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IRS Issues Proposed Regulations on Qualified Opportunity Zones

The IRS has issued proposed regulations (https://www.irs.gov/pub/irs-drop/reg-115420-18.pdf) that provide guidance on the qualified opportunity zone program under Sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code, which were enacted as part of the Tax Cuts and Jobs Act (TCJA). (All section references are to the Internal Revenue Code of 1986, as amended.) Generally, qualified opportunity zones are designated tracts in low-income communities in which eligible taxpayers may invest and elect to defer certain gain. (See our prior coverage here (https://www.stradley.com/insights/publications/2018/06/tax-insights-june-27-2018) regarding the tracts that have been designated as qualified opportunity zones.)

There are two benefits to investing in qualified opportunity zones. First, a taxpayer that invests in a designated qualified opportunity zone may defer the inclusion in gross income of certain gains that are reinvested in qualified opportunity funds (QOFs) until the earlier of Dec. 31, 2026, or the taxpayer's disposition of its investment in the QOF. QOFs are investment vehicles organized for the purpose of investing in qualified opportunity zone property. Qualified opportunity zone property includes (i) qualified opportunity zone stock, (ii) qualified opportunity zone partnership interests and (iii) qualified opportunity zone business property. Second, a taxpayer may increase its basis in the investment by a certain percentage depending on how long it holds the investment. For example, a taxpayer that holds its investment for five years can increase its basis in such investment by 10 percent of the amount of gain that was deferred (this means that a taxpayer can eliminate a portion of the existing capital gain that the taxpayer used to make the QOF investment). If the investment is held for seven years, the basis is increased by an additional 5 percent, and if the investment is held by the taxpayer for 10 years, the basis of the investment is increased to its fair market value at the time of sale. An investment that is held for 10 years permits the taxpayer to exclude from gross income any gains on investments in a QOF. Generally, the regulations provide:

- Only capital gains are eligible for deferral. The gain that would be deferred must be gain that would be recognized (without regard to the deferral) not later than Dec. 31, 2026.
- The capital gain must not arise from a sale or exchange with a related person, as such term is defined under Sections 267(b) and 707(b)(1), replacing 20 percent for 50 percent where it appears in such sections.
- An investment in a QOF must be an equity investment, e.g., preferred stock or a partnership interest with special allocations, and not a debt instrument.
- Gain must be invested in a QOF within 180 days of the sale or exchange giving rise to the gain in order to be eligible for the deferral.
- Gain from a Section 1256 contract may be eligible for investment in a QOF; however, gain from straddles (not including Section 1256 contracts) is not eligible for the election.
- The election to defer gain can be made either by the partnership or by a partner (assuming all other requirements are met).

The IRS released Revenue Ruling 2018-29 (https://www.irs.gov/pub/irs-drop/rr-18-29.pdf) addressing questions on the definitions of "original use" and "substantial improvement," which must be satisfied for certain qualified opportunity zone business property, specifically with regard to the separation of land and building improvements.

IRS Issues Proposed Regulations on Safe Harbor for Information Returns and Payee Statements

The IRS has issued proposed regulations (https://s3.amazonaws.com/public-inspection.federalregister.gov/2018-22393.pdf) that generally incorporate the de minimis safe harbor rules for information returns and payee statements set forth in Notice 2017-9 (https://www.irs.gov/pub/irs-drop/n-17-09.pdf) (see our prior coverage here (https://www.stradley.com/insights/publications/2017/01/tax-insights-january-11-2017)). Generally, except where there is reasonable cause and no willful neglect, and subject to certain other exceptions, a failure to include all of the information or correct information required to be shown on an information return or a payee statement is subject to a penalty. The amount of the penalty depends on various factors. For statements required to be filed after Dec. 31, 2016, recent legislation created a de minimis error safe harbor for such penalties. Under the proposed regulations, an information return or payee statement will be considered correct, and no correction is required, if the amount in error differs from the correct amount by no more than $100 and the correct amount of tax withheld differs from the amount reported by no more than $25. The safe harbor does not apply if the error was due to intentional disregard of the filling requirements. In those situations, higher penalties would apply to the failure to satisfy the requirements. Payees may elect out of the safe harbor by mailing a written election to the payor or filer, which would require the payor or filer to issue a corrected payee statement. Additionally, any voluntary corrections by a broker will result in an updated adjusted basis even if the dollar amounts were not required to be corrected.

IRS Issues Guidance on Issuer of Uniform Mortgage-Backed Securities

The IRS issued Revenue Procedure 2018-54 (https://www.irs.gov/pub/irs-drop/rp-18-54.pdf), which provides guidance that allows certain taxpayers to make a deemed election with respect to mortgage-backed securities with an unknown issuer in order to continue to satisfy the diversification requirements of Section 817(h). Section 817(h) provides that a variable contract (other than a pension plan contract) that is otherwise described in Section 817 and that is based on a segregated asset account will not be treated as an annuity, endowment or life insurance contract for any period (and any later period) for which the investments made by the account are not adequately diversified. A segregated asset account consists of all assets for which the investment return and market value must be allocated in a manner identical to that of any variable contract invested in any of such assets.

As part of an initiative of government entities, a mortgage-backed security will be created that combines certain features of both Freddie Mac securities and Fannie Mae securities (uniform mortgage-backed security, or UMBS). These securities will trade on the "To-Be-Announced" (TBA) market. As such, there may be instances where an investor acquires a UMBS without knowing the issuer. Revenue Procedure 2018-54 sets forth guidance and procedural rules so that taxpayers holding investments in one or more segregated asset accounts on which variable contracts are based are able to make a deemed-issuance-ratio election to treat the issuer of the UMBS in part as Fannie Mae and in part as Freddie Mac. (A "taxpayer" for this purpose is (i) an insurance company that issues variable contracts or (ii) an investment company, partnership or trust that qualifies for "look-through" treatment under Treasury Regulation Section 1.817-5(f).) At least three weeks prior to the start of each calendar year, the Federal Housing Finance Agency (FHFA) will determine and publicize the deemed-issuance ratio that electing taxpayers are to use for TBA contracts entered into during that calendar year. FHFA will determine this ratio based on the ratio of TBA-eligible securities issued by Fannie Mae and Freddie Mac during a 24-month period ending not earlier than Oct. 31 immediately preceding the year to which the new ratio will apply. The Revenue Procedure does not, however, address the identity of the issuer of the TBA contracts themselves.

Without this guidance, a segregated asset account already heavily invested in securities issued by Fannie Mae or Freddie Mac that enters into unstipulated TBA trades may have been required, pursuant to the TBA contract, to accept additional securities of that issuer that could have jeopardized the segregated asset account's satisfaction of the diversification requirements of Section 817(h).

IRS Issues Proposed Regulations Removing Final Regulations on Advance Payments

The IRS has issued proposed regulations (https://s3.amazonaws.com/public-inspection.federalregister.gov/2018-22025.pdf) that would remove Treasury Regulation Section 1.451-5. Treasury Regulation Section 1.451-5, which allowed accrual method taxpayers to defer the inclusion of income for certain advance payments, was overridden by Section 451(c), which was enacted as part of the TCJA. Generally, Section 451(c) requires a taxpayer to include any advance payment it receives in income in the year of receipt to the extent required, with the remaining portion included in the following year.

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