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Stradley Ronon Stevens & Young, LLP
2005 Market Street
Suite 2600
Philadelphia, PA 19103-7018
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

With other offices in:
Washington, D.C.
New York
New Jersey
Illinois
Delaware

IRS Issues Proposed Reliance Regulations on QOF

The IRS has issued additional proposed regulations (https://www.irs.gov/pub/irs-drop/reg-120186-18-nprm.pdf) that provide guidance on the qualified opportunity zone program under Section 1400Z-2, which was enacted as part of the 2017 Tax Cuts and Jobs Act (TCJA). Generally, qualified opportunity zones are designated tracts in low-income communities in which eligible taxpayers may invest in through a qualified opportunity fund (QOF) and elect to defer certain gain. (See our prior coverage at https://www.stradley.com/insights/publications/2018/10/tax-insights-october-24-2018, https://www.stradley.com/insights/publications/2018/10/tax-insights-october-31-2018 and https://www.stradley.com/insights/publications/2019/02/tax-insights-february-6-2019) The new proposed regulations generally address gains that may be deferred as a result of an investment in a QOF and special rules for investments in a QOF held for at least 10 years. Additionally, the regulations update portions of the previously proposed regulations, including: (i) the definition of "substantially all"; (ii) the transactions that may trigger the inclusion of gain that a taxpayer has elected to defer; (iii) the timing and amount of the deferred gain that is included; (iv) the treatment of leased property used by a qualified opportunity zone business; (v) the use of qualified opportunity zone business property in the qualified opportunity zone; (vi) the sourcing of gross income to the qualified opportunity zone business; and, (vii) the "reasonable period" for a QOF to reinvest proceeds from the sale of qualifying assets without paying a penalty. (All section references are to the Internal Revenue Code of 1986, as amended (Code).)

More specifically:

1. The term "substantially all" is used twice in Section 1400Z-2, but is not defined therein. The IRS notes in the preamble to the proposed regulations that it is necessary to have two different thresholds for the different uses of "substantially all." The proposed regulations provide that in testing the **use** of qualified opportunity zone business property, the term "substantially all" means 70%. Further, for purposes of the holding period context, "substantially all" means 90%. For example, for property to satisfy one prong of the definition of "qualified opportunity zone business property" within the meaning of 1400Z-2(d)(2)(D), during "substantially all" of the qualified opportunity fund's holding period for such property, "substantially all" of the use of such property was in a qualified opportunity zone. This means that during 90% of a QOF's holding period of property, 70% of the use of such property had to be in a qualified opportunity zone for it meet one of the requirements to be qualified opportunity zone business property.

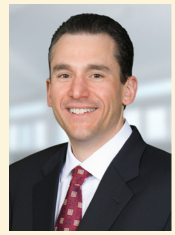
2. Under Section 1400Z-2, gain that is deferred under 1400Z-2(a) is included in the taxpayer's income in the taxable year of the earlier of (a) the date such investment is sold or exchanged, or (b) Dec. 31, 2026. The proposed regulations clarify that, subject to enumerated exceptions, an inclusion event results from a transfer of a qualifying investment in a transaction to the extent the transfer reduces the taxpayer's equity interest in the qualifying investment for federal income tax purposes. However, except as otherwise provided, a transaction that does not reduce a taxpayer's equity interest in the taxpayer's qualifying investment also is an inclusion event under the proposed regulations to the extent the taxpayer receives property from a QOF in a transaction treated as a distribution for federal income tax purposes. The regulations provide a substantial list of events that will be inclusion events.

3. Section 1400Z-2(e)(4)(B) authorizes regulations to ensure a QOF has "a reasonable period of time to reinvest the return of capital from investments in qualified opportunity zone stock and qualified opportunity zone partnership interests, and to reinvest proceeds received from the sale or disposition of qualified opportunity zone property." The proposed regulations provide that proceeds received by the QOF from the sale or disposition of (1) qualified opportunity zone business property, (2) qualified opportunity zone stock, and (3) qualified opportunity zone partnership interests are treated as qualified opportunity zone property for purposes of the 90-percent investment requirement, so long as the QOF reinvests the proceeds received by the QOF from the distribution, sale, or disposition of such property during the 12-month period beginning on the date of such distribution, sale, or disposition. The one-year rule is intended to allow QOFs adequate time in which to reinvest proceeds from qualified opportunity zone property. Further, in order for the reinvested proceeds to be counted as qualified opportunity zone business property, from the date of a distribution, sale, or disposition until the date proceeds are invested in other qualified opportunity zone property, the proceeds must be continuously held in cash, cash equivalents, and debt instruments with a term of 18 months or less. Finally, a QOF may reinvest proceeds from the sale of an investment into another type of qualifying investment.

Taxpayers may generally rely on the rules in the proposed regulations for the period prior to the finalization of the applicable sections if taxpayers apply the proposed rules consistently and in their entirety. However, taxpayers may not rely on the basis adjustment rules in Proposed Regulations Section 1.1400Z2(c)-1, which are applicable Jan. 1, 2028.

IRS Issues Proposed Regulations on ESBTs with Nonresident Alien Beneficiaries

The IRS has issued proposed regulations (https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-07919.pdf) that subject S corporation income of an electing small business trust (ESBT) shareholder to tax even if a nonresident alien is a deemed owner. S corporations can only have certain taxpayers as shareholders, including certain trusts, as set forth in Section 1361. The TCJA amended Section 1361 to permit nonresident aliens to be potential current beneficiaries of ESBTs. Prior to the amendment, a change in the immigration status of a potential current beneficiary of an ESBT that owns S corporation stock from resident alien to nonresident alien would have terminated an ESBT election, and therefore also terminated the corporation's election as an S corporation. Generally, an ESBT is taxed at the trust level on its S corporation income. However, it is possible that a portion of an ESBT could be subject to taxation under the grantor trust rules, which does not pay tax at the trust level and passes through income to the deemed owner of the grantor trust. The proposed regulations would ensure that, with respect to situations in which a nonresident alien is a deemed owner of a grantor trust that has elected to be an ESBT, the S corporation income of the ESBT would continue to be subject to taxation. Specifically, the proposed regulations would modify the allocation rules under Treasury Regulations Section 1.641(c)-1 to require that the S corporation income of the ESBT be included in the S portion of the ESBT if that income otherwise would have been allocated to a nonresident alien deemed owner under the grantor trust rules. Accordingly, such income would be taxed to the domestic ESBT by providing that, if the deemed owner is a nonresident alien, the grantor portion of net income must be reallocated from the grantor portion of the ESBT to the ESBT's S portion. Conforming changes also are made to Treasury Regulation Section 1.1361-1(m) to reflect the amendment made by the TCJA.



Christopher C. Scarpa

Jacquelyn Gordon

For more information, contact Christopher C. Scarpa at 215.564.8106 or cscarpa@stradley.com or Jacquelyn Gordon at 215.564.8176 or jgordon@stradley.com.

Ninth Circuit Holds Section 7502 Supplants Common-law Mailbox Rule

In *Baldwin v. United States* (http://cdn.ca9.uscourts.gov/datastore/opinions/2019/04/16/17-55115.pdf), the Court of Appeals for the Ninth Circuit held that Section 7502's mailing requirements supplanted the common-law mailbox rule. At issue in the case was whether the taxpayers timely filed an amended return claiming a refund with the IRS. The taxpayers asserted that the mailed their return months prior to the deadline, however, the IRS did not receive a postmarked return from the taxpayer until years after the deadline. Prior to the enactment of Section 7502, a return was timely filed only if it was physically delivered to the IRS by the applicable deadline. In response to the physical-delivery rule, the common-law mailbox rule was developed by the courts and provided that proof of proper mailing – including by testimonial or circumstantial evidence – gave rise to a rebuttable presumption that the document was physically delivered to the addressee in the time such a mailing would ordinarily take to arrive. Section 7502(a)(1) carves out an exception to the physical-delivery rule for tax documents sent and delivered by U.S. mail. It provides that if a document is received by the IRS after the applicable deadline, it will nonetheless be deemed to have been delivered on the date that the document is postmarked. This exception means that a document will be deemed timely filed so long as two things are true: (1) the document is actually delivered to the IRS, even if after the deadline; and (2) the document is postmarked on or before the deadline. When a document is sent by registered mail, the registration will serve as prima facie evidence that the document was delivered, and the date of registration will be treated as the postmark date, even if the IRS claims not to have received it, so long as the taxpayer produces the registration. Even after the enactment of Section 7502, there was still a circuit split as to the impact of the rule on the common-law doctrine. In August 2011, the Treasury Department sought to resolve the split by promulgating an amended version of Treasury Regulation Section 301.7502-1(e) that interprets Section 7502 as creating the exclusive exceptions to the physical-delivery rule. The Ninth Circuit found that the Treasury Regulation was valid under the Chevron test, and therefore, that the taxpayers did not timely file an amended return claiming a refund within the requirements of Section 7502.

IRS Releases 2019 Draft QBI Forms

The IRS released the 2019 version of draft forms to compute the qualified business income (QBI) deduction. The IRS did not issue forms for 2018, rather taxpayers had to rely on a worksheet (2018 Qualified Business Income Deduction-Simplified Worksheet) that was included with the instructions to Form 1040. Draft Form 8995 (https://www.irs.gov/pub/irs-dft/f8995--dft.pdf), Qualified Business Income Deduction Simplified Computation, is similar to the worksheet and should be used by single taxpayers with taxable income of $160,700 or less (or $321,400 or less for taxpayers married filing jointly). Draft Form 8995-A (https://www.irs.gov/pub/irs-dft/f8995a--dft.pdf), Qualified Business Income Deduction, is a substantially longer form, witvh four sections and four schedules covering the computation of the QBI deduction.

Transportation Fringe Benefits are Nonrefundable Upon Termination of Employment

The IRS, in Information Letter 2019-0002 (https://www.irs.gov/pub/irs-wd/19-0002.pdf), provides guidance on how transportation fringe benefits should be treated when a taxpayer is terminated from employment. If an employee chooses to receive a qualified transportation fringe instead of cash compensation, the law treats the benefit as provided directly by the employer rather than purchased by the employee with the amount of the compensation reduction. An employer may provide qualified transportation fringe benefits only to individuals who are current employees of the employer when the qualified transportation fringe is provided. When an employee is fired, compensation reduction amounts are not refundable to the employee. Therefore, the IRS stated that employees who stop participating in an employer's qualified transportation benefit plan without cancelling their compensation reduction election cannot receive a refund of any amount.