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Qualified Opportunity Zone Funds

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IRS Publishes Second Set Of Opportunity Zone Proposed Regulations

The Internal Revenue Service and the Treasury Department recently released a second tranche of proposed regulations that provide additional guidance on the tax incentives of investing in opportunity zones, including the structure of qualified opportunity funds. The proposed regulations provide potential investors with clarification needed to proceed with opportunity zone investments, but leave uncertainty in some areas.

The Tax Cuts and Jobs Act (the "TCJA") created a new tax incentive program to spur economic growth and investment in designated distressed communities (each an "opportunity zone" or "OZ"). Not only does the OZ incentive program allow for the deferral of certain capital gains that are invested in a qualified opportunity fund ("QOF"), but it also allows for income exclusion for gains on investments in QOFs that are held for at least 10 years. While the OZ incentive program was well received, the TCJA's provisions left both practitioners and potential investors with many unanswered questions.

In response, on October 19, 2018, the Internal Revenue Service ("IRS") and the Treasury Department issued guidance for the OZ incentive program. Specifically, they issued a set of proposed regulations and a revenue ruling, both of which can be relied on by taxpayers. The Treasury Department also provided a draft Form 8996, the self-certification form for QOFs, and corresponding instructions for the form. However, uncertainty remained about the OZ incentive program.

On April 17, 2019, the IRS and the Treasury Department issued a second tranche of proposed regulations about the program. This additional guidance which again, can be relied on by taxpayers, provides answers to open issues, including the definition of "substantially all," the use of qualified OZ business property, treatment of leased tangible property, the sourcing of gross income in a QOF a reasonable period for a QOF to reinvest proceeds from the sale of a qualifying asset without paying a penalty. As with the first set of regulations, the new set leaves a number of unanswered questions (some of which the Treasury Department solicited additional comments on).

ADDITIONAL GUIDANCE PROVIDED BY THE SECOND TRANCHE OF PROPOSED REGULATIONS

A highlight of the guidance from the proposed regulations is as follows:

Qualified Opportunity Zone Business Property

Definition of Substantially All for Purposes of Code Sections1400Z-2(d)(2) and (d)(3)

- After the first tranche of proposed regulations, the term "substantially all" remained undefined in a number of places in the OZ incentive program.

- "Substantially all" is clarified to mean (i) 70 percent as it relates to usage of tangible property in an OZ and (ii) 90 percent as it relates to the holding period of tangible property used in an OZ, an interest in stock, or a partnership interest (which qualifies as qualified OZ stock or qualified OZ partnership, respectively).

Original Use of Tangible Property by Purchase

- The "original use" of tangible property acquired by purchase starts on the date when that person (or a prior person) first places the property in service in a qualified OZ for purposes of depreciation of amortization (*i.e.,* tangible property located in a qualified OZ that is depreciated or amortized by a taxpayer other than the QOF or qualified OZ business would not be of "original use"). Tangible property (other than land) located in a qualified OZ that has not yet been depreciated or amortized by a taxpayer (other than a QOF or qualified OZ business) would satisfy the original use requirement.

- When a building or other structure has been vacant for at least five years prior to being purchased by a QOF or qualified OZ business, such property will satisfy the original use requirement.

- Improvements made by a lessee to leased property would satisfy the original use requirement and are considered purchased property for the amount of the unadjusted cost basis.

- The determination of whether the substantial improvement requirement is satisfied for tangible property that is purchased is made on an asset-by-asset basis and not on an "aggregate" basis. The IRS indicated that it is considering applying the rule on an aggregate basis, but it has not done so at this point.

Safe Harbor for Testing Use of Inventory in Transit

- Inventory (including raw materials) of a trade or business does not fail to be used in a qualified OZ solely because the inventory is in transit form a vender to a facility in the trade or business that is in a qualified OZ, or from a facility of the trade or business that is in a qualified OZ to customers of the trade or business that are not located in a qualified OZ.

Treatment of Leased Tangible Property

Status as Qualified Opportunity Zone Business Property

- Leased tangible property can satisfy the 90 percent asset test for a QOF and the substantially all requirement for a qualified OZ business if: (1) such leased tangible property is acquired under a lease entered into after December 31, 2017, and (2) substantially all of the use of such leased tangible property is in a qualified OZ during substantially all of the period for which the business leases the property.

- There is no original use requirement with respect to leased tangible property. Further, leased tangible property can be leased from a related lessor.

- All leases under which a QOF or qualified OZ business acquires rights with respect to any leased tangible property must be a "market rate lease," as determined under the regulations under Section 482.

- As noted above, the lessor and lessee of tangible property may be related. If a lessor and lessee are related, leased tangible property shall not be qualified OZ business property if, in connection with the lease, a QOF or qualified OZ business at any time makes a prepayment to the lessor (or a person related to the lessor) relating to a period of use of the leased tangible property that exceeds 12 months. Further, if a lessor and lessee are related, leased tangible property shall not be qualified OZ business property unless the lessee becomes the owner of *other* tangible property that is qualified OZ business property and that has a value not less than the value of the leased tangible property. Such acquisition must occur during a period that begins on the date that the lessee receives possession of the property under the lease and ends on the earlier of: (1) the last day of the lease or (2) the end of the 30-month period beginning on the date that he lessee receives possession of the property under the lease.

- There is an anti-abuse rule to prevent the use of leases to circumvent the substantial improvement requirement of real property (other than unimproved land). For example, warehousing of land or "land banking" is unacceptable.

Valuation of Leased Property

- On an annual basis, leased tangible property may be valued using either an applicable financial statement method or an alternative valuation method. Once a QOF or qualified OZ business selects one of the valuation methods, it must apply such method consistently to all leased tangible property with respect to the taxable year.

- A QOF or qualified OZ business may select the applicable financial statement valuation method if they actually have an applicable financial statement (within the meaning of Treasury Regulation section 1.475(a)-4(h)). Under this method, the value of leased tangible property is the value of such property as reported on the applicable financial statement for the relevant reporting period. Such applicable financial statements must be prepared in accordance with U.S. Generally Accepted Accounting Principles and there must be recognition of the lease of the tangible property.

- Under the alternative valuation approach, the value of leased tangible property is determined based on a calculation of the "present value" of such tangible property—that is, the sum of the present values of the payments to be made under the lease for such tangible property. For purposes of this calculation, the discount rate is the applicable federal rate under Code Section 1274(d)(1). Under this alternative valuation approach, once the value of the leased property is fixed at the outset of the lease, it does not change over the course of the lease; under the GAAP method above, it is expected that the valuation of the leased property will decline over time.

Qualified Opportunity Zone Businesses

Real Property Straddling a Qualified Opportunity Zone

- If the amount of real property based on square footage located within the qualified opportunity zone is substantial as compared to the amount of real property based on square footage outside of the qualified opportunity zone, and the real property outside of the qualified opportunity zone is contiguous to part or all of the real property located inside the qualified opportunity zone, then all of the property is deemed to be located within a qualified opportunity zone.

50 Percent of Gross Income of a Qualified Opportunity Zone Business

- There are three safe harbors and a facts and circumstances test for determining whether sufficient income is derived from a trade or business in a qualified OZ for purposes of the 50 percent test in Code Section 1397C(b)(2).

- The first safe harbor requires that at least 50 percent of the services performed (based on hours) for a business by its employees and independent contractors are performed within the qualified OZ.

- The second safe harbor requires that at least 50 percent of the services performed, based on the amounts paid for such services, for the business by its employees and independent contractors are performed within the qualified OZ.

- The third safe harbor provides that a trade or business may satisfy the 50 percent test if: (1) the tangible property of the business that is in a qualified OZ and (2) the management and operational functions performed for the business in the qualified OZ are each necessary to generate 50 percent of the gross income of the trade or business.

- Finally, the 50 percent test may be satisfied if based on all facts and circumstances, at least 50 percent of the gross income of a trade or business is derived from the active conduct of a trade or business in the qualified OZ.

Use of Intangibles

- The term "substantial portion" as it relates to usage of intangible assets in the active conduct of a trade or business in a qualified OZ means at least 40 percent.

Active Conduct of a Trade or Business

- The ownership and operation (including leasing) of real property used in a trade or business is treated as the active conduct of a trade or business for purposes of the OZ incentive program.

- However, merely entering into a triple-net-lease with respect to real property owned by a taxpayer is not the active conduct of a trade or business by such taxpayer.

Working Capital Safe Harbor

- The written designation for planned use of working capital includes the development of a trade or business in the qualified OZ as well as acquisition, construction, and/or substantial improvement of tangible property. There is an example of such a written plan to create a restaurant business, but without a specifically identified site yet. This example indicates that a QOF need not have identified the specific property within the qualified OZ in order to benefit from this working capital safe harbor.

- Exceeding the 31-month period does not violate the safe harbor if the delay is attributable to waiting for government action the application for which is being completed during the 31-month period.

Special Rules for Section 1231 Gains (Depreciable Real Estate Held Over One Year)

- Only net Section 1231 gains are eligible for deferral under the OZ incentive program.

- The 180-day period for investing capital gain income from Section 1231 property in an QOF begins on the last day of the taxable year. This rule may present a trap for unwary taxpayers, since gain on the sale of depreciable real estate held for more than one year is a 1231 gain treated as a long-term capital gain. But the IRS stated that it is necessary to wait for the end of the taxable year, to open the 180-day period for reinvestment, in order to see if such gains are reduced by netting against 1231 losses during the year (attributable to the taxpayer, e.g., an individual may have such losses through other partnerships or individually). A delay in receiving a Form K-1 could also create difficulties for a partner in a partnership wanting to roll over gain allocated to him from a partnership.

Relief with Respect to the 90-Percent Asset Test

Relief for Newly Contributed Assets

- A QOF may apply the 90-percent asset test without taking into account any investments received in the preceding six months.

QOF Reinvestment Rule

- Proceeds received by a QOF from the sale or disposition of: (1) qualified OZ business property, (2) qualified OZ stock, and (3) qualified OZ partnership interests are treated as qualified OZ property for purposes of the 90-percent 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.

- Such proceeds must be held in cash, cash equivalents, or debt instruments with a term of 18 months or less.

- A QOF may reinvest proceeds from a sale of an investment into another type of qualifying investment.

Amount of an Investment for Purposes of Making a Deferral Election

- A taxpayer may make an investment for purposes of the gain deferral election under the OZ incentive program by transferring cash or property to a QOF.

- There are special rules for determining the amount of an investment for purposes of the deferral election if a taxpayer transfers property other than cash to a QOF in a carryover basis transaction. In such a case, the amount of the investment equals the lesser of: (1) the taxpayer's adjusted basis in the equity received in the transaction or (2) the fair market value of the equity received in the transaction, both of which are determined immediately after the transaction.

- In the case of a contribution to a partnership QOF, the basis is calculated without regard to any liability that is allocated to the contributor under Section 752(a).

Events That Cause Inclusion of Deferred Gain

In General

- Generally, an inclusion event (*i.e.,* an event that causes the recognition of gains deferred under the OZ incentive program) results from a transfer of a qualifying investment in a transaction to the extent the transfer reduces a taxpayer's equity interest in the qualifying investment. However, except as provided elsewhere in the regulations, a transaction is also an inclusion event to the extent a taxpayer receives property from a QOF in a transaction that is treated as a distribution for U.S. federal income tax purposes.

- Inclusion events include, but are not limited to:

  – A taxable disposition of all or part of a qualifying investment;

  – A taxable disposition of interests in an S corporation which is the direct investor of a QOF;

  – A transfer by gift of a qualifying investment;

  – A redemption of qualified QOF stock that is treated as an exchange of property for the redeemed qualifying QOF stock under Code Section 302;

  – A liquidation of a QOF corporation to which Section 331 applies; and

  – Certain nonrecognition transactions.

- Certain disregarded transfers and certain types of nonrecognition transactions (*e.g.,* an acquisitive asset reorganization under Code Section 381) are not inclusion events.

- Debt-financed distributions from a QOF partnership are generally not inclusion events, subject to two limitations:

  – Such distribution will trigger inclusion of deferred gain to the extent the distribution exceeds the investor's basis (which includes such investor's share of liabilities); and

  – If such distribution generally occurs within the first two years of an investor's contribution of cash/property to the QOF (or in some cases later), there are certain rules that could re-characterize the original contribution as an investment that does not qualify for the benefits of the OZ incentive program.

Timing of Basis Adjustments

- The 10 percent and additional five percent basis step-up on a taxpayer's investment in a QOF as of the end of 2026 is basis for all purposes.

- The basis adjustment upon recognition of deferred gain is made immediately after the amount of deferred capital gain is taken into income.

- For dispositions after 10 years of qualifying QOF partnership interests, the bases of the QOF partnership's assets are also adjusted with respect to the transferred qualifying QOF partnership interest, with such adjustments calculated in a manner similar to the adjustments that would have been made to the partnership's assets if the selling partner had purchased the interest for cash immediately prior to the transaction and the partnership had a valid Section 754 election in effect. This treatment should prevent recapture of depreciation taken by the partner on assets of the QOF partnership over the 10+ years of holding the investment. It is an important technical fix which should allow taxpayers to realize substantial benefits.

Partnership and S Corporation Provisions

- The transfer by a partner of all or a portion of its interest in a QOF partnership will generally be an inclusion event. However, a transfer in a transaction governed by Code Sections 721 or 708(b)(2)(A) is generally not an inclusion event, provided there is no reduction in the amount of the remaining deferred gain that would be recognized by the transferring partners in a later inclusion event.

- Where a partner receives a partnership interest in exchange for services (*e.g.,* carried interest), such portion of such investment is not eligible for the benefits related to qualifying investments of the OZ incentive program. The first set of proposed regulations had stated that a partnership interest with special allocations was an eligible QOF investment, but these new proposed regulations would force restructuring in this area.

- The conversion of an S corporation that holds a qualifying investment in a QOF to a C corporation (or vice versa) is not an inclusion event.

- If an S corporation is an investor in a QOF, the S corporation must adjust the basis of its qualifying investment in the same manner as for C corporations, but this rule does not affect adjustments to the basis of any other asset of the S corporation.

- Solely for purposes of the OZ incentive program, an S corporation's qualifying investments in a QOF will be treated as disposed of if there is a greater than 25 percent change in ownership of the S corporation.

- For purposes of investments held for at least 10 years, a taxpayer that is the holder of a direct qualifying QOF partnership interest or qualifying QOF stock of a QOF S corporation may make an election to exclude from gross income some or all or of the capital gain from the disposition of qualified OZ property reported on Schedule K-1 of such entity, provided the disposition occurs after the taxpayer's 10-year holding period.

Consolidated Return Provisions

- QOF stock is not stock for purposes of Code Section 1504 affiliation.

- The provisions of the OZ incentive program apply separately to each member of a consolidated group.

General Anti-Abuse Rule

- If a significant purpose of a transaction is to achieve a result that is inconsistent with the purposes of the OZ incentive program, the IRS may recast a transaction (or series or transactions) for federal tax purposes as appropriate to achieve the tax results that are consistent with the OZ incentive program.

KEY ISSUES STILL NOT ADDRESSED BY SECOND TRANCHE OF PROPOSED REGULATIONS

- Should prior use of fully depreciated/amortized property be disregarded for purposes of the original use requirement?

- How should the OZ incentive program treat tangible personal property that is realistically not capable of being substantially improved?

- Should inventory be excluded from the 70 percent test for qualified OZ businesses?

- What are the specific mechanics by which the election for holders of a direct qualifying QOF partnership interest or qualifying QOF stock of a QOF S corporation can exclude from gross income some or all of the capital gain from the disposition of qualified OZ property?

CONCLUSION

The second tranche of proposed regulations is a significant step forward in providing guidance to QOF investors, developers and fund managers. It provides clarity on a number of open questions that remained after the October 2018 publication of the initial set of proposed regulations, including the definition of substantially all, the use of qualified OZ business property, treatment of leased tangible property, the sourcing of gross income in a QOF, a reasonable period for the QOF to invest proceeds for the sale of qualifying assets without paying a penalty, triple net leases and carried interests. Notwithstanding the refreshed regulations, there are still a number of unanswered questions as to which Treasury still needs to provide guidance. During 2019, we expect further direction in the form of proposed regulations and perhaps, revenue rulings. Blank Rome attorneys are prepared to advise clients on the interpretation of the existing rules as they relate to planned investments so that OZ transactions may move forward.

For additional information, please contact:

Michael I. Sanders
202.772.5808 | sanders@blankrome.com

Daniel R. Blickman
215.569.5373 | blickman@blankrome.com

Richard Chou
424.239.3477 | rchou@blankrome.com