property.

iii. The leased property must be acquired under a lease entered into after 12/31/17

iv. Substantially all of the use of the leased tangible property is in a QOZ during substantially all of the period for which the business leases the property

v. The lease must be a “market rate lease” as determined by the rate that would be paid in an arm’s length transaction.

vi. Leased property can be acquired from a related party. But if a lease is acquired from a related party:

1. Lessee cannot prepay rent for more than one year

2. The lessee must also purchase QOZ Business Property with a total value of at least the value of the leased property.

vii. General anti-abuse rules do apply to prevent a lease from being used to circumvent the substantial improvement requirement for real property (other than land): if there was a plan to purchase the property for other than fair market value at the time of purchase, the leased property will not be considered QOZ Business Property.

i. **Land.** Land can be QOZ Business Property if it is used in the trade or business of the QOZ Business or the QOF. Unimproved land is not required to be original use or substantially improved.

5. What Can a QOF Invest In? (Cont.)

j. **Nonqualified Financial Property.** There is a working capital safe harbor for QOF investments in QOZ 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 OZ, or develop a trade or business in the QOZ.

i. There must be: (1) a written plan that identifies the financial property as property held for the acquisition, construction, or substantial improvement of tangible property in the OZ or the development of a trade or business in the QOZ; (2) a written schedule consistent with the ordinary business operations of the business; and (3) the business must substantially comply with the schedule. Taxpayers are required to retain any written plans in their records.

ii. Exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for a government action, such as permitting, if the application for that action is completed during the 31-month period.

iii. A single QOZ Business can have multiple 31-month periods correlating with different infusions of capital.

k. **Real Property Straddling a QOZ:** If the amount of real property based on square footage located within the QOZ is substantial as compared to the amount of real property based on square footage located outside the QOZ, and the real property outside of the QOZ is contiguous to part or all of the real property located inside the QOZ, then all of the property is deemed to be located within the QOZ.

iii. A substantial portion (40% or more) of intangible property is used in the active conduct of a trade or business in the qualified OZ.

iv. 50% of the gross income of the QOZ business must be derived from the active conduct of a trade or business in the QOZ.

1. A QOZ Business may meet the gross income test by one of the following:

2. At least 50% of the services performed by employees or independent contractors (based on hours or amount paid for the services) are performed in the QOZ

3. The tangible property that is in a QOZ and the management or operational functions performed for the business in the QOZ are each necessary to generate 50% of the gross income of the trade or business.

4. If, based on all the facts and circumstances, at least 50% of the gross income of a trade or business is derived from the active conduct of a trade or business in the QOZ.

5. "Active conduct" includes the ownership and operation of real property. This includes leasing property, although triple net leasing of property is not permitted.

v. Asset values are determined using either the values reported on a financial statement or the cost of the assets. The unadjusted cost basis of the property or, for leased property, the net present value of lease payments can be used.

6. What Gains Are Eligible for OZ Tax Benefits if Invested in a QOF?

- Only **capital gains** (not ordinary gains) are eligible for deferral. 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” as defined by the IRS.
 - 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.
 - i. **Special Rule for 1231 gains** (gains on the sale or exchange of real or depreciable property used in a trade or business and held over one year): 1231 gains are required to be netted with 1231 losses to determine the amount of capital gains a taxpayer has. The 180-day period for investing capital gain income from 1231 property begins on the last day of the taxable year.
 - b. **Attributes of Included Income When Gain Deferral Ends.** When a taxpayer defers gains, 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, the taxpayer must use 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 achieve 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.
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7. What Taxpayers Are Eligible for OZ Tax Benefits by Investing in a QOF?

- **Any taxpayer that recognizes capital gain for federal income tax purposes** is eligible to invest in a QOF and realize the tax benefits. 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 is the day on which the partner would be required to recognize the gain if 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.
 - 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. What About Interim Gains?

- If a QOF sells QOZ Property, the benefit to investors is not affected so long as the QOF re-invests the proceeds in another qualified asset within 12 months. The sale proceeds must be held in cash, cash equivalents, and debt instruments with a term of 18 months or less in order to qualify. Investors in QOF partnerships will generally still recognize interim gains under the application or ordinary tax principles.

9. Do General Anti-Abuse Rules Apply?

- General Anti-Abuse Rules apply to QOF investments. Even if a transaction otherwise qualifies, the IRS can disqualify the transaction if the IRS finds that a significant purpose of the transaction is to achieve a result inconsistent with the purpose of the OZ statute.

10. What are the KY Tax Benefits of Investing in OZs?

- Federal OZ deferrals will also be exempt from Kentucky income tax. KRS § 141.010(14) sets the IRC conformity date for Kentucky as 12/31/2017; the effective date of the OZ legislation (26 USC § 1400Z) was 12/22/2017 as part of the Tax Cuts & Jobs Act. 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.

To find out more, see where all of Kentucky's Opportunity Zones are, and to see a portfolio of Kentucky Opportunity Zone projects ready for investment, go to

KYOZ.com

This summary includes both the first set of IRS regulations, released October 19, 2018, and the second set of IRS regulations, released on April 17, 2019. It is expected that more regulations will be forthcoming. However, taxpayers may rely on these regulations. This summary is for informational purposes only and does not constitute legal or financial advice. The Kentucky Cabinet for Economic Development recommends that qualified legal and/or financial advice be sought prior to acting pursuant to these regulations.

