

## Section 1400Z-2.--Special Rules for Capital Gains Invested in Opportunity Zones

Rev. Rul. 2018-29

### ISSUES

(1) If a qualified opportunity fund (QOF), as defined in § 1400Z-2(d)(1) of the Internal Revenue Code (Code), purchases an existing building located on land that is wholly within a qualified opportunity zone (QOZ), as defined in § 1400Z-1, can the original use of the building or the land in the QOZ be considered to have commenced with the QOF?

(2) If a QOF purchases an existing building in a QOZ and the land upon which the building is located in a QOZ, is a substantial improvement to the building measured by additions to the adjusted basis in the building or is it measured by additions to the adjusted basis in the building and the land?

(3) If a substantial improvement to the building is measured by additions to the QOF's adjusted basis in the building, does § 1400Z-2(d) require the QOF to separately substantially improve the land?

## FACTS

In September 2018, QOF A purchases for \$800x Property X, which is located wholly within the boundaries of a QOZ. Property X consists of a building previously used as a factory erected prior to 2018 and land on which the factory building is located. QOF A intends to convert the factory building to residential rental property. Sixty percent (\$480x) of the \$800x purchase price for Property X is attributable to the value of the land and forty percent (\$320x) is attributable to the value of the building. Within 24 months after the date of QOF A's acquisition of Property X, QOF A invests an additional \$400x in converting the building to residential rental property.

## LAW AND ANALYSIS

Pursuant to § 1400Z-1(b)(1)(A) of the Code, the Chief Executive Officer of each State nominated a limited number of population census tracts to be designated as QOZs for purposes of §§ 1400Z-1 and 1400Z-2.

Under § 1400Z-2(d)(1), the term "qualified opportunity fund" (QOF) means any investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (Zone Property) (other than another QOF) that holds at least 90 percent of its assets in Zone Property.

Under § 1400Z-2(d)(2)(A), Zone Property means property that is either qualified opportunity zone stock (Zone Stock), qualified opportunity zone partnership interest (Zone Partnership Interest), or qualified opportunity zone business property (Zone Business Property).

Zone Business Property is defined in § 1400Z-2(d)(2)(D). Section 1400Z-2(d)(2)(D)(i) provides that Zone Business Property is tangible property used in a trade

or business of the QOF if (a) such tangible property is purchased by the QOF after December 31, 2017, (b) the original use of such tangible property commences with the QOF or the QOF substantially improves the tangible property, and (c) during substantially all of the QOF's holding period for such tangible property, substantially all of the use of such tangible property is in a QOZ.

Under § 1400Z-2(d)(2)(D)(ii), tangible property used in a QOF's trade or business is treated as substantially improved by the QOF only if, during any 30-month period beginning after the date of acquisition of such tangible property, additions to basis with respect to such tangible property in the hands of the QOF exceed an amount equal to the adjusted basis of such tangible property at the beginning of such 30-month period in the hands of the QOF.

Questions have arisen as to whether for purposes of § 1400Z-2(d)(2)(D)(i) the original use of land in the QOZ can ever be considered to have commenced with a QOF and, therefore, constitute Zone Business Property. In addition, if the original use of land in the QOZ cannot commence with a QOF and if land is treated as property separate from a building for purposes of § 1400Z-2(d), must land be substantially improved in order to qualify as Zone Business Property?

Given the permanence of land, land can never have its original use in a QOZ commencing with a QOF. Section 1400Z-2 seeks to encourage economic growth and investment in the designated QOZs by providing Federal income tax benefits to taxpayers who newly invest in businesses located within these economically distressed communities. Consistent with this intent, a building located on land within a QOZ is treated as substantially improved within the meaning of § 1400Z-2(d)(2)(D)(ii) if, during

any 30-month period beginning after the date of acquisition of the building, additions to the taxpayer's basis in the building exceed an amount equal to the taxpayer's adjusted basis of the building at the beginning of such 30-month period. Further, the fact that the cost of the land within the QOZ upon which the building is located is not included in the taxpayer's adjusted basis in the building does not mean that the taxpayer is required to separately substantially improve such land for it to qualify as Zone Business Property.

Under the facts of this revenue ruling, QOF A purchased Property X, a factory building and the land on which was located (both wholly within a QOZ), for \$800x with the intent to convert the building into residential rental property. Sixty percent (\$480x) of the purchase price for Property X was attributable to the value of the land and forty percent (\$320x) was attributable to the value of the building. Section 1400Z-2(d)(2)(D)(ii) does not apply to the land on which the factory building is located, but does apply to the building. Because the factory building existed on land within the QOZ prior to QOF A's purchase of Property X, the building's original use within the QOZ did not commence with QOF A. However, under § 1400Z-2(d)(2)(D)(ii) QOF A substantially improved Property X because during the 30-month period beginning after the date of QOF A's acquisition of Property X QOF A's additions to the basis of the factory building (\$400x) exceed an amount equal to QOF A's adjusted basis of the building at the beginning of the 30-month period (\$320x). The fact that the cost of the land on which the building is located is not included in QOF A's adjusted basis of the building does not mean that QOF A is required to separately substantially improve the land.

## HOLDING

(1) If a QOF purchases an existing building located on land that is wholly within a QOZ, the original use of the building in the QOZ is not considered to have commenced with the QOF for purposes of § 1400Z-2(d)(2)(D)(i), and the requirement under § 1400Z-2(d)(2)(D)(i) that the original use of tangible property in the QOZ commence with a QOF is not applicable to the land on which the building is located.

(2) If a QOF purchases a building wholly within a QOZ, under § 1400Z-2(d)(2)(D)(ii) a substantial improvement to the building is measured by the QOF's additions to the adjusted basis of the building.

(3) Under § 1400Z-2(d), measuring a substantial improvement to the building by additions to the QOF's adjusted basis of the building does not require the QOF to separately substantially improve the land upon which the building is located.

## DRAFTING INFORMATION

The principal author of this revenue ruling is Erika C. Reigle of the Office of Associate Chief Counsel Income Tax & Accounting. For further information regarding this revenue ruling, contact Erika C. Reigle at (202) 317-7006 (not a toll-free call).