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IRS and Treasury Release Second Set of Opportunity Zone Guidance

On April 17, 2019, the IRS and Treasury issued its much anticipated second set of **proposed regulations** under Internal Revenue Code, Section 1400Z-2, *Special rules for capital gains invested in opportunity zones*. While some questions remain unanswered, the 169-page proposed regulations provide much needed guidance for investors, fund managers, developers and sponsors pertaining to qualified opportunity zone business (QOZB) property, the treatment of tangible leased property, Section 1231 gain, the 90-percent asset test, and more. The guidance is generally taxpayer-friendly and provides the flexibility that businesses and investors were seeking. Treasury also released a **document soliciting public input** on how best to collect public information to track and measure the economic activity in opportunity zones.

QUALIFIED OPPORTUNITY ZONE BUSINESS PROPERTY

Substantially all

The term "substantially all" was used several times in the statute, but only defined once. The guidance clarifies this requirement for both the holding period and the use of the tangible property. In the holding period context, the substantially all requirement is 90 percent and in the use context it is 70 percent.

Original use requirements

The proposed regulations provided additional guidance related to the original use requirements:

Used Property Guidance	BDO Insights
For purposes of depreciation and amortization, the proposed regulations state that the "original use" of an asset acquired by purchase starts on the date when the property is first placed in service in a qualified opportunity zone (QOZ). Tangible property located in a QOZ that is depreciated or amortized by a taxpayer other than a qualified opportunity fund (QOF) or QOZB would not qualify.	The acquisition of a partially constructed building or acquisition of a building or development prior to the receipt of a certificate of occupancy should meet the original use requirements.
Used property will satisfy the original use requirements if the property has not been previously used or placed in service by any taxpayer in the QOZ – no substantial improvement would be required.	The used property provision will permit companies to relocate and move used property into a QOZ without the need for substantial improvement of that property.
A building or structure that has been vacant for at least five years prior to being purchased by the QOF or QOZB will satisfy the original use requirement – no substantial improvement would be required.	The new guidance easing the original use requirement for vacant buildings will allow investors to improve vacant and underused properties within opportunity zones. Because there is no substantial improvement required, there currently is concern that investors may acquire vacant buildings and make no improvement to the property.
Improvements made by a lessee to leased property are treated as original use property and treated as being purchased for the cost of the improvements.	This provision is beneficial as many QOZBs will lease their property.

Land

The original use requirement is not applicable to improved or unimproved land. Further, there is no substantial improvement test applicable to the purchase of unimproved land if it is used in the active conduct of a trade or business of a QOF or a QOZB. There is a general anti-abuse provision that can be used to prevent "land banking."

Asset-by-asset vs. aggregate testing

The proposed regulations state that the substantial improvement requirement is made on an asset-by-asset basis. The guidance, however, notes that this approach might be onerous for certain businesses (e.g., a project with multiple projects over multiple parcels, with multiple structures and asset classes). As such, Treasury is seeking comments regarding the advantages and disadvantages of adopting an aggregate approach to determine potential substantial improvement requirements.

Inventory in transit

The proposed regulations clarify that inventory, including supplies such as raw materials, are QOZ property and will count for the purpose of the asset test.

TREATMENT OF LEASED TANGIBLE PROPERTY

Leased tangible property meeting certain criteria may be treated as QOZB property to satisfy the asset test and the substantially all requirements. The leased tangible property must be acquired under a lease entered into after December 31, 2017, and substantially all of the use of the leased tangible property must be in a QOZ during substantially all of the period for which the business leases the property. The regulations provided additional, flexible guidance regarding leases:

- The guidance does not impose an original use requirement on leased tangible property.
- There is no related party disallowance rule. However, if there are related parties, then the following requirements must be met:
  - The leased property must have a market rate lease.
  - The lease cannot allow prepayments relating to a period of use exceeding 12 months.

- By the last day of the lease or 30 months (whichever comes first), the lessee must become the owner of the QOZB property whose value is at least equal to the value of the lease and there must be a substantial overlap of time using both the leased and acquired property.
- There is a general anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement (i.e., for property other than unimproved land).

QOFs and QOZBs have a choice of valuation methods for the 90 percent asset test and the 70 percent value of tangible property test. The QOFs and QOZBs can use the amount reported on an applicable GAAP financial statement (if leases are assigned a value) or an alternative valuation method. Under the alternative method, the value of the leased property is the sum of the present value of all the lease payments, calculated at the time the lease is entered into. The discount rate is the applicable federal rate under Section 1274(d)(1). Once a method is selected, it must be applied consistently to all leased tangible property for the taxable year.

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The proposed regulations clarify that a QOZB can lease property in opportunity zones. Care should be taken to ensure that this is an operating lease for federal income tax purposes. The lease provisions provide opportunities to structure deals with leases where the land was owned prior to January 1, 2018, and the owner retains more than a 20-percent interest. It appears that leases with fixed price purchase options with an estimated fair market value at the time of the purchase will not qualify.

QUALIFIED OPPORTUNITY ZONE BUSINESSES

Real property straddling a QOZ

The proposed regulations rely on Section 1397C(f) from the empowerment zone provisions to determine whether a QOZ is the location of services, tangible property or business function. If the real property located within the QOZ is substantial as compared to the amount of real property outside the QOZ based on square footage, and the real property outside of the QOZ is contiguous to all or part of the real property in the QOZ, then all the property is deemed to be in a QOZ.

Fifty-percent gross income requirement

The statute stated that QOZB must derive at least 50 percent of its total income “from the active conduct of such business.” The proposed regulations have clarified this meaning and have provided three safe harbors:

- At least 50 percent of the services performed for the business, measured by hours, is performed within the QOZ;
- At least 50 percent of the services performed for the business, measured by amounts paid for such services, is performed by employees and independent contractors in the QOZ; or
- Both the tangible property of the business that is in a QOZ and the management or operational functions performed for the business in the QOZ are necessary to generate 50 percent of the gross income of the trade or business (a P.O. Box or other delivery address is not sufficient).

If the QOZB does not meet any of the safe harbors it may still meet the 50 percent test by showing that based on the facts and circumstances, at least 50 percent of the gross income of the trade or business is derived from the active conduct of the trade or business in the QOZ.

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This 50-percent requirement was a major concern for QOZBs in the service industry or with customers primarily outside the QOZ. The income sourcing rules provide needed clarity, while being very flexible, which will enable many different types of QOZBs to satisfy the 50-percent requirement.

Active conduct of a trade or business

The proposed regulations state that a trade or business for purposes of QOZ rules is a trade or business within the meaning of Section 162. Further, the guidance clarifies that the ownership and operation of real property, including leasing, is considered the active conduct of a trade or business. Merely entering into a triple-net-lease, however, will not be deemed to be the active conduct of a trade or business.

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The preamble notes that there is a large body of case law and administrative guidance interpreting this meaning under Section 162 that provides additional guidance. Stating that real estate rental is a trade or business is welcome guidance.

Working capital safe harbor expansion

The proposed regulations expand the working capital safe harbor to include expenditures used in the development of a trade or business in the QOZ, as well as the acquisition, construction, and/or substantial improvement of tangible property. The regulations provide examples of working capital (e.g., hiring and training kitchen staff, marketing, leasing equipment, etc.). Further, a QOZB will not violate the working capital safe harbor if it exceeds the 31-month period due to delays in government action (e.g., delayed permits or other government approval).

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The working capital safe harbor appears to still only apply to QOZBs and not QOFs.

Use of intangibles

The statute stated that a substantial portion of the intangible property of a QOZB must be used in the active conduct of a trade or business in the QOZ. The proposed regulations define "substantial portion" as 40 percent.

SECTION 1231 GAIN

Section 1231 property has special tax treatment. If at the end of the taxpayer's tax year, the gains from the sale of all Section 1231 property exceeds the losses of the Section 1231 property, then the net gain is treated as capital gain. If the result is a net Section 1231 loss, then the net loss is treated as an ordinary loss. The tax treatment of the Section 1231 property cannot be determined prior to the taxpayer's year-end. As such, the proposed regulations state that Section 1231 gain can only be invested in the 180 days beginning on the last day of the taxable year of the sale.

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Since income is only determinable as of the last day of the year, the new guidance provides that the 180-day window for investing capital gain in a QOF begins on the last day of the taxable year. Because of the previous lack of guidance, Section 1231 gains in 2018 were likely invested in QOFs as the sales occurred, rather than at year end. There has been criticism regarding this guidance as many early investors may have investments disqualified.

REVISIONS TO 90-PERCENT ASSET TEST – NEWLY CONTRIBUTED ASSETS

When applying the 90-percent asset test, QOFs do not need to take into account investments made in the preceding six months as long as the new assets are held in cash, cash equivalents, or debt instruments with a term of 18 months or less.

QOF short-term reinvestment rule

The proposed regulations state that if a QOF reinvests the proceeds from the sale of QOZB property, sale of QOZ stock, or QOZ partnership interest within 12 months, the proceeds will qualify as QOZ property for purposes of the 90-percent asset investment requirement. The QOF may reinvest proceeds from the sale of an investment into another type of qualifying investment (e.g., proceeds from the sale of an investment in stock into QOZB property). And, similar to the working capital provision, the proposed regulations extend the QOF reinvestment relief if failure to meet the 12-month deadline is due to the delay in government action. The proposed regulations, however, confirm that a QOF and its investors must recognize any gain on the sale of the assets.

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Many investors had hoped that there would be a provision allowing QOFs to sell QOZ property and invest the sales proceeds in other QOZ property (i.e., churn the assets) without recognizing gain. However, Treasury and the IRS concluded that it did not have the authority to avoid gain recognition under Sections 1001(c) and 61(a)(3). There may be an opportunity for investors to invest the resulting gain into a QOF to obtain a deferral of tax if the capital gain occurs before December 31, 2026.

OTHER PROVISIONS

Long-term investment sale of QOZ assets vs. QOF interest – Fund structure

The proposed regulations provide special tax treatment to investors in QOF partnerships and S corporations that have held their investments for more than 10 years. If the QOF disposes of QOZ property, the investor may elect to exclude from its gross income some or all of the capital gain generated by the disposition. The election appears to be available irrespective of the QOF partnership's holding period in the underlying asset. This benefit does not apply to investors in QOF organized as C corporations. Further, if an investor does not satisfy the 10-year holding period at the time of the sale, the allocable share of the gain or loss must be recognized.

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There was concern that investors would be required to sell their interests in QOFs to be eligible for the 10-year basis step-up benefit. As a result, most funds are set up with a separate QOF for each asset. The proposed regulations eliminate this restriction, which should enable multi-asset funds, since properties can be sold individually. Allowing multi-asset funds will help to mitigate the risk of a bad deal with one single asset and will allow for portfolio funds to exit assets without triggering taxes.

This provision appears to be only for dispositions of property by QOFs and not for tiered allocations from the sale by a QOZB subsidiary of a QOF. As such, most QOFs will continue to operate through QOZBs, since they have the most flexible and favorable provisions. The QOF will have to sell the interests in the QOZB, rather than the assets held by the QOZBs, for investors to avoid tax after holding for 10 years.

REIT QOFs

Shareholders in a REIT QOF of 10 years can benefit from the gain exclusion in connection with the capital gain dividends received from the asset sold after 10 years. Certain procedural requirements are required.

Carried interest or promote

The guidance states that any interest received attributable to services (e.g., development fee or management fee) will not be eligible for the QOZ tax benefits. If the taxpayer has both qualifying and non-qualifying interests, the investment will be treated as a mixed fund investment. Interests that are non-qualifying should be identified and tracked separately.

Debt financed distributions

The proposed regulations clarify that the taxpayer's basis in a qualifying interest will be increased by the partner's share of liabilities under Section 752. As such, the guidance allows a QOF partnership to make debt financed distributions if the distribution does not exceed the partner's basis in its partnership interest (which includes the investor's share of the liability). The leveraged distribution will not be treated as an inclusion event, as set forth in Example 10 of Section 1.1400Z2(b)-1(f)(10).

The proposed regulations, however, rely on the "disguised sale" rules under Section 707. If determined to be a disguised sale, then the sale amount will reduce the amount of the qualified investment. Also, a cash-out distribution within two years of an investment in a QOF will disqualify that amount from obtaining the QOZ tax incentives. Debt financed distributions that occur after two years from the initial investment appear to be permitted.

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Real estate development projects often involve debt financed distributions to developers or investors after asset stabilization. This typically occurs more than two years after the initial investment, so the leveraged distribution typically will not be treated as an inclusion event, assuming the other factors are met.

Secondary purchase of QOF interest

Pursuant to the proposed regulations, an investor can now use capital gain to acquire an interest in a QOF from another investor. The taxpayer is treated as making an investment in an amount equal to the amount paid for the eligible investment. The holding period would start at the date of acquisition.

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This provision assists in creating a secondary market for interests in QOFs. It will allow for more flexibility for funds that have staged closings and for investors entering a QOF after the initial offering. It also provides liquidity to the extent that an original investor needs to prematurely sell their interest in a QOF.

Depreciation recapture

The proposed regulations did not specifically address the recapture of depreciation relating to the basis step-up in connection with the sale of a QOF interest after the 10-year hold period. However, in one of the examples, no depreciation recapture was calculated.

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The example appears to allow investors the benefit of depreciation without the requirement to recapture the benefit upon a sale. It is uncertain as to the treatment if the QOZ sells the depreciated assets and the investor merely makes an election to exclude the capital gain allocation. Additional guidance is required.

Tiered partnerships

For an investment to be treated as an "eligible investment," the taxpayer must invest its capital gain into a QOF. While the proposed regulations permit investors to contribute their

QOF interest into a partnership, it does not appear that an investor can make an initial investment into a QOF through a feeder fund. If a taxpayer invests its capital gain into a partnership that then invests in a QOF, it will not be treated as an eligible investment and will not garner the benefits under the QOZ program.

Gain inclusion

The proposed regulations identify a nonexclusive listing of 11 inclusion events that cause inclusion of a deferred gain. The inclusion events result 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. In addition, inclusion events also include the taxpayer's receipt of property (e.g., cash securities) from a QOF in a transaction treated as a distribution for federal income tax purposes. The transactions are treated as inclusion events to prevent taxpayers from "cashing out" a qualifying investment in a QOF without including any deferred gain in gross income.

The guidance clarifies that a transfer of an investment by means of a gift and charitable contributions will trigger an inclusion event. Transfers by reason of death are not considered a triggering event. Likewise, transfers by the taxpayer to a grantor trust is not an inclusion event. The guidance explains that for federal income tax purposes, the owner of a grantor trust is treated as the owner of property in the trust, thus there is no reduction in the owner's interest as the taxpayer is simply transferring to himself or herself. If the grantor trust later switches to a non-grantor trust, except for reason of death, then the change in status will be deemed an inclusion event. The guidance also describes some types of nonrecognition transactions that are not inclusions events (e.g., qualifying Section 381(a)(2) and Section 355 transactions without boot).

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Taxpayers will need to carefully consider any transfers and distributions to determine if the transaction triggers the recognition of the deferred gain. The guidance on transfers by death was welcome news, however, the proposed regulations did not address the required payment of tax due on December 31, 2026, due to the original gain. A beneficiary may have received an illiquid asset with no means to pay a large tax liability on the deferred gain. Until there is further guidance, taxpayers should consider using life insurance planning or trusts to mitigate this risk.

Consolidated entities

QOF stock is not stock for purposes of determining corporate affiliation (Section 1504). A QOF C corporation can be the common parent of a consolidated group, but it cannot be a subsidiary member of a consolidated group. As such, a QOF C corporation owned by members of a consolidated group is not a member of that consolidated group.

Tacking of holding periods

The proposed regulations provide that a QOF investor's holding period for its qualifying investment does not include the period during which the QOF investor held property that was transferred to the QOF in exchange for the qualifying investment. If an investor disposes of its entire qualifying investment in the original QOF and reinvests in a second QOF within 180 days, the investor's holding period for its qualifying investment in the second QOF begins on the first day of its investment in the second QOF, there is no tacking of the holding period. Non-inclusion events, such as qualifying Section 381 transactions and qualifying Section 355 transactions, will include the investor's holding period of the QOF shareholder's qualifying QOF stock. The tacking of holding rules also apply in the case of a partnership merger where the QOF partner's resulting investment in the QOF partnership continues. Finally, the recipient of a qualifying investment by reason of death may tack on the decedent's holding period.

Mixed funds

Under the proposed regulations, a partner holding a mixed-funds investment will be treated as holding a single partnership interest with a single basis and capital account for all purposes of subchapter K, but not for purposes of Section 1400Z-2. A mixed-fund partner will be treated as holding two interests solely for the purposes of Section 1400Z-2. All of the partnership items, such as income and debt allocations, will affect the qualifying and non-qualifying investments based on the relative allocation percentages of each interest. Allocation percentages will generally be based on the relative capital contributions for qualifying investments on the relative allocation percentages of each interest. Example 6 (Section 1.1400Z2(b)-1(f)(6)) illustrates how the bifurcation of the funds would work.

Anti-abuse provision

The proposed regulations adopt a broad anti-abuse provision that provides that if a significant purpose of a transaction is to achieve a result that is inconsistent with the purposes of the QOZ program, then the IRS commissioner can recast the transaction for federal tax purposes. The determination of whether the transaction is inconsistent will be based on the facts and circumstances.

Indian tribal territories

The proposed regulations provide an entity organized under the law of a federally recognized Indian tribe, provided that the entity's domicile is located in one of the 50 states is eligible to be a QOF.

CONCLUSION

The proposed regulations are subject to further revisions based on comments received by the Treasury during the comment period. However, the Treasury has stated that taxpayers may rely upon many of these proposed rules, providing that the taxpayer applies the rules in their entirety and in a consistent manner. Treasury and the IRS announced that they expect to address the administrative rules under Section 1400Z-2(f) applicable to a QOF that fails to maintain the required 90-percent investment standard, as well as information-reporting requirements for an eligible taxpayer under Section 1400Z-2 in separate regulations, forms, or publications. Further, Treasury and the IRS anticipate revising Form 8996. While the proposed regulations did not answer every question, it is clear from the guidance that the government is trying to incentivize investment in QOZs by easing the tests and providing flexibility to investors.

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