Deferral of Gain Invested in Qualified Opportunity Zones

The Tax Cuts and Jobs Act created the new Opportunity Zone program, which seeks to encourage economic growth, investment and job creation in economically distressed communities where new investments may be eligible for preferential tax treatment. For example, an investor may elect to exclude from gross income the gain on the sale or exchange of any property to an unrelated party in the tax year of the sale or exchange if the gain is reinvested in a Qualified Opportunity Fund (QOF) within 180 days of the sale or exchange (Code Sec. 1400Z-2(a)(1)(A)).

The economically distressed zones are called Qualified Opportunity Zones (QOZs), and localities will qualify if they have been nominated for such designation by the state and the nomination has been certified by the U.S. Secretary of the Treasury. Each state has the authority to designate low-income communities as tax-favored QOZs. The designation remains in effect from the designation date through the end of the tenth calendar year that begins on or after the designation date.

Designation of Qualified Opportunity Zones

Code Sec. 1400Z-1 allows for the designation of certain low-income community population census tracts as QOZs eligible for favorable tax treatment aimed at encouraging economic growth and investment in businesses within the zone.

A population census tract that is a low-income community, as defined for the new markets tax credit under Code Sec. 45D, may be designated as a QOZ [Code Sec. 1400Z-1(a)]. In general, a population census tract that is a low-income community is designated as a qualified opportunity zone if the chief executive officer of the state in which the tract is located timely nominates the tract for designation for this treatment and notifies the IRS in writing of the nomination, and the IRS certifies the nomination and designates the tract as a QOZ [Code Sec. 1400Z-1(b)].

A QOZ business is a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is QOZ business property (Code Sec. 1400Z-2(d)(3)(A)).
QOZs retain their designation for 10 years. The designation as a QOZ remains in effect through the end of the tenth calendar year beginning on or after the date of designation (Code Sec. 1400Z-1(f)). If tangible property ceases to be QOZ business property, it will continue to be treated as such for the lesser of five years after the date it ceases to be qualified opportunity zone business property or the date it is no longer held by a QOZ business (Code Sec. 1400Z-2(d)(3)(B)).

“A QOZ business is a trade or business in which substantially all of the tangible property owned or leased by the taxpayer is QOZ business property.”

Investors can defer tax on any prior gains until no later than Dec. 31, 2026, so long as the gain is reinvested in a QOF. In addition, if the investor holds the investment in the QOF for at least 10 years, the investor would be eligible for an increase in basis equal to the fair market.

Qualified Opportunity Funds

A QOF is an investment vehicle set up as either a partnership or corporation for investing in eligible property located in a QOZ and using the investor’s gains from a prior investment to fund the QOF. An LLC that chooses to be treated as either a partnership or corporation for federal tax purposes can organize as a QOF.

Taxpayers need not live in a QOZ to take advantage of the tax benefits. All they need to do is invest in a QOF.

A QOF holds at least 90% of its assets in QOZ property [Code Sec. 1400Z-2(d)(1)]. The determination of the 90% requirement is the average of the percentage of qualified zone property held by the fund on the last day of the first six-month period of the fund’s tax year and on the last day of the fund’s tax year.

There are three types of QOZ property (Code Sec. 1400A-2(d)(2)(A)):

1. QOZ stock, which is original issue stock in a domestic corporation acquired after Dec. 31, 2017, solely in exchange for cash [Code Sec. 1400Z-2(d)(2)(B)]. The corporation must be a QOZ business at the time of issue (or organized as such, if a new corporation) and for substantially all of the fund’s holding period. The qualified small business stock redemption rules of Code Sec. 1202(c)(3) apply to QOZ stock [Code Sec. 1400Z-2(d)(2)(B)(ii)].

2. QOZ partnership interest, which is any capital or profits interest in a domestic partnership acquired after Dec. 31, 2017, from the partnership solely in exchange for cash [Code Sec. 1400Z-2(d)(2)(C)]. The partnership must be a QOZ business at the time of acquisition (or organized as such if a new partnership) and for substantially all of the fund’s holding period.

3. QOZ business property, which is tangible property used in a trade or business of the QOF, if it was purchased, as defined in Code Sec. 179(d)(2), by the QOF after Dec. 31, 2017, originally used or “substantially improved” by the QOF, and used in a QOZ during substantially all of the QOF’s holding period [Code Sec. 1400Z-2(d)(2)(D)(ii)]. Property is substantially improved if, during the 30-month period beginning after the date of acquisition, additions to basis with respect to the property in the hands of the QOF exceed its adjusted basis at the beginning of the 30-month period [Code Sec. 1400Z-2(d)(2)(D)(ii)].

A QOF must pay a penalty for each month it fails to hold at least 90% of its assets in QOZ property, unless the failure is due to reasonable cause [Code Sec. 1400Z-2(f)(3)].

Final Transition Tax Regulations Issued

The Department of the Treasury and the IRS have issued final regulations for determining the inclusion and “transition tax” under Code Sec. 965 for a U.S. shareholder of a foreign corporation with post-1986 accumulated deferred foreign income. The final regulations retain the basic approach and structure of the proposed regulations, with certain changes.
The final regulations generally apply beginning the last tax year of the foreign corporation that begins before Jan. 1, 2018, and with respect to a U.S. person, beginning the tax year in or with which such tax year of the foreign corporation ends.

**Controlled Domestic Partnerships**

Certain controlled domestic partnerships may be treated as foreign partnerships for determining the section 958(a) U.S. shareholders of a specified foreign corporation owned by the controlled domestic partnership and the section 958(a) stock owned by the shareholders. The definition of controlled domestic partnership is revised not to be defined only with respect to a U.S. shareholder, so that the controlled foreign partnership is clearly treated as a foreign partnership for all partners if the rule applies.

**Pro Rata Share**

The definitions of pro rata share and section 958(a) U.S. shareholder inclusion year are modified. The final regulations will require a section 965(a) inclusion by a section 958(a) U.S. shareholder if the specified foreign corporation, whether or not it is a controlled foreign corporation, ceases to be a specified foreign corporation during its inclusion year.

**Downward Attribution Rule**

A special rule applies when determining downward attribution from a partner to a partnership where the partner has a de minimis interest in the partnership. The threshold for applying the special attribution rule for partnerships is increased from 5% to 10% and is extended to trusts.

**Basis Election Rules**

The final regulations let a taxpayer elect to increase its basis in the stock of its deferred foreign income corporations (DFICs) by the lesser of its section 965(b) previously taxed earnings and profits or the amount it can reduce the stock basis of its E&P deficit foreign corporations without recognizing gain. Within limits, a taxpayer may designate which stock of a DFIC is increased and by how much.

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**Exception from Anti-abuse Rules**

The final regulations provide an exception from the anti-abuse rules for certain incorporation transactions. The rules will not apply to disregard a transfer of stock of a specified foreign corporation by a U.S. shareholder of a domestic corporation, if certain requirements are met. The section 965(a) inclusion amount with respect to the transferred stock of the specified foreign corporation must not be reduced, and the aggregate foreign cash position of both the transferor and the transferee is determined as if each had held the transferred stock of the specified foreign corporation owned by the other on each of the cash measurement dates.

“The final regulations provide an exception from the anti-abuse rules for certain incorporation transactions.”

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**Cash Position**

Code Sec. 965 taxes foreign earnings of a domestic corporate U.S. shareholder at a 15.5% rate if held in cash (and cash equivalents), but only an 8% rate if held otherwise. The final regulations provide a narrow exception from the definition of cash position for certain commodities held by a specified foreign corporation in the ordinary course of its trade or business, as well as for certain privately negotiated contracts to buy and sell these assets.

**Election and Payment Rules**

Under the final regulations, the signature requirement on an election statement is satisfied if the unsigned copy is attached to a timely filed return of the person making the election, provided that the person retains the signed original in the manner specified. Transition rules for filing transfer agreements have also been updated. If a triggering event or acceleration event occurs on or before Dec. 31, 2018, the transfer agreement must be filed by Jan. 31, 2019. Rules are added to address the death of an S corporation shareholder transferor. The final regulations also include modifications to certain requirements for the terms of a transfer agreement.
The final regulations provide that, in the case of an additional liability reported on a return or amended return, any amount prorated to an installment whose due date has already passed will be due with the return reporting the additional amount. The rule on deficiencies remains the same, and payment for a deficiency prorated to an installment whose due date has already passed is due on notice and demand.

Total Net Tax Liability
A taxpayer may elect to defer the payment of total net tax liability under Code Sec. 965(h) and (i). Total net tax liability under Code Sec. 965, which defines the portion of a taxpayer’s income tax eligible for deferral, is equal to the difference between a taxpayer’s net income tax with and without the application of Code Sec. 965. The final regulations will disregard effective repatriations taxed similarly to dividends under Code Sec. 951(a)(1)(B), resulting from investments in U.S. property under Code Sec. 956 when determining net income tax liability without the application of Code Sec. 965.

Consolidated Groups
The consolidated group aggregate foreign cash position is determined under the final regulations as if all members of the consolidated group that are section 958(a) U.S. shareholders of a specified foreign corporation are a single section 958(a) U.S. shareholder.

How to Deduct Business Meals
In Notice 2018-76, 2018-42 IRB 599, the IRS provided guidance on deducting expenses under Code Sec. 274 for business meals purchased in an entertainment context. The IRS explained that 50% of the cost of food and beverages provided for business purposes during or at entertainment events is deductible if they are purchased separately from the entertainment or the cost is stated separately from the cost of the entertainment.

The guidance provided in Notice 2018-76 was needed to clarify the tax treatment of business meals purchased while taxpayers are entertaining clients or customers, because the Tax Cuts and Jobs Act (TCJA) eliminated the deduction for entertainment expenses effective for amounts paid or incurred after 2017. However, the legislative history of the new law clarified that taxpayers generally may continue to deduct 50% of the food and beverage expenses associated with operating their trade or business.

"Code Sec. 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the year in carrying on any trade or business."

The IRS also announced that it intends to publish proposed regulations on this issue and that, until the proposed regulations are effective, taxpayers can rely on the guidance provided in Notice 2018-76.

Background
Code Sec. 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the year in carrying on any trade or business. However, effective beginning in 2018, Code Sec. 274(a)(1) was revised by the TCJA to generally disallow a deduction with respect to an activity considered to constitute entertainment, amusement or recreation.

Code Sec. 274(k) generally provides that a deduction is allowed for the expense of any food or beverages if the expense is not lavish or extravagant under the circumstances and the taxpayer (or an employee of the taxpayer) is present at the furnishing of such food or beverages.

Code Sec. 274(n)(1) generally provides that the amount allowable as a deduction for any expense for food or beverages may not exceed 50% of the amount of the expense that otherwise would be allowable. The TCJA amended the 50% limitation in Code Sec. 274(n)(1) to remove the reference to entertainment expenses. Otherwise allowable meal
expenses remain deductible, subject to the 50% limitation.

In Reg. §1.274-2(b)(1)(i), the term “entertainment” is defined to mean any activity generally considered to constitute entertainment, amusement or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, and sporting events, as well as hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer’s family.

However, the term “entertainment” does not include activities which, although satisfying personal, living or family needs of an individual, are clearly not regarded as constituting entertainment, such as:

• Meal money provided by an employer to an employee working overtime
• A hotel room maintained by an employer for lodging of employees while in business travel status
• An automobile used in the active conduct of trade or business as well as for routine personal purposes such as commuting to and from work

On the other hand, an employer providing a hotel room or an automobile to an employee who is on vacation would constitute entertainment of the employee.

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**Proposed Regulations Update and Clarify Exempt Bond Retirement**

Proposed regulations (NPRM REG-141739-08) would unify and clarify the rules for retiring tax-exempt bonds. The proposed regulations would also provide special rules for tender option bonds, including variable rate demand bonds.

**Existing Rules**

The current rules for refunding exempt bonds are found in Notice 88-130, 1988-2 CB 543, and Notice 2008-41, 2008-1 CB 742. These notices are similar, but Notice 2008-41 was intended to coordinate the retirement standards for exempt bonds with regulations issued in 1996 to govern modifications of debt instruments. However, issuers could apply either notice.

**Proposed Regulations**

The proposed regulations generally provide retirement standards that follow Notice 2008-41, with some technical refinements. Thus, a tax-exempt bond is retired if any of the following conditions is met:

• A significant modification to the terms of the bond occurs under Reg. §1.1001-3.
• The issuer or its agent acquires the bond in a way that liquidates or extinguishes the bondholder’s investment.
• The bond is otherwise redeemed (for example, if it is redeemed at maturity).

The issuer is the state or local governmental unit that issues the bonds, plus any related party. Thus, the acquisition of an exempt bond by a conduit borrower that is not a related party to the actual issuer does not retire the bond.

“The proposed regulations would also provide special rules for tender option bonds, including variable rate demand bonds.”

When a modification causes a deemed exchange that retires a bond under Reg. §1.1001-3, the bond is treated as a new bond issued at the time of the modification. In contrast, a bond acquired by the issuer or its agent is generally retired. However, if the issuer resells the acquired bond, it is treated as a new bond issued at the time of resale. In either case, when a retired bond is treated as a newly issued bond, the issuer must consider whether the new bond refunds the retired bond under the Reg. §1.150-1(d) rules that define a refunding issue.
Exceptions
The proposed regulations provide three exceptions that limit retirements of exempt bonds. One general exception applies to all tax-exempt bonds and is adopted from Notice 2008-41. The other two exceptions are intended to prevent the special features of tender option bonds from resulting in a retirement. The proposed regulations largely adopt Notice 2008-41’s definition of tender option bond.

Applicability Dates
The regulations are proposed to apply to actions taken at least 90 days after they are published as final. However, issuers may apply the proposed regulations before that date. The IRS expects the final regulations to make Notice 88-130 and Notice 2008-41 obsolete.

Determination to Sustain Lien and Proposed Levy Not Abuse of Discretion
In *D.J. Humiston*, TC Memo. 2019-9, Dec. 61,410(M), an IRS settlement officer (SO) did not abuse his discretion by sustaining a notice of federal tax lien (NFTL) and proposed levy to collect unpaid trust fund recovery penalties (TFRPs) imposed against an individual. The taxpayer was the majority shareholder and president of a tanning corporation that became delinquent in its excise tax obligations and went into liquidation. Therefore, the IRS assessed a TFRP against the taxpayer as a person required to collect excise tax. The taxpayer asserted that the TFRP was wrongly imposed by the revenue agent and the SO failed to verify the requirements of Code Sec. 6751(b) supervisory approval.

However, the revenue agent had generated a Form 4183, *Recommendation re: Trust Fund Recovery Penalty Assessment*, asserting trust fund recovery penalties, and had the penalties approved by his immediate supervisor, satisfying the supervisory approval requirement and the SO’s verification compliance. Further, the taxpayer failed in his argument that he provided the SO with the correct bankruptcy paperwork and the SO never requested a Form 433, *Collection Information Statement for Wage Earners and Self-Employed Individuals*. The SO had requested the taxpayer provide evidence that the tanning corporation liquidation was applying payments against the excise tax liability, as well as a list of its assets, which the taxpayer was unable to fulfill. Additionally, the taxpayer did not provide the SO with Form 433-A, thus failing to submit the requested financial information.

“Therefore, the IRS assessed a TFRP against the taxpayer as a person required to collect excise tax.”
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