

OPPORTUNITY ZONES SERIES

Better Fit: Actual Business Practices and 10-Year Gain Exclusion on Asset Sales

This alert is part of the OZ Series that highlights topics in the Opportunity Zones final regulations published in the Federal Register on January 13, 2020.

Under the Opportunity Zones program, a taxpayer who has held a qualifying investment in a Qualified Opportunity Fund for at least 10 years may elect to exclude from income gain realized on a sale or exchange of that Qualified Opportunity Fund investment and avoid federal income tax on that gain. The final regulations fill in some gaps in the prior proposed regulations. So now the mechanics of the 10-year gain exclusion better match actual business practices for selling real estate projects and assets of operating businesses.

The final regulations address, among other things, the following:

- Is gain arising from the sale of property by a Qualified Opportunity Zone Business (that is, for federal tax purposes, a partnership) in which a Qualified Opportunity Fund S corporation or partnership has invested eligible for the 10-year gain exclusion? Under the prior regulations, the 10-year gain exclusion applied at the level of the Qualified Opportunity Fund so the Fund had to sell its partnership interest in the Qualified Opportunity Zone Business for eligible taxpayers to take advantage of the 10-year gain exclusion.
 - ◊ The final regulations provide that gain arising from the sale or exchange of property by a Qualified Opportunity Fund (that itself is a partnership or S corporation), directly or indirectly, is eligible for the 10-year gain exclusion. This means that a Qualified Opportunity Zone Business partnership may sell or exchange property directly and the eligible taxpayer (to whom the Fund allocates a share of that gain) may make an election to exclude its share of the gain from income for federal income tax purposes. The final regulations include complex rules regarding deemed distribution and retribution of net proceeds (sale price less certain indebtedness) which may result in the net proceeds being treated as retained by the Fund as a nonqualifying investment (with the result that a subsequent sale of that interest in the Fund is not eligible for gain exclusion). However, if the Fund actually distributes the net proceeds in cash to partners within 90 days of the sale or exchange, the proceeds are not treated as reinvested.

Continued on next page...

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- Can a Qualified Opportunity Fund with multiple assets dispose of assets at different times and still preserve a taxpayer's right to elect the 10-year gain exclusion for each disposition?
 - ◊ The final regulations provide that sales or exchanges by a Qualified Opportunity Fund of different assets at different times may still qualify for the 10-year gain exclusion by a taxpayer who has held a qualifying investment in the Fund for at least 10 years. This clarification gives flexibility to multi-asset Qualified Opportunity Funds to make decisions regarding holding or selling interests in Qualified Opportunity Zone Businesses and Qualified Opportunity Zone Business Property based on economic and business considerations.
- What fair market value is used to adjust basis for the 10-year gain exclusion when property is sold for less than its fair market value (such as the direct sale by a Qualified Opportunity Fund of its investment in an affordable housing project)?
 - ◊ The final regulations provide that in the case of the disposition of assets directly by a Qualified Opportunity Fund or indirectly by a Qualified Opportunity Zone Business to an unrelated party, fair market value of the assets will, for purposes of the 10-year gain exclusion, generally be the sale price of the assets.

The final regulations clarify that for purposes of the 10-year gain exclusion, gains and losses include all gains and losses except those arising from the sale or exchange of inventory in the ordinary course. As a result, the gain exclusion allows a taxpayer to elect to avoid all federal income taxes (e.g., capital gains, ordinary income gain and depreciation recapture) arising from a sale or exchange of a qualifying investment.

Application of the 10-year gain exclusion is not automatic for taxpayers who hold a qualifying investment in a Qualified Opportunity Fund for at least 10 years. An eligible taxpayer is required to file with its federal returns an election to exclude gain from income to take advantage of the 10-year gain exclusion.

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Jean Everett and Michael Tyszko prepared this Alert. Please feel free to contact them or any member of our Opportunity Zones team to discuss the OZ program.

Linking tax policy and economic development, the federal Opportunity Zones program offers federal income tax deferral and reduction to encourage equity investment of capital gains in designated low income census tracts to facilitate increased business activity and economic revitalization. Bousquet Holstein has a long history advising investors, developers, entrepreneurs and local governments on maximizing federal and state income tax credits and incentives; on developing, implementing and taking advantage of federal, state and local economic development programs; and on forming, raising capital for, lending to, operating and selling business organizations. We have assembled a team of professionals with diverse experience to work with our clients to understand the rewards and risks of the OZ program and help them structure OZ investment and OZ businesses to preserve OZ tax benefits and leverage OZ investments to maximize their impact on neighborhoods and communities.

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Links to OZ Resources:

- ◆ [BH Legal Alert 2: Opportunity Zones Series: Gains Eligible of OZ Tax Incentives Expand: Section 1231 Property](#)
- ◆ [BH Legal Alert 1: Opportunity Zones Series: Final Regulations Enhance Tax Incentive Program](#)
- ◆ [Listing of Opportunity Zones in New York State](#)
- ◆ [U.S. Treasury Department Opportunity Zones Final Regulations](#)
- ◆ [Opportunity Zones Frequently Asked Questions](#)